

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-52827; File No. SR-PCX-2005-56)

November 23, 2005

Self-Regulatory Organizations; Pacific Exchange, Inc.; Order Approving Proposed Rule Change and Amendment No. 1 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 Relating to the Directed Order Process and the Establishment of Designated Market Makers and Lead Market Makers

I. Introduction

On April 21, 2005, the Pacific Exchange, Inc. (“PCX” or “Exchange”), through its wholly-owned subsidiary PCX Equities, Inc. (“PCXE”), filed with the Securities and Exchange Commission (“Commission” or “SEC”), 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> a proposed rule change to modify its rules governing the Directed Order Process on the Archipelago Exchange (“ArcaEx”).<sup>3</sup> The PCX filed Amendment No. 1 to the proposed rule change on October 4, 2005.<sup>4</sup> The proposed rule change, as amended, was published for comment in the Federal Register on October 13, 2005.<sup>5</sup> The Commission received no comments from the public in response to the proposed rule change. The PCX filed Amendment No. 2 to the proposed rule change on November 17, 2005.<sup>6</sup> This order approves the proposed rule, as amended by Amendment No. 1; grants accelerated approval to Amendment No. 2; and solicits comments from interested persons on Amendment No. 2.

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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> See PCXE Rules 7.31 and 7.37.

<sup>4</sup> Amendment No. 1 replaced and superseded the original filing in its entirety.

<sup>5</sup> See Securities Exchange Act Release No. 52566 (October 5, 2005), 70 FR 59791.

<sup>6</sup> Amendment No. 2 clarified language in PCXE Rule 7.34(d).

## II. Description

The PCX proposed to add two new classifications of Market Makers, Designated Market Makers (“DMMs”) and Lead Market Makers (“LMMs”), in connection with ArcaEx’s Directed Order Process. Under the proposal, only DMMs and LMMs would be eligible to receive orders in ArcaEx’s Directed Order Process. DMMs would be required to meet certain selection criteria and ongoing performance criteria, making them eligible to participate in the Directed Order Process. LMMs would be granted exclusive eligibility to receive Directed Orders and would be held to higher ongoing performance standards than DMMs in listings for which ArcaEx is the primary market. Such ongoing performance standards would include (i) percent of time the DMM is quoting at the NBBO; (ii) percent of executions better than the NBBO; (iii) average displayed size; (iv) average quoted spread; and (v) in the event the security is a derivative security, the ability of the DMM to transact in the underlying markets. LMMs would be held to higher ongoing performance standards than DMMs. Although the Exchange would have the ability to apply specific levels to be used in defining the performance standards, the Exchange would not modify the types of standards to be used without changing its rules. The Exchange also proposed to amend PCXE Rule 7.22 to provide the Corporation with the ability to limit the number of DMMs with prior written notice to ETP Holders. Lastly, PCXE Rule 7.25 would be modified to require LMMs to register as Odd Lot Dealers in the securities in which they are registered as LMM.

The PCX also sought to modify its Directed Order process in a number of ways. First, the Exchange proposed to add a provision that requires Users<sup>7</sup> to be given permission by DMMs

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<sup>7</sup> See PCXE Rule 1.1(yy).

in order to send a Directed Order to that DMM. The Exchange also proposed to eliminate the provision limiting the Directed Order Process to the Core Trading Session and proposed to eliminate a provision that suspends the Directed Order Process when a locked or crossed market exists in a security. In addition, the amendment to the definition would also make clear that a Directed Fill specifies the size and price of the Directed Fill.

The Exchange also proposed that marketable Directed Orders would first attempt to match against the DMM to which the order has been directed, but that, prior to execution, Directed Orders matched against DMMs pursuant to their Directed Fill instructions first would be executed against any displayed order in the Arca Book priced at or better than the terms of the Directed Fill before executing as a directed match.<sup>8</sup> If such matched orders are broken up by orders on the Arca Book, the remaining portion of the Directed Order would be posted in the Arca Book. Lastly, the Exchange proposed to delete a reference in the Directed Order Process rules restricting the price at which executions can occur within the Directed Order Process.

In Amendment No. 2, the Exchange proposed to remove provisions in PCXE Rule 7.34(d) that limit the availability of the Directed Order Process during the Opening Session and Late Trading Session.

