Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act") and Rule 19b-4 thereunder, notice is hereby given that on March 1, 2005, the Pacific Exchange, Inc. ("PCX" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by PCX. The Exchange filed the proposal pursuant to Section 19(b)(3)(A) of the Act, and Rule 19b-4(f)(6) thereunder, which renders the proposal effective upon filing with the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

PCX proposes to amend PCX Rule 6.75 relating to split price transactions. The text of the proposed rule change is set forth below. Proposed new language is in italics;

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5 Based on a conversation with PCX, the Commission staff made two grammatical corrections to the proposed rule text. Telephone conference on March 3, 2005 between Steven Matlin, Senior Counsel, PCX and Ann Leddy, Special Counsel, Division of Market Regulation, Commission.
Rule 6.75(h) Priority on Split Price Transactions Occurring in Open Outcry.

(1) Purchase or sale priority. If an OTP Holder or OTP Firm purchases (sells) one or more option contracts of a particular series at a particular price or prices, the OTP Holder or OTP Firm must, at the next lower (higher) price at which another OTP Holder or OTP Firm bids (offers), have priority in purchasing (selling) up to the equivalent number of option contracts of the same series that the OTP Holder or OTP Firm purchased (sold) at the higher (lower) price or prices, provided that the OTP Holder or OTP Firm's bid (offer) is made promptly and continuously and that the purchase (sale) so effected represents the opposite side of a transaction with the same order or offer (bid) as the earlier purchase or purchases (sale or sales). This paragraph only applies to transactions effected in open outcry.

(2) [Sale priority. If an OTP Holder or OTP Firm sells one or more option contracts of a particular series at a particular price or prices, he shall, at the next higher price at which another OTP Holder or OTP Firm offers, have priority in selling up to the equivalent number of option contracts of the same series that he sold at the lower price or prices, provided that his offer is made promptly and that the sale so effected represents the opposite side of a transaction with the same order or bid as the earlier sale or sales.] If an OTP Holder or OTP Firm purchases (sells) fifty or more option contracts of a particular series at a particular price or prices, he/she shall, at the next lower (higher) price have priority in purchasing (selling) up to the equivalent number of option contracts of the same series that he/she purchased (sold) at the higher (lower) price or prices, but
only if his/her bid (offer) is made promptly and the purchase (sale) so effected represents
the opposite side of the transaction with the same order or offer (bid) as the earlier
purchase or purchases (sale or sales). The Exchange may increase the “minimum
qualifying order size” above 100 contracts for all products. Announcements regarding
changes to the minimum qualifying order size shall be made via an Exchange Bulletin.

This paragraph only applies to transactions effected in open outcry.

(3) No Change.

(4) Except for the provisions set forth in Rule 6.75(h)(2), [T]he priority afforded
by this rule is effective only insofar as it does not conflict with orders on the book of the
Order Book Official as provided in Rule 6.75. Such orders on the book of the Order
Book Official have precedence over OTP Holders and OTP Firms’ orders at a particular
price; orders on the book also have precedence over OTP Holder or OTP Firms’ orders
that are not superior in price by at least the MPV.

(5) Floor Brokers are able to achieve split price priority in accordance with
paragraphs (1) and (2) above. Provided however, that a floor broker who bids (offers) on
behalf of a non-market-maker PCX broker-dealer (“PCX BD”) must ensure that the PCX
BD qualifies for an exemption from Section 11(a)(1) of the Exchange Act or that the
transaction satisfies the requirements of Exchange Act Rule 11a2-2(T), otherwise the
floor broker must yield priority to orders for the accounts of non-OTP Holders or non-
OTP Firms.

