PACIFIC EXCHANGE
STOCK & OPTIONS

RULE
ADOPTION
NOTICE

RAN-01-45
November 28, 2001

TO: **All PCX Member and Member Organizations**

FROM: **Department of Regulatory Policy**

SUBJECT: **New Rules Relating to Full Implementation of Decimal Pricing (File No. SR-PCX-01-39)**

On October 22, 2001, the Exchange filed a rule change with the SEC to fully implement decimal pricing and eliminate references to fractional pricing from the PCX and PCXE Rules. This rule change became effective upon filing pursuant to SEC Rule 19b-4(f)(6). Under the amended rules, prices for securities traded on the Exchange and trading differentials for bids and offers made on the Exchange may be expressed in decimal form only.

The following is the text of the rule change. Questions regarding this notice may be addressed to Mai Shiver, Senior Attorney, at (415) 393-4266.

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EXHIBIT A

PCX EQUITIES, INC.

CONVERSION TO DECIMALS

Text of the Rule Change:[1]

EQUITIES TRADING

¶7911J **Trading Differentials**

Rule 7.10(a) The Corporation has determined the minimum price variation ("MPV") for equity securities traded on the Corporation will be quoted in decimals at a value of .01. [For those equity securities that are quoted in decimals the MPV will be .01. Those equity securities that are quoted in fractions will continue to be governed by the existing MPVs contained within the PCX Rules.]

[This rule will govern the activity of all ETP Holders, Equity ASAP Holders, and ETP Firms when their conduct relates to trading of issues quoted in decimals. However, this rule in no way diminishes the

[1] Underscoring indicates new text; strikethrough indicates deleted text.

obligations of ETP Holders, Equity ASAP Holders, and ETP Firms to abide by the current rules of the Exchange when their business activity relates to trading of issues quoted in fractions.]

Commentary:

.01 No change.

.02 Notwithstanding Commentary .01, an ETP Holder may trade on the Floor at increments of .01 [1/32 or 1/64] in order to match bids and offers displayed by other markets for the purpose of preventing Intermarket Trading System trade-through.

.03 No change.

.04 The minimum price variation for orders generated from Profiles designated for the midpoint pricing service by the OptiMark System will be the variation of the midpoint price between the highest published bid and the lowest published offer displayed on the Consolidated Quotation System. Any executions resulting from processing Profiles designated for midpoint pricing will be priced and reported in increments as small as [1/64th or, upon conversion to decimals,] one-half of the minimum price variation.

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¶7911L **Firm Quotations**

Rule 7.12(b) – No change.

Commentary:

.01 - .04 – No change.

.05 No offer shall be executed in violation of applicable short sale rules:

Example:

PCX market in XYZ— 43.25 – 43.50 [or 43 1/4 – 43 ½] (short)

NYSE market in XYZ—43.40 – 43.60 [or 43 3/8 - 43 5/8]

Consolidated tape last sale = 43.40 [or 43 3/8]

The Pacific Exchange offering at 43.50 [or 43 ½] may not be filled at its limit price subsequent to a Consolidated Tape sale at 43.60 [or 43 5/8]. However, any approved trader entering a short offering into the quote system is responsible for promptly adjusting the order into conformity with applicable short sale rules.

.06 - .08 – No change.

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Rule 7.66(a) – No change.

Rule 7.66(b) – No change.

(1) – (7) – No change.

(8) Openings on the Exchange

(i) Notification Requirements

(A) Applicable Price Change

(1) Initial Notification—Whenever a specialist, in arranging an opening transaction on the Corporation in any Eligible Listed Security, anticipates that the opening transaction through the facilities of the Corporation will be at a price that represents a change from the security's previous day's consolidated closing price of more than the "applicable price change" (as defined below), he shall notify the other Participant markets of the situation by sending a "pre-opening notification" through the System. Thereafter, the specialist shall not open the security in his market until not less than three minutes after his transmission of the pre-opening notification.

