



RULE
ADOPTION
NOTICE

RAN-04-48
October 25, 2004

TO: All PCX OTP Holders and OTP Firms

FROM: Department of Regulatory Policy

SUBJECT: Obvious Error Rule
(File No. SR-PCX-2004-87)

On September 21, 2004, the Exchange filed with the Securities and Exchange Commission a proposed rule to amend the Exchange's obvious error rule. The Commission approved the proposed rule change on October 15, 2004.

The following is the text of the rule change. Questions regarding this bulletin may be directed to Mai Shiver at (415) 393-4266.

Exhibit A
Text of the Rule Change¹ :

Rules of the
Pacific Exchange, Inc.

Rule 6
Options Trading

Rule 6.87 (g) Trade Nullification and Price Adjustment Procedures

The Exchange shall either bust a transaction or adjust the execution price of a transaction that results from an Obvious Error as provided in this Rule.

(1) Definition of Obvious Error. For purposes of this Rule only, an Obvious Error will be deemed to have occurred when the execution price of a transaction is higher or lower than the Theoretical Price for the series by an amount equal to at least the amount shown below:

¹ New text is underscored. Deleted text is in brackets.

Theoretical Price Minimum Amount

<u>Below \$2</u>	<u>.25</u>
<u>\$2 to \$5</u>	<u>.40</u>
<u>Above \$5 to \$10</u>	<u>.50</u>
<u>Above \$10 to \$20</u>	<u>.80</u>
<u>Above \$20</u>	<u>1.00</u>

(2) Definition of Theoretical Price. For purposes of this Rule only, the Theoretical Price of an option is:

(A) if the series is traded on at least one other options exchange, the last bid price with respect to an erroneous sell transaction and the last offer price with respect to an erroneous buy transaction, just prior to the trade, disseminated by the competing options exchange that has the most liquidity in that option; or

(B) if there are not quotes for comparison purposes, as determined by designated personnel of the Exchange.

(3) Obvious Error Procedure. The Exchange shall administer the application of this Rule as follows.

(A) Notification. If a Market Maker on the Exchange believes that it participated in a transaction that was the result of an Obvious Error, it must notify the Exchange within five (5) minutes of the execution. If an OTP Holder or OTP Firm not serving as a Market Maker on the Exchange believes that an order it executed on the Exchange was the result of an Obvious Error, it must notify the Exchange within twenty (20) minutes of the execution. Absent unusual circumstances, the Exchange will not grant relief under this Rule unless notification is made within the prescribed time periods.

(B) Adjust or Bust. The Exchange will determine whether there was an Obvious Error as defined above. If it is determined that an Obvious Error has occurred, the Exchange shall take one of the following actions listed below. Upon taking final action, the Exchange shall promptly notify both parties to the trade.

(i) where each party to the transaction is a Market Maker on the Exchange, the execution price of the transaction will be adjusted by the Exchange to the prices provided in paragraphs (aa) and (bb) below unless both parties agree to adjust the transaction to a different price or agree to bust the trade within ten (10) minutes of being notified by the Exchange of the Obvious Error

(aa) Erroneous buy transactions will be adjusted to their Theoretical Price: plus \$.15 if the Theoretical Price is under \$3 and plus \$.30 if the Theoretical Price is at or above \$3.

(bb) Erroneous sell transactions will be adjusted to their Theoretical Price: minus \$.15 if the Theoretical Price is under \$3 and minus \$.30 if the Theoretical Price is at or above \$3.

(ii) Where at least one party to the Obvious Error is not a Market Maker on the Exchange, the trade will be busted by the Exchange unless both parties agree to an adjustment price for the transaction within thirty (30) minutes of being notified by the Exchange of the obvious error.

[(1) Mutual Agreement: The determination as to whether an Auto-Ex trade was executed at an erroneous price may be made by mutual agreement of the affected parties to a particular transaction. A trade may be nullified or adjusted on the terms that all parties to a particular transaction agree. In the absence of mutual agreement by the parties, a particular trade may only be nullified or adjusted when the transaction results from an Obvious Error as provided in this Rule.

(2) Obvious Error Subject to Trade Nullification or Price Adjustment: Absent mutual agreement as provided in Rule 6.87(g)(1), parties to a trade may have a trade nullified or its price adjusted if: (i) any such party makes a documented request within the time specified in Rule 6.87(g)(3); and (ii) one of the conditions below is met:

A. The trade resulted from a verifiable disruption or malfunction of an Exchange execution, dissemination, or communication system that caused a quote/order to trade in excess of its disseminated size (e.g. a quote/order that is frozen, because of an Exchange system error, and repeatedly traded) in which case trades in excess of the disseminated size may be nullified; or

B. The trade resulted from a verifiable disruption or malfunction of an Exchange dissemination or communication system that prevented a member from updating or canceling a quote/order for which the OTP Holder is responsible where there is Exchange documentation providing that the OTP Holder sought to update or cancel the quote/order; or

C. The trade resulted from an erroneous print disseminated by the underlying market which is later cancelled or corrected by the underlying market where such erroneous print resulted in a trade higher or lower than the average trade in the underlying security during the time period encompassing two minutes before and after the erroneous print, by an amount at least five times greater than the average quote width for such underlying security during the time period encompassing two minutes before and after the erroneous print. For purposes of this Rule, the average trade in the underlying security shall be determined by adding the prices of each trade during the four minute time period referenced above (excluding the trade in question) and dividing by the number of trades during such time period (excluding the trade in question); or

