

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-50998; File No. SR-PCX-2004-122]

Self-Regulatory Organizations; Order Granting Accelerated Approval of Proposed Rule Change by Pacific Exchange, Inc., Relating to the Implementation of a New Order Audit Trail System

January 7, 2005.

I. Introduction

On December 14, 2004, the Pacific Exchange, Inc., ("PCX" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² a proposed rule change relating to the creation of an electronic order audit trail. The proposed rule change was published for comment in the **Federal Register** on December 22, 2004 for a 15-day comment period, which expired on January 6, 2005.³ The Commission received no comments on the proposed rule change. This order approves the proposed rule change on an accelerated basis.

II. Background

The proposed rule change is intended to fulfill certain of the undertakings contained in an order issued by the Commission relating to the settlement of an enforcement action against the American Stock Exchange LLC, Chicago Board Options Exchange, Inc., PCX, and Philadelphia Stock Exchange, Inc., (collectively "Options Exchanges") for failure to comply with their own rules and to enforce compliance with their own rules by their members and persons associated with their members⁴ as is required by Section 19(g) of the Act.⁵ The Order found that the Options Exchanges impaired the operations of the options market by: (1) Following a course of conduct under which they refrained from multiply listing a large number of options; and (2) inadequately discharging their obligations as self-regulatory organizations by failing adequately to enforce compliance with

(a) certain of their rules, including order handling rules, that promote competition as well as investor protection, and (b) certain of the rules prohibiting anticompetitive conduct, such as harassment, intimidation, refusals to deal and retaliation directed at market participants who sought to act competitively. In addition, the Commission found that the Options Exchanges failed to enforce compliance with their trade reporting rules, which promote transparency of the market and facilitate surveillance and enforcement of other exchange rules and the Federal securities laws.

As part of the Order, the Options Exchanges agreed to, and were ordered to comply with, a variety of undertakings. Among other things, they agreed to, and were ordered to, design and implement an accurate, time-sequenced, consolidated options audit trail system ("COATS") that would enable the Options Exchanges to reconstruct markets promptly, effectively surveil them, and enforce order handling, firm quote, trading reporting and other rules. The Options Exchanges were required to complete this undertaking in five phases. The Options Exchanges have completed the first four phases. The final phase of the undertaking to implement COATS requires that each exchange incorporate into its audit trail all non-electronic orders. This proposed rule change addresses that aspect of the undertaking.

III. Description of Proposed Rule Change

The Exchange proposes to adopt new PCX Rule 6.67(c), which would require that every OTP Holder or OTP Firm that receives an order for execution on the Exchange immediately records the details of the order (including any modification of the terms of the order or cancellation of the order) into its Electronic Order Capture ("EOC") system, unless such order has been entered into the Exchange's other electronic order processing facilities (e.g., orders sent electronically through the Exchange's MFI). OTP Holders and OTP Firms would have two ways to record the details of an order into EOC prior to representation in the trading crowd: (1) Direct entry into the EOC system, or (2) entry to an Electronic Tablet that enables the user to hand-write the order information onto the tablet, which converts the information into an electronic format.

The details of each order that would be required to be recorded upon receipt if directly entered into the EOC system

include the following:⁶ (1) CMTA information/Clearing OTP Holder or OTP Firm; (2) Option symbol, expiration month, exercise price, and type of option (call or put); (3) Side of market (buy or sell); (4) Quantity of option contracts; (5) Any limit price, stop price, or special conditions; (6) Opening or closing transaction; (7) Time in force; (8) Account origin code; and (9) Solicited or unsolicited.

The details of each order that would be required to be recorded upon receipt if entered into the Electronic Tablet include the following:⁷ (1) CMTA information/Clearing OTP Holder or Firm; (2) Option symbol, expiration month, exercise price, and type of option (call or put); (3) Side of market (buy or sell); (4) Quantity of option contracts; (5) Any limit price, stop price, or special conditions; and (6) Opening or closing transaction.

The Exchange also proposes to add interpretive language to make it clear that EOC and the Electronic Tablet are approved formats for transmitting orders for purposes of this Rule. In addition, proposed PCX Rule 6.67(b) requires that orders sent to the Exchange for execution must comply with the order format requirements established by the Exchange relating to, among other things, option symbol, expiration month, exercise price, type of option (call or put), quantity of option contracts, clearing member organization, whether the order is to buy or sell, and whether the order is market or limit.

An exception to the requirement for recording order information into EOC or the Electronic Tablet is contained in proposed PCX Rule 6.67(d). Under this proposed rule, if a disruption or malfunction to EOC or the Electronic Tablet or any other Exchange electronic order processing system occurs, the EOC or the Electronic Tablet entry requirement would be suspended upon the approval of two Trading Officials, and the EOC/Electronic Tablet Contingency Reporting Procedures will be in effect pursuant to PCX Rule 6.67(d)(1)(A).⁸ If the Exchange is still able to process and disseminate quotes

⁶ The Exchange represents that the order entry time and identification number are automatically assigned upon entry into EOC.

⁷ The Exchange also represents that the order entry time and identification number are automatically assigned upon entry into the Electronic Tablet.

⁸ Under the proposed rule, OTP Holders and OTP Firms must use a backup supply of tickets to record the details of the order received through non-electronic means and time stamp the order of events. Once the disruption or malfunction has been corrected, as determined by one Floor Official, OTP Holders and OTP Firms must input all orders into an EOC device using the "as-of" field.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 50866 (December 14, 2004), 69 FR 76808.

