



RULE
ADOPTION
NOTICE

RAN-05-54
August 15, 2005

TO: All PCX OTP Holders and OTP Firms

FROM: Department of Regulatory Policy

**SUBJECT: Electronic Lead Market Maker
(File No. SR-PCX-2005-31)**

On March 15, 2005, the Exchange filed with the Securities and Exchange Commission PCX-2005-31 a proposal to adopt rule changes that would allow for a Lead Market Maker to conduct their business from a remote location, through a facility of The Exchange. The Exchange filed Amendment Nos. 1 and 2 on May 27, 2005 and June 6, 2005 respectively. The rule change was approved as amended on August 11, 2005.

The following is the text of the rule changes as approved by the SEC. Questions regarding this bulletin may be directed to Glenn H.Gsell at (415)-835-4805.

EXHIBIT 5
Text of the Proposed Rule Change:¹

**Rules of the
Pacific Exchange, Inc.**

**Rule 6
Options Trading**

Rule 6.32(a). A Market Maker is an individual who is registered with the Exchange for the purpose of making transactions as a dealer-specialist on the Floor of the Exchange or, in the case of a Remote Market Maker or a Lead Market Maker, through the facilities of the Exchange in accordance with the provisions of this subsection. Registered Market Makers are designated as specialists on the Exchange for all purposes under the Securities Exchange Act of 1934 and the Rules and Regulations thereunder. Except as provided in subsection (c) below, only transactions

¹ New text is underlined, deleted text is in brackets for changes made pursuant to Amendment 2 filing; new text is in bold and deleted text is in strike through for changes made pursuant to partial Amendment No. 3

that are initiated on the Floor of the Exchange or executed through the facilities of the Exchange [by a Remote Market Maker] will count as Market Maker transactions for the purposes of Rule 6.32. A Market Maker on the Exchange must be either a Lead Market Maker, a Remote Market Maker, a Supplemental Market Maker, or a Floor Market Maker.

(1) A Lead Market Maker is a registered Market Maker who makes transactions as dealer-specialist [while] on [the Floor of] the Exchange and who meets the qualification requirements of Rule 6.82(b).

(2) A Remote Market Maker is an individual who is registered with the Exchange for the purpose of making transactions as dealer-specialist from a location off the Floor of the Exchange. A Remote Market Maker may also execute transactions while on the Floor of the Exchange. Transactions of Remote Market Makers that are executed through the facilities of the Exchange are deemed to be Market Maker transactions for purposes of Rule 6.32.

(3) A Supplemental Market Maker is a registered Market Maker who makes transactions as dealer-specialist while on the Floor of the Exchange and who provides quotations: (A) manually, by public outcry; or (B) automatically, through an electronic interface device at the LMM's prevailing bid or offering price, with a size to be designated by the Supplemental Market Maker.

(4) A Floor Market Maker is a registered Market Maker who makes transactions as a dealer-specialist while on the Floor of the Exchange and provides quotations: (A) manually, by public outcry, or (B) automatically through an auto-quoting device.

(b) Market Makers and Floor Brokers effecting transactions as Market Makers are instructed that, except as specified in subsection (c) below, only transactions that are initiated on the Floor of the Exchange or[, in the case of a Remote Market Maker,] through the facilities of the Exchange by that person shall count as Market Maker transactions and be entitled to special margin treatment, pursuant to the net capital requirements of Rule 15c3-1 under the Securities Exchange Act of 1934 and Regulation T of the Board of Governors of the Federal Reserve system. Accordingly, any position established for the account of a Market Maker [other than a Remote Market Maker] which has been "entered [from off the floor] through an OTP Firm acting as a floor broker" must be placed in the Market Maker's investment account and be subject to applicable customer margin.

