

**SECURITIES AND EXCHANGE COMMISSION**  
**(Release No. 34-51751; File No. SR-PCX-2005-33)**

**May 27, 2005**

**Self-Regulatory Organizations; Pacific Exchange, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change and Amendment No. 1 thereto Relating to OTP Holders and OTP Firms Borrowing from or Lending to Their Customers**

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on April 15, 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 proposed rule change has been filed by the PCX as a "non-controversial" rule change pursuant to Rule 19b-4(f)(6) under the Act.<sup>3</sup> On May 23, 2005, the PCX filed Amendment No. 1 to the proposed rule change (“Amendment No. 1”).<sup>4</sup> The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

PCX proposes to adopt a new rule restricting registered persons of OTP Holders or OTP Firms from borrowing from or lending to their customers, except pursuant to the

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> 17 CFR 240.19b-4(f)(6).

<sup>4</sup> Amendment No. 1 revised and clarified the statutory basis for the proposed rule change. See Letter Dated May 23, 2005, from Melanie Grace, Office of the Corporate Secretary, PCX, to Nancy Sanow, Assistant Director, Division of Market Regulation.

conditions specified in the rule. The text of the proposed rule change is set forth below.

Proposed new language is in italics.

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Rule 9.29. Borrowing From or Lending to Customers

(a) No person associated with an OTP Holder or OTP Firm in any registered capacity may borrow money from or lend money to any customer of such person unless:

(1) The OTP Holder or OTP Firm has written procedures allowing the borrowing and lending of money between such registered persons and customers of the OTP Holder or OTP Firm; and

(2) The lending or borrowing arrangement meets one of the following conditions:

(A) the customer is a member of such person's immediate family;

(B) the customer is a financial institution regularly engaged in the business of providing credit, financing, or loans, or other entity or person that regularly arranges or extends credit in the ordinary course of business;

(C) the customer and the registered person are both registered persons of the same OTP Holder or OTP Firm;

(D) the lending arrangement is based on a personal relationship with the customer, such that the loan would not have been solicited, offered, or given had the customer and the associated person not maintained a relationship outside of the broker/customer relationship; or

(E) the lending arrangement is based on a business relationship outside of the broker/customer relationship;

(b) Procedures.

(1) OTP Holders or OTP Firms must pre-approve in writing the lending or borrowing arrangements described in subparagraphs (a)(2)(C), (D), and (E) above.

(2) With respect to the lending or borrowing arrangements described in subparagraph (a)(2)(A) above, an OTP Holder's or OTP Firm's written procedures may indicate that registered persons are not required to notify the OTP Holder or OTP Firm, or receive OTP Holder or OTP Firm approval either prior to or subsequent to entering into such lending or borrowing arrangements.

(3) With respect to the lending or borrowing arrangements described in subparagraph (a)(2)(B) above, an OTP Holder's or OTP Firm's written procedures may indicate that registered persons are not required to notify the OTP Holder or OTP Firm or receive their approval either prior to or subsequent to entering into such lending or borrowing arrangements, provided that the loan has been made on commercial terms that the customer generally makes available to members of the public similarly situated as to need, purpose, and creditworthiness. For purposes of this subparagraph, the OTP Holder or OTP Firm may rely on the registered person's representation that the terms of the loan meet the above-described standards.

(c) The term immediate family shall include parents, grandparents, mother-in-law or father-in-law, husband or wife, brother or sister, brother-in-law or sister-in-law, son-in-law or daughter-in-law, children, grandchildren, cousin, aunt or uncle, or niece or nephew, and shall also include any other person whom the registered person supports, directly or indirectly, to a material extent.

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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, PCX included statements concerning the purpose of and basis for the proposed rule change, as amended, 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. PCX 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

The purpose of the proposed rule change is to adopt a rule that prohibits registered persons of an OTP Holder or OTP Firm from borrowing money from or lending money to a customer unless each of the following applies: (1) the OTP Holder or OTP Firm has written procedures allowing such borrowing or lending arrangements; and (2) the borrowing or lending arrangement falls within one of five permissible types of lending arrangements.<sup>5</sup> In certain cases, the OTP Holder or OTP Firm must also pre-approve the loan in writing. The five types of permissible lending arrangements are:

- (i) the customer is a member of the registered person's immediate family (as defined in the proposed rule);
- (ii) the customer is a financial institution regularly engaged in the business of providing credit, financing, or loans, or other entity or person that regularly arranges or extends credit in the ordinary course of business;

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<sup>5</sup> The proposed rule is substantially similar to NASD Rule 2370. See Securities Exchange Act Release No. 48242 (August 29, 2003), 68 FR 52806 (September 5, 2003). NASD Rule 2370 was amended in Securities Exchange Act Release No. 49269 (February 18, 2004), 69 FR 8718 (February 25, 2004). See also Securities Exchange Act Release No. 50874 (December 16, 2004), 69 FR 76803 (December 22, 2004) (SR-CBOE-2004-66).

- (iii) the customer and the registered person are both registered persons of the same OTP Holder or OTP Firm;
- (iv) the lending arrangement is based on a personal relationship outside of the broker-customer relationship; or
- (v) the lending arrangement is based on a business relationship outside of the broker-customer relationship.