### III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 2, including whether Amendment No. 2 is consistent with the Act. Comments may be submitted by any of the following methods:

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<sup>8</sup> Accordingly, a Directed Order would only execute against a Directed Fill at a price superior to the Arca best bid or offer.

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-PCX-2005-56 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, Station Place, 100 F Street, NE, Washington, DC 20549-9303.

All submissions should refer to File Number SR-PCX-2005-56. 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, Station Place, 100 F Street, NE, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the 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-2005-56 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

#### IV. Discussion

After careful review, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.<sup>9</sup> In particular, the Commission finds that the proposal, as amended, is consistent with the provisions of Section 6(b)(5) of the Act,<sup>10</sup> which requires, among other things, that a national securities exchange's rules be designed to prevent fraud and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and to perfect the mechanism of a free and open market and a national market system and; in general, to protect investors and the public interest.

Under the proposal, the two new classifications of Market Makers, DMMs and LMMs, would be entitled to receive Directed Orders. In exchange for this benefit, the Exchange would subject DMMs and LMMs to certain selection criteria and ongoing performance standards. In addition, DMMs and LMMs must comply with obligations currently set forth in the Exchange's rules. In particular, DMMs and LMMs would be required to maintain continuous two-sided Q Orders in those securities in which they are eligible to receive Directed Orders and to engage in a course of dealings to assist in the maintenance of fair and orderly markets. The Commission believes that providing the benefit of receiving Directed Orders to DMMs and LMMs while in turn holding DMMs and LMMs to increased obligations to the market is consistent with the Act. The Commission notes that the Exchange would hold an LMM to higher standards than a DMM. The Commission believes that applying a higher standard to LLMs is appropriate because

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<sup>9</sup> In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>10</sup> 15 U.S.C. 78f(b)(5).

LMMs would have exclusive access to participate in the Directed Order Process as a Market Maker for primary listings.

The Commission also believes that the amendments to the operation of the Directed Order Process are consistent with the Act. In this regard, the Commission notes that if there is an order displayed on the Arca Book at a price that is at or better than the price of a Directed Fill, the Directed Order would not execute against the Directed Fill. Further, the Commission notes that executions in the Directed Order process may not take place at prices inferior to the NBBO.<sup>11</sup> Accordingly, in order for a DMM or LMM to receive a Directed Order execution, the DMM or LMM must improve the best displayed price on the Arca Book, and such price must be equal to or better than the NBBO.

The Commission emphasizes that approval of this proposal does not affect a broker-dealer's duty of best execution. A broker-dealer has a legal duty to seek to obtain best execution of customer orders, and any decision to preference a particular DMM or LMM must be consistent with this duty.<sup>12</sup> A broker-dealer's duty of best execution derives from common law agency principles and fiduciary obligations, and is incorporated in Self-Regulatory Organization rules and, through judicial and Commission decisions, the antifraud provisions of the federal securities laws.<sup>13</sup>

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<sup>11</sup> See PCXE Rule 7.37.

<sup>12</sup> See, e.g., Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 269-70, 274 (3d Cir.), cert. denied, 525 U.S. 811 (1998); Certain Market Making Activities on Nasdaq, Securities Exchange Act Release No. 40900 (January 11, 1999) (settled case) (citing Sinclair v. SEC, 444 F.2d 399 (2d Cir. 1971); Arleen Hughes, 27 SEC 629, 636 (1948), aff'd sub nom. Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949)). See also Order Execution Obligations, Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996) ("Order Handling Rules Release").