(c) A Market Maker may enter opening orders from off the Floor of the Exchange for execution by Floor Brokers and receive special margin treatment for such orders during any calendar quarter, provided that such Market Maker executes in person or through a facility of the exchange, and not through the use of orders, at least 80% of his or her total transactions during that calendar quarter. This provision, if applicable, shall supersede the 60% in-person requirement of Rule 6.37. In addition, the [off-floor] orders executed by a Floor Broker for which a Market Maker received market-maker treatment shall be consistent with a Market Maker's duty to maintain fair and orderly markets and in general shall be effected for the purpose of hedging, reducing the risk of, or rebalancing open positions of the Market Maker. Remote Market Makers may enter opening orders from off the Floor of the Exchange for execution by Floor Brokers and receive special margin treatment for them as long as the entry of such orders

is consistent with the Remote Market Maker's duty to maintain fair and orderly markets and such orders are entered for the purpose of hedging, reducing the risk of, or rebalancing open positions of the Remote Market Maker.

(d) A Market Maker, while on the floor, may enter a GTC order with a Floor Broker and still receive special margin treatment, as described in subsection (b) above. However, the order must be a limit order where the quantity cannot be increased or the limit changed. If the quantity is increased or the limit changed, the GTC order shall be treated as an order entered from off the floor. Likewise, limit orders to "buy and sell" in the same series, discretionary orders, and "market not-held" orders may not be handled on a GTC basis without being treated as orders subject to customer margin treatment.

(e) With regard to orders of Market Makers entered from off the floor that are not entitled to special margin treatment pursuant to subsections (c) and (d), above, Market Maker clearing firms are directed to instruct their respective trading desks to identify such orders by placing a "C" after the Market Maker's number in the "firm" box on the ticket. Floor Brokers, when accepting an order by phone from a Market Maker, are similarly directed to identify such orders in the same manner.

Rule 6.33 – 6.35(h)(3) – No Change.

Rule 6.35(h)(4) at no time will a Remote Market Maker concurrently trade or quote the same option issue as a Remote Market Maker or Lead Market Maker who is a Nominee for the same OTP Holder or OTP Firm.

Rule 6.36(a). Required of Each OTP Holder. No Market Maker may make any transaction on the floor of the Exchange or, in the case of a Remote Market Maker or a Lead Market Maker, through the facilities of the Exchange unless there is in effect a Letter of Guarantee which has been issued for such OTP Holder or OTP Firm by a Clearing Member and approved by the Options Clearing Corporation and the Exchange. An OTP Holder or OTP Firm may not have more than one such Letter in effect at the same time except for the purpose of facilitating the transfer of that OTP Holder or OTP Firm's Market Maker account from one Clearing Member to another or unless the Exchange determines otherwise.

Rule 6.36(b) – 6.37(c) – No Change.

Rule 6.37(d) In-Person Requirements for Market Makers [(other than Remote Market Makers who are not present on the Trading Floor)]. In order to meet the obligations of this rule, and in the interest of a fair and orderly market, an adequate number of Market Makers must be available throughout each trading session. In acknowledgement thereof, the following minimum in-person trading requirements shall be in effect: At least 60% of a Market Makers transactions must be executed by the Market Maker in-person or through an approved facility of the exchange [, while he is present on the Options Trading Floor of the Exchange]. Orders executed for a Market Maker through a Floor Broker will not be credited toward the 60% requirement. A failure to comply with this 60% in-person trading requirement may result in a fine pursuant to Rule 10.13; however, if aggravating circumstances are present, formal disciplinary action may be taken

pursuant to Rule 10.4.

Rule 6.37(e) – No Change.

Rule 6.37(f) – Notwithstanding the prohibitions set forth in Subsection (e), the LMM and members of the trading crowd are permitted to act collectively as set forth below:

(1) Reserved. [The LMM may receive input from the members of the trading crowd on any one or more of the following variables of the formula the LMM uses to generate automatically updated market quotations in each option issue: (A) options pricing calculation model; (B) volatility; (C) interest rates; and (D) dividends (both declared and anticipated). However, members of the trading crowd are not required to provide input to the LMM on any of these variables. Notwithstanding any input that the members of the trading crowd may have provided with regard to these variables, it is within the LMM's sole discretion to make the final independent decision regarding the variables to be used in operating the automated quotation system. LMMs using Exchange-approved proprietary automated quotation updating systems are not required to disclose proprietary information concerning the variables used by those systems; provided, however, that LMMs may disclose the variables themselves pursuant to Rule 6.82(c)(8).]