⁴ See Order Instituting Public Administrative Proceedings Pursuant to Section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Imposing Sanctions, Securities Exchange Act Release No. 43268 (September 11, 2000) and Administrative Proceeding File 3-10282 (the "Order").

⁵ 15 U.S.C. 78s(g).

accurately, then any orders received by the Exchange would be processed manually through the use of paper tickets. In such circumstances, all other Exchange rules governing options trading would remain in effect. Accordingly, the Exchange proposes to retain its existing rules that are applicable to the manual processing of order tickets.

Current PCX Rule 6.68(a) requires OTP Holder and OTP Firms to maintain and preserve certain information items relating to the terms of each option order. The Exchange proposes to make minor technical changes to the text by renaming and renumbering certain information items enumerated in the Rule for clarity. The Exchange also proposes language to specify that the Exchange would be required to maintain and preserve all electronic orders on behalf of OTP Holders and OTP Firms. The proposed rule change does not replace existing requirements for recording orders contained in this Rule. The Exchange further proposes to amend PCX Rule 6.68(b) to make it clear that OTP Holders and OTP Firms would be required to comply with their recordkeeping obligations for orders excepted from the EOC/Electronic Tablet requirements.

Finally, the Exchange proposes to add a Commentary .01 to PCX Rule 6.67, which provides that Cabinet Trades and FLEX options are exempt from the EOC and Electronic Tablet Entry Requirements as set forth in PCX Rule 6.67(c). However, such trades would be required to be processed using manual time stamped order tickets. The PCX would maintain a separate record of quotes, orders and transactions related to such trades in the same format as the COATS data and would make such information available upon Commission request.

The system entry requirement proposed in this rule change would become completely operative on January 10, 2005.

IV. Discussion

After careful consideration, the Commission finds that the proposed rule change is consistent with Act and the rules and regulations thereunder applicable to a national securities exchange.⁹ In particular the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,¹⁰ which requires among other things, that the Exchange's

rules be designed to promote just and equitable principles of trade, to remove impediments 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.

The Commission believes that the rules as proposed should allow the Exchange to comply with its obligations under the Order in that they should result in the creation of an audit trail that incorporates manual orders sent to PCX. Specifically, the proposed rule change requires that PCX members enter certain details immediately upon receipt, prior to representation of the order, into either EOC or the Electronic Tablet, which the Commission believes should result in an accurate, time-sequenced record of orders.

The Commission also believes that the Exchange's plan for recording order details in the event of a systems outage or malfunction is reasonable. In the event of a systems outage or malfunction, floor brokers would revert to the use of trade tickets and would record on those tickets the times that various events occur in the life of the order. Further, the Exchange would ensure that the information recorded on trade tickets is entered into the Exchange's electronic systems in a timely manner so that it can be incorporated into the electronic audit trail.

The Commission notes that the Exchange has acknowledged the need for effective and proactive surveillance for activities such as trading ahead and front-running in connection with the creation of its audit trail. The Exchange represents that it will implement proactive and effective surveillance procedures for violations of Exchange rules and Federal securities laws, including, but not limited to, rules prohibiting trading ahead and front running, related to the entry of customer orders into the EOC system. The Commission views effective surveillance as critical to the integrity of COATS and expects that the Exchange will inform the Commission of any problems it encounters in conducting effective surveillance.

The Commission finds good cause for accelerating approval of the proposed rule change prior to the thirtieth day after the date of the publication of notice thereof in the **Federal Register**. The Commission notes that the proposed rule change was noticed for a 15-day comment period and that no comments were received. The Commission believes that it is appropriate to accelerate approval of the proposed rule change so that the

proposal may be implemented on a timely basis to ensure prompt compliance with the undertakings contained in the Commission's Order.

V. Conclusion

For all of the aforementioned reasons, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.

It is therefore ordered, pursuant to section 19(b)(2) of the Act,¹¹ that the proposed rule change (SR-PCX-2004-122) is approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹²

Jill M. Peterson,

Assistant Secretary.

[FR Doc. E5-126 Filed 1-12-05; 8:45 am]

BILLING CODE 8010-01-P

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-50997; File No. SR-Phlx-2003-40]

Self-Regulatory Organizations; Order Approving Proposed Rule Change by the Philadelphia Stock Exchange, Inc. and Notice of Filing and Order Granting Accelerated Approval to Amendments No. 2, 3, 4 and 5 Relating to the Options Floor Broker Management System

January 7, 2005.

I. Introduction

On June 2, 2003, the Philadelphia Stock Exchange, Inc. ("Phlx" or "Exchange"), filed with the Securities and Exchange Commission ("Commission" or "SEC") a proposed rule change pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² to adopt new rules relating to the implementation of its Floor Broker Management System ("FBMS" or "System"). On July 28, 2003, the Exchange filed Amendment No. 1 to the proposed rule change. On August 7, 2003, the proposed rule change, as amended, was published for comment in the **Federal Register** to solicit comment from interested persons.³ No comments were received.

¹ 15 U.S.C. 78s(b)(2).

² 17 CFR 200.30-3(a)(12).

³ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 48265 (July 31, 2003), 68 FR 47137.

⁹ 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).

¹⁰ 15 U.S.C. 78f(b)(5).