

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of and basis for the proposed rule change 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. The Exchange 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

Background

The Exchange is proposing to effect rule changes to support the implementation of its new audit trail system known as Electronic Order Capture System ("EOC").⁵ EOC is intended to fulfill one of the undertakings contained in the Commission's Order Instituting Public Administrative Proceedings Pursuant to Section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions. ("Order").⁶ Specifically, this rule filing is intended to respond to Section IV.B.e.(v) of the Order, which requires, among other things, that the PCX incorporate into its audit trail all non-electronic orders such that the audit trail provides an accurate, time-sequenced record of electronic and other orders, quotations and transactions, beginning with the receipt of the order and documenting the life of the order through the process of execution, partial execution, or cancellation.⁷

Currently, the PCX operates an electronic order routing and execution system called Pacific Options Exchange Trading System ("POETS"),⁸ and

several other peripheral systems including the Pacific Options Processing System ("POPS")⁹ and the Floor Broker Hand Held trading system,¹⁰ in conjunction with traditional open outcry trading with Floor Brokers and competing Market Makers. The Exchange's Member Firm Interface ("MFI") enables Member Firms to send orders electronically to the Exchange for delivery to either POETS, a Floor Broker Hand Held Terminal, or to a Member Firm's default destination.¹¹ While all executions using POETS and electronic hand-held devices carry immediately assigned system times, orders that are routed to the Floor by telephone or sent to Member Firm printers located on the Floor generally require manual trade ticket processing. Under the proposal, EOC will eliminate the manual processing of order tickets and will further facilitate the creation and development of a comprehensive audit trail and automated surveillance systems.

Summary of Proposed Rule Changes

The Exchange is proposing to adopt a number of changes to its rules regarding the record of orders (principally PCX Rules 6.67 and 6.68) to enhance the Exchange's audit trail and self-regulatory capabilities. The proposed changes to the text of the PCX rules are summarized below.

(1) *Electronic Order Capture System ("EOC")*

EOC is the Exchange's proposed electronic audit trail and order tracking system that will provide a time-sequenced record of all orders and transactions on the Exchange.¹² EOC will record the receipt of an order and will document the life of the order through the process of execution, partial execution, or cancellation. This system includes the electronic communications interface between EOC booth terminals and the Floor Broker Hand Held

system, an automatic execution system ("Auto-Ex"), an on-line limit order book system ("Auto-Book"), and an automatic market quote update system ("Auto-Quote").

⁹ POPS is the Exchange's automated system that compares trade information entered by Member Firms and submits trades to the Options Clearing Corporation for clearance and settlement.

¹⁰ The Floor Broker Hand Held interface is an automated order delivery system that enables Floor Brokers to receive and execute orders electronically, and to report trade executions to the tape via the Options Price Reporting Authority ("OPRA") and to POPS for clearing. See PCX Rule 6.89.

¹¹ A Member Firm's default destination may be either a particular firm booth or a remote entry site, to which orders that fail to meet the eligibility criteria necessary for Auto-Ex or Auto-Book will be delivered.

¹² See proposed PCX Rule 6.1(b)(39) (definition of "Electronic Order Capture System").

Terminal applications. Each Member's EOC booth terminal and each Floor Broker Hand Held Terminal will contain an electronic order entry screen that displays the terms and conditions of each order received by that Member.

The Exchange is proposing to adopt new PCX Rule 6.67(c),¹³ which requires that every Member or Member Organization that receives an order for execution on the Exchange must immediately¹⁴ record the details of the order (including any modification of the terms of the order or cancellation of the order) into EOC, unless such order has been entered into the Exchange's other electronic order processing facilities¹⁵ (e.g., orders sent electronically through the Exchange's MFI).¹⁶ The details of each order that will be required to be recorded upon receipt include the following:¹⁷ (1) Clearing member organization; (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.¹⁸

Member Firms may comply with the proposed rule in one of three ways: (1) Required order details may be transmitted via the Exchange's other electronic order processing facilities that electronically assign the time of receipt on the Exchange; (2) Order details may be routed to the Member

¹³ Former PCX Rules 6.67(b), (c) and (d) are being deleted as they are redundant and superfluous provisions pursuant to proposed PCX Rules 6.67(c), 6.67(d) and 6.67(d)(1).

¹⁴ The Exchange commits 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.

¹⁵ The EOC entry requirement will also apply to PCX Plus.

¹⁶ The systemic entry requirement would not be applicable to transactions initiated on the Floor and executed by a registered Market Maker or a Lead Market Maker for their own account, as such trades that may be initiated on the Floor and that are already reported to POETS via proprietary hand-held devices.

¹⁷ The Exchange notes that the order entry time and identification number are automatically assigned upon entry into EOC. Further, the Exchange notes that certain data elements tied to execution, such as executing broker, contra broker, execution time and price are not available at the time that order details are entered into EOC. This information will be captured automatically by EOC at the time of execution of an order. Telephone call between Peter D. Bloom and Tania J. Cho, Attorneys, PCX, and Jennifer Colihan, Special Counsel, Division, Commission, on July 29, 2003.

¹⁸ The proposed rule also includes a provision that would require Member Firms to record such other information as may be required by the Exchange from time to time.

⁵ PCX is currently working with the other options exchanges through the Intermarket Surveillance Group ("ISG") in the design and implementation of the Consolidated Options Audit Trail System ("COATS"). Upon its completion, COATS is expected to be a fully integrated intermarket audit trail using quote and trade data from all the options exchanges. EOC is a project specific to PCX and it will contain certain trade information for inclusion into COATS.

⁶ See Securities Exchange Act Release No. 43268 (September 11, 2000) and Administrative Proceeding File No. 3-10282.

⁷ *Id.* at 13-14.

⁸ POETS is the Exchange's automated trading system comprised of an options order routing