Rule 6.37(f)(2) – Rule 6.37(f)(2) Commentary .02 – No Change

Rule 6.37 Commentary .03(a) – When a Market Maker other than a Remote Market Maker or a Lead Market Maker operating from off the trading floor, displays a market on the screen that is the best market in that crowd, the Market Maker is obligated to ensure that its market is removed from the screen when the Market Maker leaves the crowd.

Rule 6.37 Commentary .04 - Rule 6.81 – No Change

Rule 6.82(a). General Provisions

(1) *Lead Market Maker Defined.* A Lead Market Maker ("LMM") is an individual or entity that has been deemed qualified by the Exchange [Options Allocation Committee] for the purpose of making transactions on [the Options Floor of] the Exchange in accordance with the provisions of Rule 6.82. Each LMM or nominee thereof must be registered with the Exchange as a Market Maker. Any OTP Holder or OTP Firm registered as a Market Maker with the Exchange is eligible to be qualified as an LMM. [Remote Market Makers are not eligible to act as LMMs from a location off the trading floor.]

Rule 6.82(a)(2) – (c)(4) – No Change.

Rule 6.82(c)(5) Be [present at the trading post] accessible throughout every business day and, in addition, designate an approved LMM to act as a back-up LMM and notify Book Staff of such designation;

Rule 6.82(c)(6) – (g) – No Change.

Rule 6.82(h)(1) – Reserved. [LMM Performance of Order Book Official Functions.

(a) The LMM may, subject to the approval of the Exchange, perform all functions of the Order Book Official ("OBO") in designated option issues pursuant to Rules 6.51 through 6.59.

(b) The Exchange shall make personnel available to assist the LMM as the LMM shall reasonably require in performing the OBO function. The Exchange may charge the LMM a reasonable fee for such use of Exchange personnel.

(c) Subject to the review of two Trading Officials or the Exchange, the LMM shall resolve trading disputes upon request of any party to such dispute.

(d) The LMM shall disclose Book information to OTP Holders or OTP Firms upon request, pursuant to Rule 6.57.

(e) If the Exchange decides to reallocate an issue to the Market Maker system pursuant to Section (f)(2) of this Rule, the terminated LMM may receive a share of the net Book revenues, not to exceed one-half, for any period specified by the Exchange up to a maximum of five years. Such award shall take into account the length of time of LMM service, the LMM's capital commitment, efforts expended as LMM and any other relevant factors.]

Rule 6.82(h)(2) – (h)(3) – No Change.

Commentary:

.01 It shall be the duty of the Exchange to promulgate and recommend to the Board of Directors rules and policies with regard to the [Options Floor] trading activities of the LMM.

[.02 LMMs who perform the function of an Order Book Official pursuant to Rule 6.82(h) shall maintain "minimum net capital" as provided in SEC Rule 15c3-1, and shall also maintain a cash or liquid asset position of at least \$500,000, plus \$25,000 for each issue over 5 issues for which they perform the function of Order Book Official.]

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Rule 7.1. Unless otherwise ruled by the Board of Directors, the Exchange shall be open for the transactions of business daily except on Saturdays and Sundays. The hours at which trading sessions shall open and close shall be established by the Board of Directors.

Dealings upon the Exchange shall be limited to the hours during which the Exchange is open for the transaction of business. No OTP Holder or OTP Firm shall make any bid, offer or transaction upon the Floor or in the case of Remote Market Makers or Lead Market Makers operating from off the Floor, through the facilities of the Exchange before the official opening of the Exchange and loans of securities may be made after those hours.

Commentary:

.01 The Board of Directors has resolved that transactions may be effected on the Options Floor of the Exchange or in the case of Remote Market Makers or Lead Market Makers operating from off the Floor, through the facilities of the Exchange until 1:02 p.m. for equity options and until 1:15 p.m. for index options at which time no further transactions may be made.

.02 – No Change.

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