The "applicable price changes" are:

Security	Consolidated Closing Price	Applicable Price Change (More Than)
Network A		
	Under $15	.10 [or 1/8 point]
	$15 or over	.25 [or 1/4 point]
Network B	Under $5	.10 [or 1/8 point]
	$5 or over	.25 [or 1/4 point]

—A pre-opening notification shall:

(A) be designated as a pre-opening notification ("IND");
(B) identify the participant market ("P"), the specialist and the security ("XYZ"); and
(C) indicate the "applicable price range" by being formatted as a standardized pre-opening administrative message as follows:
IND N/XYZ (RANGE)

The price range shall not exceed the "applicable price range" shown below:

Security	Consolidated Closing Price	Applicable Price Change (More Than)
	Under $50	.50 [or ½ point]

Network A	Under $50 $15 or over	.50 [or ½ point] $1[4] [1 point or, or for stocks trading in decimals, 1.00]
Network B	Under $10 $10 or over	.50 [or ½ point] $1[5] [1 point or, for stocks] trading in decimals, 1.00]

[4] If the previous day's consolidated closing price of a Network A Eligible Security exceeded $100 and the security does not underlie an individual stock option contract listed and currently trading on a national securities Exchange, the "applicable price change" is two dollars.

[5] If the previous day's consolidated closing Network B eligible Security exceeded $75 and the security is not a Portfolio Depository Receipt, Index Fund Share, or Trust Issued Receipt, or does not underlie an individual stock option contract listed and currently trading on a national securities exchange, the "applicable price change" is two dollars.

The price range also shall not straddle the previous day's consolidated closing price, although it may include it as an endpoint (e.g., a .10 - .60 [or 1/8 - 5/8] price range would be permissible if the previous day's consolidated closing price were .10 or .60 or [1/8 or 5/8], but not if the closing price were .25, or .40 or .50 [or ¼, or 3/8 or ½].

(1) – No change.

Commentary:

01. – 03. – No change.

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¶7914P Pacific Computerized Order Access System ("P/COAST)

Rule 7.70(h) P/COAST will assure that incoming orders will execute first against any matching agency orders with priority and then against any specialist interest with priority. Unfilled portions of such orders will default to the specialist who receives them according to previously-established routing procedures. P/COAST will continue to designate orders for representation by the specialist who has been specified to represent them according to pre-defined routing parameters (such as because the order-sending firm designated the specialist), even if another specialist has priority under Rule 7.19(c). Once P/COAST receives a market or marketable limit order, if another specialist in that security has a bid or offer with priority at the NBBO, the system will "lock in" the execution match so that the contra specialist will be guaranteed an execution, unless the receiving specialist executes the order at a price superior to the NBBO. For example, assume that there are five PCX specialists (A, B, C, D and E) each bidding $20 for 500 shares for their own accounts. The specialist's quotes have time priority in the following order: A, B, C, D, E. There are no agency orders to buy at 20 on the PCX, and 20 is the national best bid. E's customer sends a market order to the PCX to sell 5,000 shares. The order will be represented by E. The order will be displayed for up to 15 seconds on E's auto-ex window. E may execute the entire order at <u>20.05</u> [20-1/16]. However, the system will lock in A's, B's, C's, D's and E's bids, so that if any trades at $20 occur on the PCX, they will be executed in time priority order. If E moves the order into the manual-ex window, then A, B, C and D will receive a 30-second shadow message of the order. Their outstanding bids remain locked in, unless updated so that they no longer match with the original order. However, A, B, C and D can improve the price of their proprietary quotes, and these will become locked in, as long as the original order remains in E's manual-ex window. To change the example, if A were bidding $20 for 5,000 shares (with priority, and B, C and D were bidding <u>$19.90</u> [$19-7/8], E can keep the order by filling it at <u>$20.05</u> [$20-1/16] otherwise, if the order is filled at $20, A can fill the entire order. If E moves the order into E's manual-ex window, A will receive a shadow message (but B, C and D will not).

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¶7914Z Definition – Price – Special Commission

Rule 7.79(e). Information on Tape. The terms of a Special Offering shall be printed on the tape before it is effective, with statement, if such be the fact, that stabilizing transactions have been effected or are contemplated and that it is intended to over allot shares as permitted by Rule 7.79(c)(1). Transactions effected pursuant to a Special Offering shall when feasible be printed currently on the tape, and the tape shall show the gross price and the special commission in a legend such as "SP OFF 100 XYZ 40 COM .50 [or ½]," as well as the number of orders involved in such transaction where more than one order is involved; and after the close of the market, any unprinted remainder of such transactions executed during the day shall be so printed. When the offering is terminated, an announcement to that effect shall be printed on the tape; and when the intention to stabilize is terminated, such fact shall be announced on the tape together with a statement that stabilizing transactions have been effected, if such be the fact.

