

RAN-01-19
March 28, 2001

TO: All PCX Members and Member Organizations

FROM: Department of Regulatory Policy

**SUBJECT: Options Firm Quote Rule
(File No. SR-PCX-01-18)**

The SEC recently amended its Rule 11Ac1-1 under the Securities Exchange Act of 1934, the “Firm Quote Rule,” so that it will apply to the options markets.¹ These changes will become operative on Monday, April 2, 2001. In that regard, the Exchange has amended its rules in order to adopt various implementing provisions. Attached is the text of the rule change that the Exchange anticipates the SEC will approve prior to April 2, 2001.

The PCX intends to comply with SEC Rule 11Ac1-1 by establishing by rule and periodically publishing the quotation size for which each Responsible Broker or Dealer on the PCX is obligated to execute an order to buy or sell an option that is a reported security at its published bid or offer. The Options Floor Trading Committee and Options Allocation Committee recently approved rule changes establishing that the minimum quotation size for customer orders will be 20 contracts for each option series and for broker-dealer orders will be one contract for each option series.

The Exchange will continue to disseminate over OPRA, on a series-by-series basis, the quotation size for which the Responsible Broker or Dealer on the PCX will be firm at its disseminated bid or offering price. The Exchange will also publish on its website, and update periodically, the Firm Quote Size and the Auto-Ex Size applicable to each option issue.

The Firm Quote Rule will not apply (a) during trading rotations or (b) during unusual market conditions that have been declared by a Floor Official. It is important to note that the unusual market condition that justifies a Non-Firm-Quote-Mode is not the same as a “fast market” that may be declared pursuant to Rule 6.28. Under the new rules, an unusual market condition that justifies a Non-Firm Quote Mode will only occur when “the Exchange cannot collect, process and make available to quotation vendors quotation data in a manner that accurately reflects the current state of the market at the Exchange.” When this is the case, the Exchange will append to each quotation made available to a quotation vendor an identifier that will indicate that the obligation that is imposed upon Exchange members and the Exchange by SEC Rule 11Ac1-1 has been suspended.

¹ See SEC Rule 11Ac1-1 and Securities Exchange Act Release No. 34-43591 (November 17, 2000).

The rule changes that are being approved in conjunction with the implementation of the SEC's Firm Quote Rule also include the elimination of the PCX's rule on guaranteed markets for customer orders (Rule 6.86, the "20-Up rule") and the "trade or fade" rule (Rule 6.37(d)) which are being replaced by new Rule 6.86 ("Firm Quotes"). In addition, the Exchange is adopting new procedures on Unusual Market Condition Exception to the Firm Quote Rule. The Exchange anticipates that the SEC will be approving the rule changes of the PCX and similar rules of the other options exchanges on a temporary, 60-day basis.

Questions regarding this bulletin may be directed to Michael Pierson, Regulatory Policy, at (415) 393-4107 or Peter Armstrong, Options Operations, at (415) 393-4232.

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Text of the Proposed Rule Change:²

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Obligations of Market Makers

RULE 6.37(a) – (c) – No change.

[(d) Trade or Update. When an order is represented at a trading post for execution at the currently disseminated bid or offer, Market Makers or Lead Market Makers at the trading post, if they do not satisfy the order in its entirety, shall lower their bid or raise their offer. Thereafter, the dissemination of such revised bid or offer must be maintained for a reasonable period of time, as specified in Commentary .09.]

Commentary:

.01 - .09 – No change.

[.10 For purposes of subsection (d), two minutes shall be presumed to be a "reasonable" period of time in which to maintain a revised bid or offer. However, a revised market may be further revised before two minutes pass if the following market changes occur:

- (1) A change in the market quote in the underlying security or a change in the size of the market quoted; or
- (2) In the case of another option series on the same underlying security, a quote change of twice the minimum price differential resulting from a customer order.

² New text is underscored; deleted text in brackets.

Two Floor Officials may grant exemption from the rule on a case-by-case basis if the individual situation warrants such action.]

