

MEMO# 12954

December 20, 2000

PROPOSED RULE CHANGE ESTABLISHING THE ARCHIPELAGO EXCHANGE

[12954] December 20, 2000 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 64-00 RE: PROPOSED RULE CHANGE ESTABLISHING THE ARCHIPELAGO EXCHANGE The Securities and Exchange Commission has published for comment a proposed rule change filed by the Pacific Exchange ("PCX"), through its subsidiary, PCX Equities ("PCXE"), to create a new electronic trading facility of the PCXE called the Archipelago Exchange ("Arca").¹ Arca, which would be operated by Archipelago Exchange, L.L.C., would provide automatic order execution capabilities for the equity securities listed or traded on the PCXE and would operate in the place of the PCXE's traditional floor trading environment. Under the proposal, the PCX and PCXE would maintain responsibility for all regulatory functions related to Arca and Archipelago Exchange, L.L.C. would be responsible for the business of the trading facility. The SEC's proposed rule change describing Arca and the text of the proposed Arca rules are attached. In addition, attached is (1) a summary prepared by Archipelago of the most significant aspects of the Arca rules including trading on Arca, access to Arca, and qualifications and obligations of Arca market makers; and (2) a description prepared by Archipelago of the types of orders that can be placed on Arca and of Arca's order execution processes. SEC Solicitation of Comments The Proposing Release contains several items on which the SEC specifically requests comments. In particular, the SEC requests comments on: (1) "Discretionary Orders," (2) the minimum price improvement level for Directed Orders, (3) the priority of customer orders, and (4) the Arca trading sessions. Discretionary Orders The proposal would enable users to submit "Discretionary Orders" for execution on Arca. The proposed rules define a Discretionary Order as "an order to buy or sell a stated amount of a security at a specified, undisplayed price (the 'discretionary price'), in addition to at a specified, displayed price ('displayed price')." For example, as the Proposing Release illustrates, an Arca user could submit a Discretionary Order to buy 5000 shares of XYZ at a price 1 Securities Exchange Act Release No. 43608 (November 21, 2000), 65 FR 78822 (December 15, 2000) ("Proposing Release"). 2 of \$20, with discretion to buy up to a price of \$20.25. In that case, the Arca user represents a displayed price of \$20 but is willing to buy the 5000 shares at a price up to the discretionary price of \$20.25. The SEC requests general comments on the proposed availability of Discretionary Orders in the light of the Quote Rule, which requires each responsible broker or dealer to promptly communicate to its exchange or association, pursuant to the procedures established by that exchange or association, its best bids, offers, and quotation sizes for any subject security. In addition, the SEC seeks specific comments on the potential advantages or disadvantages of Discretionary Orders with regard to: (1) price discovery; (2) market transparency; and (3) transaction costs for investors. Finally, the SEC requests comments on whether a distinction should be made between Discretionary Orders placed on behalf of public customers and Discretionary Orders placed by PCXE market makers trading for their own accounts.

Minimum Price Improvement Level The proposed rules would establish a minimum price improvement increment of \$.01 or 10% of the spread, whichever is greater, with regard to the execution of Directed Orders. The SEC notes that the minimum price improvement increment for these orders therefore would not be less than \$.01 but that under the proposal, the minimum price variation for equity securities traded on Arca would be 1/64 of \$1.00 for securities that are quoted in fractions and \$.01 for equity securities that are quoted in decimals. The SEC therefore specifically requests comment on whether the PCX's proposed minimum price improvement interval that may be greater than the minimum price variation for internalized or otherwise preferred orders is appropriate.

Customer Order Priority The SEC states that historically securities exchanges have adopted rules that give priority to the agency orders of public customers over the proprietary trades of member firms, in recognition that traders on the floor of an exchange generally possess an informational advantage over public customers. The Proposing Release states, however, that because the PCX seeks to establish Arca as a purely electronic facility that would not employ a trading floor, they do not believe that its users would possess any informational advantage over public customers and that the Arca Book would therefore not give precedence to agency orders over principal orders and would rank orders based upon price/time priority.² The SEC therefore specifically requests comment on the order execution priority of the Arca Book, including whether market makers' orders should have priority equal to orders of the same type placed by public customers.

Trading Sessions The PCX proposes to operate three distinct trading sessions for Arca: an opening session, a core trading session, and a late trading session. The opening session, which would begin at 8:00 a.m. Eastern Time and run until the start of the core trading session, would include an Opening Auction at the start of the opening session and a Market Order Auction that would begin at 9:30 a.m. Eastern Time. The core trading session for each security would begin immediately after conclusion of the Market Order Auction for that security. The SEC specifically requests comments about the opening session, particularly the opening procedures and the transition from the opening session to the core trading session. The PCX also proposes to operate a late trading session that would begin when the core trading session ends and conclude at 8:00 p.m. Eastern Time. The Proposing Release notes that currently after-hours trading sessions for listed securities end at 6:30 p.m. Eastern Time. The SEC therefore requests comments about the PCX's proposed late trading session, including the possible extension of the late trading session to 8:00 p.m. Eastern Time. Comments on the proposed rule change are due to the SEC no later than January 5, 2001. If you have any comments you would like the Institute to consider including in a possible comment letter, please provide them to the undersigned by phone at (202) 371-5408, by fax at (202) 326-5839, or by e-mail at aburstein@ici.org no later than December 29. Ari Burstein Associate Counsel Attachment (in .pdf format)