The proposed rule change establishes a regulatory framework that would give OTP Holders and OTP Firms greater control over, and more specific supervisory responsibilities for, lending arrangements between registered persons and their customers. OTP Holders and OTP Firms could choose to permit their registered persons to borrow from or lend to specified customers consistent with the requirements of the rule. If OTP Holders or OTP Firms choose to permit their registered persons to engage in lending arrangements with those customers, the proposed rule change would require OTP Holders and OTP Firms to have written procedures allowing the borrowing and lending of money between registered persons and customers or OTP Holders or OTP Firms. As stated above, OTP Holders and OTP Firms would be permitted to approve loans only if the loan falls within one of the five types of permissible lending arrangements set forth in the rule.

The proposed rule would require OTP Holders and OTP Firms to pre-approve in writing three out of the five types of lending arrangements permitted by the rule. It would exempt from the rule's notice and approval requirements lending arrangements involving a registered person and his/her customer that is (1) a member of his/her immediate family (as defined in the proposed rule); or (2) a financial institution regularly

engaged in the business of providing credit, financing, or loans (or other entity or persons that regularly arranges or extends credit in the ordinary course of business), provided the loan has been made on commercial terms that the customer generally makes available to members of the general public similarly situated as to need, purpose, and creditworthiness. PCX believes the requirement in the proposed rule that certain types of lending and borrowing arrangements must be pre-approved by the OTP Holder or OTP Firm would enhance the OTP Holder's and OTP Firm's ability to supervise such lending and borrowing activities of registered personnel.

PCX also believes that the proposed rule change would enhance PCX's ability to monitor loans between registered persons and their customers. Currently, under controlling Commission decisions, to bring a disciplinary action against a registered person who has entered into an unethical lending arrangement with a customer, PCX generally must prove that the arrangement is inconsistent with just and equitable principles of trade because the registered person has acted in bad faith or unethically. This can be difficult to prove in cases in which the customer is unable or unavailable to testify, or refuses to testify because he or she is relying on the registered person for financial advice. The proposed rule change would better enable PCX to monitor and bring disciplinary actions in cases involving such loans.

PCX notes that the safeguards provided under the proposed rule, including bringing disciplinary actions for violations of the rule, are in addition to the general powers that PCX has to bring disciplinary actions against a registered person who has entered into an unethical lending arrangement with a customer. It is also important to note that this proposal does not change the applications of Regulation T to lending

activities by associated persons. Specifically, the definition of “creditor” under Regulation T extends to associated persons of broker-dealers and therefore, certain loans to customers by associated persons may require compliance with the provisions of Regulation T.

## 2. Statutory Basis

For the above reasons, PCX believes that the proposed rule change would enhance competition. PCX believes that the proposed rule change is consistent with Section 6(b)<sup>6</sup> of the Act, in general, and furthers the objectives of Section 6(b)(5),<sup>7</sup> in particular, in that it is designed to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, to foster competition and to protect investors and the public interest. PCX believes that the proposed rule change is designed to accomplish these ends by establishing a regulatory framework that will give OTP Holders and OTP Firms greater control over lending arrangements by permitting OTP Holders and OTP Firms to permit such arrangements only if they fall within the five types of permissible arrangements, or, as was the case before the proposal of this new rule, prohibit such arrangements altogether. OTP Holders and OTP Firms that permit such arrangements would be required to keep written procedures. These procedures would enable both OTP Holders and OTP Firms and PCX to proscribe certain customer-broker loans and monitor those that have been approved.

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

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<sup>6</sup> 15 U.S.C. 78f(b).

<sup>7</sup> 15 U.S.C. 78f(b)(5).

PCX 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**

PCX has stated that the foregoing proposed rule change has become effective pursuant to Section 19(b)(3)(A)(iii) of the Act<sup>8</sup> and Rule 19b-4(f)(6)<sup>9</sup> thereunder because the proposed rule change: (i) does not significantly affect the protection of investors or the public interest; (ii) does not impose any significant burden on competition; and (iii) does not 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. At any time within 60 days of the filing of such 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.<sup>10</sup> The PCX provided the Commission with written notice of its intent to file this

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<sup>8</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>9</sup> 17 CFR 240.19b-4(f)(6)(iii).

<sup>10</sup> For purposes only of calculating the 60-day abrogation period, the Commission considers the proposed rule change to have been filed on May 23, 2005, when Amendment No. 1 was filed.

proposed rule change at least five business days prior to the date of filing the proposed rule change.

Pursuant to Rule 19b-4(f)(6)(iii) under the Act,<sup>11</sup> the proposal does not become operative for 30 days after the date of its filing, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest. The PCX has requested that the Commission waive the 30-day operative delay so that the proposed rule change will become immediately effective upon filing.

The Commission believes that waiving the 30-day operative delay is consistent with the protection of investors and the public interest.<sup>12</sup> Accelerating the operative date will allow for an immediately effective mechanism for proscribing certain customer-broker loans and monitoring those that have been approved. For these reasons, the Commission designates that the proposed rule change has become effective and operative immediately.

#### **IV. Solicitation of Comments**

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

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or

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<sup>11</sup> Id.

<sup>12</sup> For purposes 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).

- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-PCX-2005-33 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-2005-33. 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>). 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 inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of PCX. 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-2005-33 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.<sup>13</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>13</sup> 17 CFR 200.30-3(a)(12).