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Firm Quotes

RULE 6.86 (a) Definitions

(1) For purposes of this Rule the terms “bid and offer,” “quotation size,” “quotation vendor,” “reported security,” “listed option,” “option series” and “trading rotation” will have the meanings set forth in SEC Rule 11Ac1-1.

(2) For purposes of this Rule and SEC Rule 11Ac1-1 as applied to the Exchange and its members, the term “Responsible Broker or Dealer” means that with respect to any bid or offer for any listed option made available by the Exchange to quotation vendors, the Lead Market Maker and any registered Market Makers constituting the trading crowd in such option series will collectively be the Responsible Broker or Dealer to the extent of the aggregate quotation size specified.

(b) Dissemination Requirements

(1) Price. The Exchange will, at all times that it is open for trading, collect, process and make available to quotation vendors the best bid and best offer for each option series that is a reported security. The Exchange may collect, process and make available to quotation vendors a best bid and best offer determined by an automated quotation system.

(2) Size. The Exchange will for each listed option, establish by rule and periodically publish the quotation size for which the Responsible Broker or Dealer is obligated to execute an order to buy or sell an option series that is a reported security at its published bid or offer as set forth in subsection (c) below.

(3) The Exchange’s obligation to collect, process and make available data as set forth above will not include:

(A) collecting, processing or making available any such bid or offer that is executed immediately after being made in the trading crowd and any such bid or offer that is cancelled or withdrawn if not executed immediately after being made; or

(B) data communicated during any period when trading in such reported security: (i) has been suspended or halted; (ii) prior to the commencement of

trading in such reported security on any trading day; or (iii) during a trading rotation.

(c) Obligations of Responsible Brokers or Dealers

(1) *Customer Orders.* Except as provided in subsection (d), below, each Responsible Broker or Dealer is obligated to execute any customer order in a listed option series in an amount up to the quotation size established by rule and periodically published by the Exchange. The minimum quotation size established by rule and published by the Exchange for customer orders will be 20 contracts for each option series.

(2) *Broker-Dealer Orders.* Except as provided in subsection (d), below each Responsible Broker or Dealer is obligated to execute any order in a listed option for the account of a broker or dealer in an amount up to the quotation size established by rule and periodically published by the Exchange. The minimum quotation size established by rule and published by the Exchange for broker-dealer orders will be one contract for each option series.

(3) Each Responsible Broker or Dealer, within thirty seconds of receiving an order to buy or sell a listed option in an amount greater than the quotation size required pursuant to subsections (c)(1) or (c)(2), above, must either:

(A) execute the entire order; or

(B) execute the portion of the order that is equal to the size required pursuant to this subsection (c) and revise its bid or offer.

(d) Exception for Unusual Market Conditions

(1) If the Exchange determines, in accordance with the procedures set forth below, that the level of trading activity or the existence of unusual market conditions is such that the Exchange cannot collect, process and make available to quotation vendors quotation data in a manner that accurately reflects the current state of the market at the Exchange, the Exchange will immediately notify the persons specified in SEC Rule 11Ac1-1(b)(3) and, upon such notification, the obligation imposed upon Exchange members under SEC Rule 11Ac1-1(c)(2) and the Exchange under subsection (b), above, will be suspended, until the Exchange determines that the unusual market activity or condition has terminated and the specified persons have been notified that the unusual market activity or condition has terminated.

(A) If a Responsible Broker or Dealer is unable to update its quotations on a timely basis due to the high level of trading activity or the existence of unusual market conditions, the Responsible Broker or Dealer will promptly notify a Floor Official.

(B) Upon notification by a Responsible Broker or Dealer, the Floor Official will promptly verify the existence of the unusual market activity or condition and if, in the Floor Official's judgment, the Responsible Broker or Dealer is unable to update its quotations on a timely basis, the Floor Official will promptly notify the Exchange. If a Floor Official, independent of notification by a responsible broker or dealer, becomes aware of any unusual market activity or condition that adversely affects a Responsible Broker or Dealer's ability to promptly communicate quotation data, the Floor Official will likewise promptly advise the Exchange.