<sup>13</sup> Order Handling Rules Release, 61 FR at 48322. See also Newton, 135 F.3d at 270. Failure to satisfy the duty of best execution can constitute fraud because a broker-dealer,

The duty of best execution requires broker-dealers to execute customers' trades at the most favorable terms reasonably available under the circumstances, *i.e.*, at the best reasonably available price.<sup>14</sup> The duty of best execution requires broker-dealers to periodically assess the quality of competing markets to assure that order flow is directed to the markets providing the most beneficial terms for their customer orders.<sup>15</sup> Broker-dealers must examine their procedures for seeking to obtain best execution in light of market and technology changes and modify those practices if necessary to enable their customers to obtain the best reasonably available prices.<sup>16</sup> In doing so, broker-dealers must take into account price improvement opportunities, and whether

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in agreeing to execute a customer's order, makes an implied representation that it will execute it in a manner that maximizes the customer's economic gain in the transaction. See Newton, 135 F.3d at 273 (“[T]he basis for the duty of best execution is the mutual understanding that the client is engaging in the trade – and retaining the services of the broker as his agent – solely for the purpose of maximizing his own economic benefit, and that the broker receives her compensation because she assists the client in reaching that goal.”); Marc N. Geman, Securities Exchange Act Release No. 43963 (February 14, 2001) (citing Newton, but concluding that respondent fulfilled his duty of best execution). See also Payment for Order Flow, Securities Exchange Act Release No. 34902 (October 27, 1994), 59 FR 55006, 55009 (Nov. 2, 1994) (“Payment for Order Flow Final Rules”). If the broker-dealer intends not to act in a manner that maximizes the customer's benefit when he accepts the order and does not disclose this to the customer, the broker-dealer's implied representation is false. See Newton, 135 F.3d at 273-274.

<sup>14</sup> Newton, 135 F.3d at 270. Newton also noted certain factors relevant to best execution - order size, trading characteristics of the security, speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market. Id. at 270 n. 2 (citing Payment for Order Flow, Securities Exchange Act Release No. 33026 (October 6, 1993), 58 FR 52934, 52937-38 (October 13, 1993) (Proposed Rules)). See In re E.F. Hutton & Co. (“Manning”), Securities Exchange Act Release No. 25887 (July 6, 1988). See also Payment for Order Flow Final Rules, 59 FR at 55008-55009.

<sup>15</sup> Order Handling Rules Release, 61 FR at 48322-48333 (“In conducting the requisite evaluation of its internal order handling procedures, a broker-dealer must regularly and rigorously examine execution quality likely to be obtained from different markets or market makers trading a security.”). See also Newton, 135 F.3d at 271; Market 2000: An Examination of Current Equity Market Developments V-4 (SEC Division of Market Regulation January 1994) (“Without specific instructions from a customer, however, a broker-dealer should periodically assess the quality of competing markets to ensure that

different markets may be more suitable for different types of orders or particular securities.<sup>17</sup>

Furthermore, the Commission finds good cause for approving Amendment No. 2 to the proposed rule change prior to the thirtieth day after the amendment is published for comment in the Federal Register pursuant to Section 19(b)(2) of the Act.<sup>18</sup> Amendment No. 2 clarified that the Exchange proposed to make the Directed Order Process available during the Opening Session and the Late Trading Session. The Commission does not believe that Amendment No. 2 materially affects the original proposed rule change, as amended, or that it presents any novel regulatory issues. Accordingly, the Commission finds good cause to accelerate approval of Amendment No. 2.

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its order flow is directed to markets providing the most advantageous terms for the customer's order."); Payment for Order Flow Final Rules, 59 FR at 55009.

<sup>16</sup> Order Handling Rules, 61 FR at 48323.

<sup>17</sup> Order Handling Rules, 61 FR at 48323. For example, in connection with orders that are to be executed at a market opening price, "[b]roker-dealers are subject to a best execution duty in executing customer orders at the opening, and should take into account the alternative methods in determining how to obtain best execution for their customer orders." Disclosure of Order Execution and Routing Practices, Securities Exchange Act Release No. 43590 (November 17, 2000), 65 FR 75414, 75422 (December 1, 2000) (adopting new Rules 11Ac1-5 and 11Ac1-6 under the Act and noting that alternative methods offered by some Nasdaq market centers for pre-open orders included the mid-point of the spread or at the bid or offer).

<sup>18</sup> 15 U.S.C. 78s(b)(2).

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>19</sup> that the proposed rule change (SR-PCX-2005-56), as amended by Amendment No. 1, be, and it hereby is, approved, and that Amendment No. 2 is approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>20</sup>

Jonathan G. Katz  
Secretary

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<sup>19</sup> 15 U.S.C. 78s(b)(2).

<sup>20</sup> 17 CFR 200.30-3(a)(12).