MEMO# 14136

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SEC APPROVES PROPOSAL TO ESTABLISH THE ARCHIPELAGO EXCHANGE

[14136] November 13, 2001 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 43-01 RE: SEC APPROVES PROPOSAL TO ESTABLISH THE ARCHIPELAGO EXCHANGE The Securities and Exchange Commission (SEC) recently approved the Pacific Exchange, Inc.'s (PCX) proposed rule change to create a new electronic trading facility, the Archipelago Exchange (ArcaEx).1 The ArcaEx facility will operate in place of the trading floor of the PCX's subsidiary, PCX Equities, Inc., with ArcaEx market makers replacing the traditional floor specialists. Several significant aspects of the new trading facility are briefly discussed below. Oversight ArcaEx is owned and operated by the Archipelago Exchange LLC, a wholly-owned subsidiary of Archipelago Holdings LLC. The PCX currently has a 10% ownership interest in Archipelago Holdings. As a self-regulatory organization under the Securities Exchange Act of 1934 (Exchange Act), the PCX is fully responsible for the trading that will take place through ArcaEx, including conducting all necessary surveillance and maintaining an audit trail. Additionally, the PCX board must approve all rule changes relating to ArcaEx. ArcaEx will also be subject to SEC oversight and examination as a facility of the PCX. In response to comments it received on the proposal, the SEC notes its belief that it was not necessary for ArcaEx to register as a national securities exchange independent of the PCX under Section 6(a) of the Exchange Act. Trading Sessions ArcaEx will operate three trading sessions each day: an early trading session, a core trading session, and a late trading session. Members and other users of ArcaEx will submit orders to an electronic file of orders, known as the Arca Book, where all trades will be executed at prices equal to or better than the national best bid or offer. 1 Securities Exchange Act Release No. 44983 (Oct. 25, 2001), 66 FR 55225 (Nov. 1, 2001) (copy attached). See also Memorandum to Equity Markets Advisory Committee No. 64-00, dated Dec. 20, 2000 (transmitting proposing release). 2 Discretionary Orders An ArcaEx user will be able to submit a discretionary order, "which is an order to buy or sell a stated security at a specified, undisplayed price as well as at a specified, displayed price." A nonmarketable discretionary order will be displayed to all users at the displayed price, but the discretionary prices of the order will not be displayed. The undisplayed prices of a discretionary order will be represented in the working order process and could be matched with orders on the other side of the market under prescribed conditions. 2 A commenter asserted that ArcaEx's discretionary orders would violate the SEC's Quote Rule. After "careful consideration of the advantages and disadvantages of discretionary orders," the SEC determined that such orders are consistent with the Quote Rule, and that it would not be in the best interests of the national market system or the protection of investors to prohibit the use of discretionary orders on ArcaEx. However, because "discretionary orders raise novel issues under the Quote Rule," the SEC will

monitor their application and the PCX will submit data to the Commission with respect to: (a) the manner and frequency with which PCX market makers and other users are employing discretionary orders on ArcaEx; (b) the extent to which market makers are using discretionary orders when trading for their own accounts; (c) the quality of execution of discretionary orders (e.g., inside the quote); and (d) the volume of trading attributed to discretionary orders. Customer Order Priority All ArcaEx users, including exchange members, will transmit their orders electronically directly to ArcaEx from remote terminals. Once an order has been transmitted, a user cannot further control or influence the order's execution. Consequently, the Arca Book will not give precedence to agency orders over principal orders, and will rank orders based upon price/time priority. The SEC has determined that ArcaEx's electronic order and execution process satisfies the four criteria of Rule 11a2-2T3 because: (a) all orders are entered electronically from remote terminals; (b) a member relinquishes control of its order after transmission to ArcaEx and receives no special or unique trading advantages; (c) the requirement that an order be executed by an exchange member who is unaffiliated with the member initiating the order is not applicable when automated exchange facilities are used; and (d) ArcaEx members trading for covered accounts will disclose discretionary account compensation, as required by the rule. Doretha VanSlyke Zornada Associate Counsel Attachment (in .pdf format) 2 For example, an ArcaEx user could submit an order to buy 5000 shares of XYZ at $20.00, with discretion to buy at a price up to $20.25. In that case, the order is represented at a displayed price of $20.00, but under prescribed conditions the order may be filled partially or completely, at any allowable price up to the maximum discretionary price of $20.25. 3 Section 11(a) of the Exchange Act prohibits a member of a national securities exchange from effecting transactions on that exchange for its own account, the account of an associated person, or an account over which it or its associated person exercises discretion, unless an exemption applies. Rule 11a2-2(T) is one such exemption for transactions that would otherwise be prohibited by Section 11(a).