(C) If the Exchange is unable to accurately collect, process, or disseminate quotation data owing to a high level of trading activity or the existence of unusual market conditions, the Exchange, after consultation with a Floor Official, will make a determination that this is the case.

(D) The Exchange, after receiving notification from a Floor Official pursuant to either subsection (A) or (B), above, will notify the persons specified in SEC Rule 11Ac1-1(b)(3) regarding the Exchange's inability to accurately collect, process, and make available the quotation data required by SEC Rule 11Ac1-1. The Exchange will append to each quotation made available to a quotation vendor an identifier that will indicate that the obligation that is imposed upon Exchange members and the Exchange by SEC Rule 11Ac1-1 has been suspended.

(E) The Floor Official or Exchange staff (as the case may be) will monitor the unusual market activity or condition until it has terminated. Thereupon, the Exchange will immediately notify the persons specified in SEC Rule 11Ac1-1(b)(3) that the Exchange is once again capable of disseminating the quotation data required by SEC Rule 11Ac1-1 and Responsible Brokers or Dealers will be once again obligated under SEC Rule 11Ac1-1.

Commentary:

.01 As of April 1, 2001, the compliance date for the application of SEC Rule 11Ac1-1 to the trading of options, the Exchange will collect, process and disseminate the best bid and best offer in each option series, and establish by rule and periodically publish the quotation size for which the responsible broker or dealer is obligated to execute a customer order to buy or sell an option in that series.

.02 No Lead Market Maker or Market Maker will be deemed to be a Responsible Broker or Dealer with respect to a published bid or offer that is erroneous as a result of an error or omission made by the Exchange or any quotation vendor. If a published bid or offer is accurate but the published quotation size associated with it is erroneous as a result of an error or omission made by the Exchange or any quotation vendor, then the Lead Market Maker or Market Maker who is responsible for the published bid or published

offer will be obligated to the extent set forth in SEC Rule 11Ac1-1(c), but only to the extent of one unit of trading in the option series in question.

[GUARANTEED MARKETS]

[Trading Crowd Firm Disseminated Market Quotes]

[(a) Each trading crowd is required to provide a depth of twenty (20) option contracts, or such greater number of contracts as may be required pursuant to subsection (g), below, for all non-broker/dealer customer orders, at the bid/offer that is displayed as the disseminated market quote at the time such orders are announced or displayed at the trading post designated for trading the subject option class. For purposes of this Rule, the term "broker/dealer" includes foreign broker/dealers.]

[(b) The member/member organization entering an order for execution pursuant to this Rule is responsible for ascertaining the account origin of such order and for communicating such information to the executing member organization. The executing member organization pursuant to this Rule shall personally inquire as to the account origin upon receipt of the order or prior to its execution and to note the information on the order ticket. If the firm entering the order is a non-member, the executing member organization and the member clearing organization shall bear greater responsibility in determining the account origin.]

[(c) The Rule shall be in effect at all times other than during a trading rotation at the subject trading post and a reasonable period of time immediately following a trading rotation, not to exceed five (5) minutes.]

[(d) A trading crowd shall be exempt from the provisions of this rule upon the declaration of a "fast market" pursuant to Rule 6.28.]

[(e) Should the response of members present at a trading post be insufficient to provide a depth of the number of contracts required by subsections (a), the Order Book Official must allocate among the eligible Market Makers as specified in Commentary .08 the balance of contracts necessary to provide an execution of the number of contracts required by subsection (a). The Order Book staff shall record and maintain lists of the individual Market Makers who were allocated contracts, and consider such allocations when similar occasions arise within the same trading session. The Order Book Official must seek, as reasonably as possible, to equalize such allocations.]

[(f) The enforcement of this Rule, and the determination of the expiration months and strike prices subject to the provisions of this Rule shall be within the jurisdiction of the Options Floor Trading Committee. Two Options Floor Officials may grant exemptions to the provisions of this Rule for either a class or series within a class of

option contracts if, in their determination, the individual situation warrants such action, or upon their determination that an error occurred in the dissemination of a market quote.]