D. The trade resulted from an erroneous quote in the Primary Market (as defined in Rule 6.1(b)(27)) for the underlying security that has a width of at least \$1.00 and that width is at least five times greater than the average quote width for such underlying security during the time period encompassing two minutes before and after the dissemination of such quote. For the purposes of this rule, the average quote width shall be determined by adding the quote widths of each separate quote during the four minute time period referenced above (excluding the quote in question) and dividing by the number of quotes during such time period (excluding the quote in question); or

E. The execution price of the trade is higher or lower than the mid-point of the Best Bid and Offer (among all of the exchanges other than the PCX) by an amount equal to at least the bid/ask spread provided in Rule 6.37(b)(1). The bid/ask spread set forth in Rule 6.37(b)(1) will also apply to LEAPS and options subject to unusual market conditions. In the event the bid/ask spread in the underlying is greater than the bid/ask spread set forth in Rule 6.37(b)(1), the Exchange will apply the bid/ask spread differential set forth in Rule 6.37 (b)(3).

F. The trade resulted in an execution price in a series quoted no bid and at least one strike price below (for calls) or above (for puts) in the same class were quoted no bid at the time of the erroneous execution.

G. The trade is automatically executed at a price where the OTP Holder sells \$0.10 or more below parity. Parity describes an option contract's total premium when that premium is equal to its intrinsic value. Parity for calls is measured by reference to the offer price of the underlying security in the Primary Market at the time of the transaction minus the strike price for the call. Parity for puts is measured by reference to the strike price for the put minus the bid price of the underlying security in the Primary Market at the time of the transaction.

(3) Obvious Error Procedure. Two Trading Officials will administer the application of this Rule as follows:

A. Notification. If an OTP Holder believes that it participated in a transaction that was the result of an Obvious Error, it must notify two Trading Officials within five (5) minutes of the execution. If an Order Entry Firm representing a public customer believes an order it executed on the Exchange was the result of an Obvious Error, it must notify the Exchange within twenty (20) minutes of the execution. Absent unusual circumstances, two Trading Officials will not grant relief under this Rule unless notification is made within the prescribed time periods.

B. Adjust or Nullify. Two Trading Officials will determine whether the execution is subject to a trade nullification or price adjustment. If two Trading Officials determine that one of the conditions of Rule 6.87(g)(2) has been met and

that the complaining party has timely documented a request for relief, then a trade will be adjusted or nullified as follows:

(1) Where each party to the transaction is a Market Maker on the Exchange, or the trade involves a limit order that may be adjusted to its limit, the Exchange will adjust the execution price of the transaction within ten (10) minutes of two Trading Officials making such determination. In such case, the adjusted price will be the last bid (offer) price, just prior to the trade, from the exchange providing the highest total contract volume in the option for the previous sixty (60) days with respect to an erroneous bid (offer) entered on the Exchange. If there is no quote for comparison purposes, then the adjusted price of an option will be determined by two Trading Officials; or

(2) Where at least one party to the transaction is not a Market Maker on the Exchange or where the trade does not involve a limit order that may be adjusted to its limit, the Exchange will nullify the transaction within ten (10) minutes of two Trading Officials making such determination.

(3) Upon taking final action, the two Trading Officials will promptly notify both parties to the trade.]

Commentary:

[.01 In no case will the two Trading Officials involved in an obvious error determination include a person related to a party to the trade in question.]

.01 [02] All determinations made by the [two Trading Officials] Exchange under subsection [(g)(2)] (g)(3) will be rendered without prejudice as to the rights of the parties to the transaction to submit a dispute to arbitration.

.02 [.03] Nothing in this rule prevents a potentially aggrieved party from appealing the decision of [two Trading Officials] the Exchange pursuant to Rule [11] 10.14 of the Exchange rules.

.03 When the Exchange determines that an Obvious Error has occurred and action is warranted under Rule 6.87(g)(3)(B) above, the identity of the parties to the trade will be disclosed to each other in order to encourage conflict resolution.

.04 Buyers of options with a zero bid and \$.05 offer (i.e., a Theoretical Price of \$.05) may request that their execution be busted if at least the two strikes below (for calls) or above (for puts) in the same options class were quoted with a zero bid and \$.05 offer at the time of the execution. Such buyers must follow the procedures of Rule 6.87(g)(3) above.

.05 For purposes of Rule 6.87 (g)(2)(A), the competing options exchange with the most liquidity will be the options exchange that had the highest total contract volume in the options class for the previous two months (e.g., if an obvious error occurs on March 9, the total contract volume from January 8 to March 9 will be used).

.06 For purposes of Rule 6.87(g)(3)(B), an “erroneous sell transaction” is one in which the price received by the person selling the option is erroneously low, and an “erroneous buy transaction” is one in which the price paid by the person purchasing the option is erroneously high.

* * *

Rule 10.14(a). *General Provisions*. This Rule provides the procedure for persons aggrieved by any of the following actions taken by the Exchange to apply for an opportunity to be heard and to have the action reviewed. These actions are:

(1) – (4) – No change.

(5) actions taken pursuant to Rules 6.37, 6.82(f), [and] 6.82(g), and 6.87; or

(6) – No change.

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