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EXHIBIT B

PACIFIC EXCHANGE, INC.

CONVERSION TO DECIMALS

Text of the Proposed Rule Change:[2]

OPTIONS TRADING

[¶ 3088 Mandatory Decimal Pricing Testing]

Rule 1.15(b) Reserved

[(1) Point-to-Point Testing. Each member organization that has an electronic interface with the Exchange must participate in point-to-point testing with the Exchange of its computer systems designed to ascertain decimal pricing conversion compatibility of those computer systems, in a manner and frequency as prescribed by the Exchange. A member organization that has its electronic interface through a service provider need not participate in point-to-point testing if, by a time designated by the Exchange, (A) the service provider conducts successful tests with the Exchange on behalf of the firms it serves, (B) the member organization conducts successful point-to-point testing with the service provider and (C) the Exchange agrees that further testing is not necessary.

(2) Industry Wide Testing. The Exchange may require certain of its member organizations to participate in industry wide testing of computer systems for decimal pricing conversion compatibility. The Exchange may require any member organization who will participate in industry wide testing to also participate in any tests necessary to ensure preparedness to participate in industry wide testing.

(3) Reports. Member organizations participating in point-to-point testing (whether between the firm and the Exchange, between the firm and its service provider, or between the firm's service provider and the Exchange) or industry wide testing must file reports with the Exchange concerning the required tests in the manner and frequency required by the Exchange.

(4) Documentation. Member organizations must maintain adequate documentation of tests required by this Rule and the results of such testing for examination by the Exchange.

Commentary:

01. This rule will expire automatically upon the full implementation of decimal pricing.]

[2] Underscoring indicates new text; strikethrough indicates deletion.

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¶4935 Obligations of Market Makers

Rule 6.37 (a) – (b) – No change.

(1) Bidding and/or offering so as to create differences of no more than

(A) .25 [or ¼ of $1] between the bid and the offer for each option contract for which the bid is less than $2,

(B) no more than .40 [or 3/8 of $1] where the bid is $2 or more but does not exceed $5,

(C) no more than .50 [or 1/2 of $1] where the bid is more than $5 but does not exceed $10,

(D) no more than .75 [or 3/4 of $1] where the bid is more than $10 but does not exceed $20, and

(E) no more than $1 when the last bid is $20.10 [$20-1/8] or more, provided that the Options Floor Trading Committee may establish differences other than the above for one or more series or classes of options.

(2) – No change.

(3) In the event the bid/ask differential in the underlying security is greater than the bid/ask differential set forth in subsection (b)(1), the permissible price differential for any in-the-money option series may be identical to those in the underlying security market. In the case of the at-the-money and out-of-the-money series, two Floor Officials may waive the requirements of subsection (b)(1) on a case-by-case basis when the bid/ask differential for the underlying security is greater than .50 [or 1/2 of a point]. In such instances, the bid/ask differentials for the at-the-money series and the out-of-the-money series may be half as wide as the bid/ask differential in the underlying security in the primary market. Whenever in the judgment of two Floor Officials the interest of maintaining a fair and orderly market so requires, those Floor Officials may waive the requirements of subsection (b)(2) on a case-by-case basis. Exemptions from subsections (b)(1) and (b)(2) are subject to Options Floor Trading Committee review.

(4) No change.

(c) No change.

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¶4987 "Crossing Orders"

Rule 6.47(b) – No change.

(1)– (2) – No change.

(3) – No change.

(4) Once a market has been established and all public customer orders represented in the trading crow have been satisfied, the Floor Broker may cross:

(A) forty percent (40%) of any remaining contracts at a price between the trading crowd's quoted market (e.g., if the trading crowd's quoted market is <u>2.10 – 2.50</u> [2-1/8 – 2½], and the Floor Broker is representing a customer order to buy 1000 contracts, then the Floor Broker may cross 40% of 1000 at any <u>2.25</u> [2-1/4] or any other improved price); or

(B) twenty-five percent (25%) of the contracts at the trading crowd's best bid or offer (e.g., if the trading crowd's quoted market is <u>2.10 – 2.50</u> [2-1/8 – 2-1/2], and the Floor Broker is representing a customer order to buy 1000 contracts, then the Floor Broker may cross 25% of 1000 at the trading crowd's offer.)

[No change to remainder of paragraph]

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¶ 5073 Trading Rotations

Rule 6.64(g) – No change.