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II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

PCX Rule 6.75(h) establishes priority for split-price transactions. Generally, an OTP Holder or OTP Firm buying (selling) at a particular price shall have priority over other OTP Holders or OTP Firms purchasing (selling) up to an equivalent number of contracts of the same order at the next lower (higher) price. Awarding split price priority serves as an inducement to OTP Holders and OTP Firms to bid (offer) more aggressively for an order that may require a split-price execution by giving them priority at the next lower (higher) price point. For example, assume the market is $1.00 - $1.20, 300 up when a floor broker (“FB”) receives instructions from a customer that it would like to buy 500 options at a price or prices no higher than $1.20. The FB could attempt to execute the order in open outcry at a price better than the displayed market of $1.20. Assume a market maker (“MM”) in the crowd is willing to sell 250 contracts at $1.15 provided he can also sell the remaining 250 contracts at $1.20. Under current PCX rules, that MM could offer $1.15 for 250 contracts and then, by virtue of the split price priority rule, he/she would have priority for the balance of the order (up to 250 contracts) over
other crowd members. If executed, the resulting net price of $1.175 is better than the current displayed market of $1.20, which results in a better fill for the customer.\(^6\)

One limitation on the ability of crowd participants to use the split price priority rule is the rule’s requirement that orders in the limit order book (“Book”) have priority over the OTP Holder or OTP Firm attempting to fill the balance of the order at the split price. Using the example above, if the $1.20 price represented orders in the Book, those orders would have priority over the MM at $1.20. This means that a MM who is willing to trade at $1.15 and $1.20 may be completely unwilling to trade at the better price of $1.15 if he/she cannot trade the balance of the order at $1.20 because of the requirement to yield to existing customer interest in the Book. This jeopardizes the FB’s ability to execute the first part of the order at a price of $1.15, thereby potentially making it difficult to achieve price improvement for the customer at the PCX. Instead, the order may trade at another exchange that has no impediments, i.e., no customer interest at those price levels. Accordingly, the purpose of this proposal is to adopt a limited exception to the existing priority requirement.

Under newly proposed paragraph (2) of Rule 6.75, an OTP Holder or OTP Firm with an order for at least 100 contracts who buys (sells) at least 50 contracts at a particular price would have price priority over all others in purchasing (selling) up to an equivalent number of contracts of the same order at the next lower (higher) price.\(^7\) Using

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\(^6\) If successful, two trades will be reported at $1.15 and $1.20 and the net price result to the customer will be $1.175.

\(^7\) Orders for less than 100 contracts would be unaffected by this proposal. The Exchange also takes the opportunity to consolidate current paragraphs (1) and (2) of Rule 6.75(h) into one paragraph (paragraph (1)). This consolidation would not effect the operation of the rule in any way; it simply would make the rule shorter.
the above example, the MM trading at $1.15 would have priority over OTP Holders and OTP Firms and orders in the Book at $1.20 to trade at $1.20 with the balance of the order in the trading crowd. The Exchange believes the proposal will lead to more aggressive quoting by MMs, which in turn could lead to better executions. As indicated above, a MM may be willing to trade at a better price for a portion of an order if he/she is assured of trading with the balance of the order at the next pricing increment. As a result, FBs representing orders in the trading crowd may receive better-priced executions. As proposed, the Exchange will have the ability to increase the minimum qualifying order size to a number larger than 100 contracts. Any changes, which would have to apply to all products, would be announced to the OTP Holders and OTP Firms via an Exchange Bulletin.

The Exchange believes that it is reasonable to make a limited exception to the customer priority rule to allow split price trading. In this regard, the proposed exception would be similar in operation to the limited priority exception that exists for Combination, Spread, Ratio and Straddle orders (contained in Rule 6.75, Commentary .04). This priority exception generally provides that a crowd member affecting a qualifying order may trade ahead of the Book on one side of the order provided the other side of the order betters the Book. This exception was intended to facilitate the trading of Combination, Spread, Ratio and Straddle orders, which by virtue of their multi-legged composition could be more difficult to trade without a limited exception to the priority rule for one of the legs. The purpose behind the proposed split-price priority exception is the same – to facilitate the execution of large orders, which by virtue of their size and the need to execute them at multiple prices may be difficult to execute without a limited
exception to the priority rules. The proposed exception would operate in the same manner as the Combination, Spread, Ratio and Straddle order exception by allowing an OTP Holder or OTP Firm affecting a trade that betters the market to have priority on the balance of that trade at the next pricing increment even if there are orders in the Book at the same price.

