

D. Section 11(a) Under the Act

The PCX believes that the use of identity orders on ArcaEx would not confer ETP Holders any time and place advantages over other orders on ArcaEx. As such, the introduction of identity orders would not change the analysis of Section 11(a) of the Act¹⁴ to the PCX provided to the Commission prior to the approval of ArcaEx.¹⁵ Accordingly, the introduction of the identity order would not change the PCX's conclusion that the order execution algorithm of ArcaEx complies with the requirements of, and satisfies the policy concerns underlying, Section 11(a) of the Act¹⁶ without requiring public customer priority.

Section 11(a) of the Act¹⁷ prohibits a member of a national securities exchange from effecting transactions on the exchange for its own account, the account of an associated person, or an account in which it or an associated person exercises investment discretion (collectively, "covered accounts"), unless an exception applies. In enacting this provision, Congress was concerned about members benefiting in their principal transactions from special "time and place" advantages associated with floor trading—such as the ability to "execute decisions faster than public investors."¹⁸ The Commission, however, has adopted a number of exceptions to the general statutory prohibition for situations in which the principal transactions contribute to the fairness and orderliness of exchange

customer order will be executed in a fair and consistent manner. A Market Maker from that same firm is subject to the same rules, and importantly, has no special advantage over the execution of other orders in the book, including the customer order represented by the agency desk. The price time priority granted to orders in the ArcaEx book dictate that orders with the best price are executed first, and, where there is more than one order at the best price, the order first in time receives an execution. With these rules, a Market Maker's order at a price equal to the price of other orders in the ArcaEx book, would receive an execution over these orders only if the Market Maker's order was entered first. A Market Maker's order entered *after* other orders in the book can receive an execution over other orders in the book only if the Market Maker order is at a better price (by a minimum of one penny) than the orders displayed. These rules for the ranking, display and interaction of orders apply equally to all orders entered by all Users of the ArcaEx.

¹⁴ 15 U.S.C. 78k.

¹⁵ See Letter, dated April 19, 2001 from Cherie MacCauley, Counsel to PCX, Wilmer Cutler & Pickering to John Polise, Division of Market Regulation.

¹⁶ 15 U.S.C. 78k(a).

¹⁷ 15 U.S.C. 78k(a).

¹⁸ See Securities Exchange Act Release No. 14563 (March 14, 1978), 43 FR 11542 (March 17, 1978); Securities Exchange Act Release No. 14713 (April 28, 1978), 43 FR 18557 (May 1, 1978); Securities Exchange Act Release No. 15533 (January 29, 1979), 44 FR 6093 (Jan. 31, 1979). The 1978 and 1979 Releases cite the House Report at 54–57.

markets or do not reflect any time and place trading advantages. The PCX believes that the use of identity orders on ArcaEx would not alter Rule 11a2–2(T),¹⁹ commonly referred to as the "effect versus execute" rule,²⁰ which provides an exemption that applies to the PCX. The effect versus execute rule imposes four requirements "designed to put members and non-members on the same footing, to the extent practicable, in light of the purposes of Section 11(a)."²¹ Given ArcaEx's automated matching and execution services, no ETP Holder enjoys any special control over the timing of execution or special order handling advantages, as all orders would be centrally processed for execution by computer, rather than being handled by a member through bids or offers made on the trading floor. Because ArcaEx's open, electronic structure is designed to prevent any ETP Holders from gaining any time and place advantages, the PCX believes that ArcaEx satisfies the four requirements of the "effect versus execute" rule as well as the general policy objectives of Section 11(a) of the Act.²²

E. Surveillance

According to the PCX, PCXE has developed procedures to maintain a high level of surveillance of ETP Holders and their use of specific order types, including those orders designated as identity orders, for executions that take place on ArcaEx. Among its procedures, the PCX has developed mechanisms to help detect manipulation of prices on ArcaEx whether or not through use of identity orders.

Use of identity orders would help an ETP Holder to advertise the trading interest and activity the firm has in a particular stock. Should an ETP Holder attract order flow and wish to match buy and sell orders for execution away from the centralized limit order book of ArcaEx, an ETP Holder would have to

¹⁹ 17 CFR 240.11a2–2(T).

²⁰ Rule 11a2–2(T) permits an exchange member, subject to certain conditions, to effect transactions for covered accounts by arranging for an unaffiliated member to execute the transactions directly on the exchange floor. To comply with the rule's conditions, a member (1) must transmit the order from off the exchange floor; (2) may not participate in the execution of the transaction once it has been transmitted to the member performing the execution; (3) may not be affiliated with the executing member; and (4) with respect to an account over which the member or an associated person has investment discretion, neither the member nor the associated person may retain any compensation in connection with effecting the transaction without express written consent from the person authorized to transact business for the account in accordance with the rule.

²¹ See 1978 Release II at 18560.

²² 15 U.S.C. 78k(a).

report that trade to a marketplace that allows broker-dealers to "print" trades to the tape. Specifically, broker-dealers in the Nasdaq dealer market are permitted to define parameters of a trade (*i.e.*, price) without bringing the trade to an exchange system for validation. By design, the Nasdaq dealer market enables broker-dealers to control trade execution outside of a centralized price validation system. The regulation of these trades is the responsibility of the marketplace that supports and encourages the execution of these trades away from an exchange infrastructure. Any executions by a broker-dealer brought to a marketplace that permits "printing" are trades appropriately within the jurisdiction of the alternate marketplace.²³ Should Nasdaq (or other marketplace) determine that it requires information or assistance from the PCX for the surveillance of these trades, the PCX would provide such information and assistance.

To facilitate the identity order feature, the Exchange proposes to make changes to PCXE Rules 7.7(b) and 7.36(b). Currently, PCXE Rule 7.7(b) prohibits an ETP Holder from transmitting information "regarding a bid, offer or other indication of an order" to a non-ETP Holder until the bid, offer or other indication information has been disclosed and permission to transmit the information has been obtained from the originating ETP Holder. Conversely, PCXE Rule 7.36(b) provides for anonymity in displaying orders in the Display Order Process²⁴ of the ArcaEx Book.²⁵

The Exchange wishes to revise PCXE Rule 7.36(b) to state that except as provided by PCXE Rule 7.7(b), all orders at all price levels will continue to be displayed on an anonymous basis. Therefore, a User could choose to either display its ETPID or remain anonymous.

²³ The ability of broker-dealers to advertise trading interest is not limited to the use of exchange trading systems. Broker-dealers can display indications of interest through services such as Autex (offered by Thompson Financial). Autex permits broker-dealers to display the price and size of indications of interest and communicate with other subscribers interested in facilitating trades. While not a trading system, Autex allows broker-dealers to advertise their trading activity and attract trading interest. Broker-dealers finding counterparties through this service must bring such trades to Nasdaq's dealer market which permits the printing of trades. Whether the prices of these transactions are executed within the standards of best execution or other standards of appropriate order handling is the business of the regulator for the marketplace supporting the "printing" infrastructure.

²⁴ See PCXE Rule 7.36(a)–(c) for a discussion of the Display Order Process.

²⁵ See PCXE Rule 1.1(a) for a definition of Arca Book.