[(g) If the Options Floor Trading Committee determines, pursuant to Rule 6.87(b), that the size of orders in an issue that are eligible to be executed on Auto-Ex will be greater than twenty contracts, then the trading crowd will be required to provide a market depth in that greater amount, as provided in Rule 6.86(a).]

[Commentary:

.01 If a bid/offer displayed as a disseminated market quote is on behalf of an order represented by a Floor Broker or the Order Book Official and is for less than the number of contracts required by subsection (a), the trading crowd is obligated to buy/sell the balance of contracts necessary to provide a depth of that number of contracts at the disseminated bid/offer.]

[.02 Should a Floor Broker cause a bid/offer to be disseminated and the order is subsequently executed or canceled, the Floor Broker shall be responsible for causing the removal of such disseminated bid/offer. Failure to remove such bid/ offer may thereafter result in the Floor Broker being held responsible for providing a depth of the number of contracts required by subsection (a) upon being present or returning to the trading crowd, and/or being subject to disciplinary action by the Exchange for a violation of Rule 6.86. A Market Maker or Floor Broker who has caused a bid/offer to be disseminated, but who leaves the trading crowd without removing such bid/offer, may also be held responsible for providing a depth of the number of contracts required by subsection (a) upon returning to the trading crowd, and/or be subject to disciplinary action by the Exchange for a violation of this Rule.]

[.03 Market Maker, broker/dealer or firm orders for less than the number of contracts required by subsection (a) that are represented at a trading post by a Floor Broker shall not be disseminated. Floor Brokers shall remain obligated to use due diligence in the representation of orders pursuant to Rule 6.46(b).]

[.04 Violations of this Rule and its Commentary shall be subject to disciplinary action pursuant to Rule 10.]

[.05 This Rule shall apply to certain types of orders as follows:]

[(a) Combination orders: If an order is for option contracts on only one side of the market, Market Makers shall be responsible for providing an aggregate amount of twenty contracts on one side of the market; if an order is for option contracts on both sides of the market, Market Makers shall be responsible for providing a depth of twenty contracts on both sides of the market;]

[(b) Spread and straddle orders: Market makers must provide a depth of twenty contracts on both sides of the market.]

[(c) Contingency orders: The Rule shall apply to the following types of contingency orders:]

[(1) Immediately executable market "not-held" orders:]

[(2) Immediately executable limit "not-held" orders;]

[(3) Immediately executable delta orders;]

[(4) "Minimums" of twenty contracts or less; and]

[(5) All-or-none orders of twenty contracts or less.]

[In executing a contingency order, the order ticket must be time-stamped upon being taken into the subject trading crowd. Eligible contingency orders are entitled to twenty contracts on the market disseminated at that time.]

[.06 Market Makers must be afforded a "reasonable" opportunity to update their markets for the execution of consecutive eligible orders in options on the same underlying security. In addition, such orders must be executed on a time priority basis so that the order with the earliest time stamp receives a guaranteed fill of twenty contracts.]

[.07 Pursuant to this Rule and Rule 6.46, if a Floor Broker can immediately execute a limit order at the disseminated market price, but instead, the Floor Broker quotes a better price than the limit price stipulated on the order ticket, and the market then changes, so that the order can no longer be executed at the disseminated market price, the Floor Broker shall be held liable to the customer for the execution of a minimum of the number of contracts required by subsection (a) at the original disseminated price.]

[.08 Pursuant to Subsection (e), Order Book Officials may allocate options contracts to Market Makers who:]

[(a) are present at the trading post at the time of the call for a market; and either]

[(b) hold an appointment in the option classes at that trading post; or]

[(c) regularly effect transactions in person for their trading accounts at that trading post.]

[Market Makers who have logged onto the Automatic Execution system but who are not present in the trading crowd will not be eligible for an allocation by the Order Book Official.]