Commentary:

.01 (a)–(b) – No change.

(c) If eligible market and marketable limit orders can be completely satisfied by trading against other orders in the Book, then the market may open between the established bid and ask prices, with no Market Maker participation. For example, if the market is 2 - 2.25 [or 2 – 2 ¼], with an order in the Book to sell 20 contracts at 2.10 [or 2-1/8], and there is a market order to buy 5 contracts, the single price opening will occur with 5 contracts trading at 2.10 [or 2-1/8]. The opening price will always be on or between the established bid and offer.

(d) If there is no trading increment available at the half-way point between the bid and offering prices (e.g., as in the case of a market of 2 bid, 2.10 [or 2-1/16] asked), then the opening price will be established at the price closest to the last sale price of option contracts in that series.

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¶5121 Trading Differentials

Rule 6.72(a). The Exchange has determined the minimum price variation ("MPV") for option contracts quoted on the Exchange. For those options issues that are quoted in decimals the MPV will be:

(1) For options issues that, prior to August 28, 2000, were quoted under $3.00 per contract: .05 MPV

(2) For equity issues that, prior to August 28, 2000, were quoted at $3.00 per contract or greater: .10 MPV

[Those options issues that continue to be quoted in fractions the MPVs will be, Bids and offers above $3 must be expressed in eighths of one dollar (e.g., 3 1/8) and bids and offers below $3 must be expressed in sixteenths of one dollar (e.g., 2 1/16).]

[This rule will govern the activity of all member and member organizations when their conduct relates to trading of issues quoted in decimals. However, this rule in no way diminishes the obligations of member and member organizations to abide by the current rules of the Exchange when their business activity relates to trading of issues quoted in fractions.]

Commentary:

.01 The Exchange may only change the trading differentials for option contracts traded on the Exchange by filing a rule change proposal with the SEC, pursuant to Section 19(b)(3)(A) of the Securities Exchange Act of 1934 (effective upon filing). [Provided that no change in the trading differentials may be made while the industry wide decimals implementation plan is in effect].

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¶ 5139 Priority of Bids and Offers

Rule 6.75(a)-(e) – No change.

Commentary:

.04 (a) – (e) – No change.

(f) If there is a Locked Book Market. The situation may occur when the only prices at which the order may be executed are equal to the Book's bids or offers for both series involved in the order. If those prices are the only prices at which the order may be executed, then the order will be given priority over the Book. For example, a Floor Broker enters the crowd with a spread order to sell XYZ April 20/July 20 call spread for a credit of 1. The Book's bids and offers for these two series are:

XYZ April 20: <u>.90 - 1.20</u> [15/16 – 1-1/6]

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¶ 5169 Accommodation Transactions

Rule 6.80 (i) – (vi) –No change.

Commentary

.01 An Order Book Official who receives a closing buy order for $1 per option contract shall attempt to execute the order against any $1 closing sell orders in his possession. If any part of the buy order cannot be immediately executed the Order Book Official shall display the $1 bid.

The Order Book Official shall effect all cabinet transactions by matching closing purchase or sale orders which have been placed in the cabinet or, provided there is no matching closing purchase or sale order in the cabinet by matching an open purchase or sale order.

Upon receiving a closing sell order for $1 per option contract the Order Book Official shall attempt to execute the order at the best price available. If any part of the sell order cannot be immediately executed the Order Book Official shall display the order as a $1 per option contract offering. However, since the market or a .10 [or 1/16] buy order may come to the market next, the $1 per contract closing sell order should be filed in time sequence with any order to sell at .10 [or 1/16]. This provides the ability to execute the closing sell order at $1 per contract if a $1 per contract buy order arrives next, or at .10 [or 1/16] if a market or .10 [or 1/16] buy order arrives next.

¶5329 Meaning of Premium Bids and Offers

Rule 7.9. Bids and offers shall be expressed in terms of dollars and cents [and fractions] per unit of the index [(e.g. a bid of 5-1/2 would represent a bid of $5.50 per unit)].

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¶5562 Terms of FLEX Options

Rule 8.102 (a)-(e) – No change.

(f) Special Terms for FLEX Equity Options

(4) Exercise prices and premiums may be stated in dollar amount<u>s</u> [or percentage of the price] of the underlying security, rounded to the nearest minimum tick or, in the case of exercise prices, to the nearest .10 [or one-eighth of a dollar].