To address potential concerns regarding Section 11(a) of the Act, the Exchange proposes to adopt Rule 6.75(h)(5). Section 11(a) generally prohibits members of national securities exchanges from effecting transactions for the member’s own account, absent an exemption. With respect to the proposal, there could be situations where because of the limited exception to customer priority, orders on behalf of members could trade ahead of orders of nonmembers in violation of Section 11(a). The proposed Commentary makes clear that FBs may avail themselves of the split-price priority rule but that they will be obligated to ensure compliance with Section 11(a). In this regard, a FB that bids (offers) on behalf of a non-market maker PCX OTP Holder or OTP Firm (“PCX BD”) must ensure that the PCX BD qualifies for an exemption from Section 11(a)(1) of the Act or that the transaction satisfies the requirements of Rule 11a2-2(T). Otherwise, the FB would be required to yield priority to orders for the accounts of non-OTP Holders or non-OTP Firms.

2. Statutory Basis

For the above reasons, the Exchange believes that the proposed rule change would

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9 For example, assume FB A walks into the trading crowd attempting to find a crowd member willing to effect a split-price transaction. FB B, who is representing either a proprietary or member BD order, expresses interest. In this instance, Section 11(a) could be implicated, absent an exemption.
enhance competition. The Exchange believes that the proposed rule change is consistent with Section 6(b)\textsuperscript{10} of the Act, in general, and furthers the objectives of Section 6(b)(5),\textsuperscript{11} in particular, in that it is designed to facilitate transactions in securities, to promote just and equitable principles of trade, to foster competition and to protect investors and the public interest.

B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments on the proposed rule change were neither solicited nor received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Because the foregoing proposed rule change does not:

\begin{itemize}
  \item [(i)] significantly affect the protection of investors or the public interest;
  \item [(ii)] impose any significant burden on competition; and
  \item [(iii)] become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest, it has become effective pursuant to Section 19(b)(3)(A)
\end{itemize}

\begin{footnotesize}
\textsuperscript{10} 15 U.S.C. 78f(b).
\textsuperscript{11} 15 U.S.C. 78f(b)(5).
\end{footnotesize}
of the Act, 12 and Rule 19b-4(f)(6) thereunder. 13 At any time within 60 days of the filing of the proposed rule change the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

A proposed rule change filed under Rule 19b-4(f)(6) 14 normally does not become operative prior to 30 days after the date of filing. However, pursuant to Rule 19b-4(f)(6)(iii), the Commission may designate a shorter time if such action is consistent with the protection of investors and the public interest. PCX has requested that the Commission waive the thirty-day operative date specified in Rule 19b-4(f)(6)(iii) 15 in order to conform its rules pertaining to split price priority with those of other options exchanges.

The Commission believes that waiving the thirty-day operative delay is consistent with the protection of investors and the public interest 16 because it will allow PCX to implement immediately rules similar to ones already in place at another options exchange and should encourage more aggressive quoting by market makers in competition for

13 17 CFR 240.19b-4(f)(6). The Commission notes that the Exchange provided written notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing of the proposed rule change.
16 For purposes only of accelerating the operative date of this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).
large-sized orders, and, in turn, better-priced executions. For these reasons, the Commission waives the 30-day pre-operative period.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-PCX-2005-25 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-PCX-2005-25. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission’s Internet Web site ([http://www.sec.gov/rules/sro.shtml](http://www.sec.gov/rules/sro.shtml)). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for

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inspection and copying in the Commission’s Public Reference Section. Copies of such filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-PCX-2005-25 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.  

Margaret H. McFarland  
Deputy Secretary