



RULE
ADOPTION
NOTICE

RAN-02-12
May 24, 2002

TO: All PCX Members and Member Organizations

FROM: Department of Regulatory Policy

SUBJECT: Options Rules on Priority and Allocation of Orders
File No. SR-PCX-2002-13

On May 15, 2002, the Securities and Exchange Commission approved the PCX's rule proposal that amends existing rules on the priority of bids and offers on the Options Floor and the manner in which orders must be allocated in connection with options transactions on the Exchange.

Following is the text of the approved rule change. Questions regarding this bulletin may be directed to Michael Pierson at (415) 393-4107.

EXHIBIT A

PACIFIC EXCHANGE, INC.

RULES OF THE BOARD OF GOVERNORS

Text of the Rule Change¹

¶4935 Obligations of Market Makers

Rule 6.37(a) – (c) – No change.

(d) – No Change.

(e) Prohibited Practices and Procedures.

(1) – No Change

¹ New text is underscored.

(2) Any practice or procedure whereby Market Makers trading any particular option issue determine by agreement the allocation of orders that may be executed in that issue is prohibited.

¶5139

Priority of Bids and Offers

Rule 6.75 – No change.

(a) – (b) – No change.

Simultaneous Bids and Offers

(c) Except as otherwise provided, if the bids (or offers) of two or more members are made simultaneously, or if it is impossible to determine clearly the order of time in which they were made, such bids (or offers) will be deemed to be on parity and priority will be afforded to them, insofar as practicable, on an equal basis.

(d) – (e) [(c) – (d)]

Order Allocation Procedures

(f) Determination of Time Priority Sequence.

(1) Floor Brokers. A Floor Broker is responsible for determining the sequence in which bids or offers are vocalized on the Trading Floor in response to the Floor Broker's bid, offer or call for a market. Any disputes regarding a Floor Broker's determination of time priority sequence will be resolved by the Order Book Official, provided that such determinations of the Order Book Official are subject to further review by two Floor Officials, pursuant to Rule 6.77.

(2) When a Floor Broker's bid or offer has been accepted by more than one member, that Floor Broker must designate the members who were first, second, third and so forth. Except as provided below, the member with first priority is entitled to buy or sell as many contracts as the Floor Broker may have available to trade. If there are any contracts remaining, the member with second priority will be entitled to buy or sell as many contracts as there are remaining in the Floor Broker's order, and so on, until the Floor Broker's order has been filled entirely.

(3) Market Makers and Order Book Officials. A Market Maker is responsible for determining the sequence in which bids and offers are vocalized on the Trading Floor in response to that Market Maker's bid, offer or call for a market. Likewise, an Order Book Official is responsible for determining the sequence in which bids and offers are vocalized on the Trading Floor in response to the Order Book Official's bid, offer or call for a market. The order allocation

procedures for Market Makers and Order Book Officials, including the determination of time priority sequence, are the same as those for Floor Brokers as set forth in this Rule 6.75(f).

(4) LMM Guaranteed Participation.

(A) If the LMM establishes first priority during the vocalization process, the LMM will be entitled to buy or sell as many contracts as the Floor Broker may have available to trade. However, if the LMM does not establish first priority during the vocalization process, but does establish second, third or some other time priority sequence, the LMM will be entitled to buy or sell the number of contracts equal to the LMM's guaranteed participation level (pursuant to Rule 6.82(d)(2)) plus any contracts the Floor Broker has remaining after the bids or offers of other members with higher time priority have been satisfied.

(B) If one or more orders in the limit order book have priority over an LMM's bid or offer, then the LMM's guaranteed participation level will apply only to the number of contracts remaining *after* all contracts in the limit order book that are at, or better than, the LMM's bid or offer have first been satisfied.

(C) LMMs may waive some or all of their guaranteed participation on particular trades, but only to the extent that doing so is permissible under Rule 6.86 ("Firm Quotes"). In such circumstances, if the LMM has waived the right to trade a certain number of option contracts, those option contracts will then become available for execution by the member (or members) who are next in priority sequence. For example, assume that there are 100 contracts available to sell, the LMM has guaranteed participation on 25 contracts, and the time priority sequence is as follows: the LMM is first, Market Maker #1 is second and Market Maker #2 is third. If the LMM buys 20 contracts, the remaining 80 contracts will then be available for execution by Market Maker #1. If Market Maker #1 buys 40 of those contracts, then the remaining 40 contracts will be available for execution by Market Maker #2.

(D) LMMs may direct some or all of their guaranteed participation to competing public orders in the trading crowd pursuant to Rule 6.82(d).

(E) Bid and offering prices that are disseminated by an automatic quotation system are presumed to be the bid and offering prices of the LMM for purposes of Rule 6.86 ("Firm Quotes") and Rule 6.82(d)(2) ("Guaranteed Participation"). Nevertheless, LMMs must vocalize all of their bids and offers in response to a call for a market and in acceptance of another member's bid or offer. If a Floor Broker enters the trading crowd

and vocalizes acceptance of a bid or offer that is then being disseminated, the LMM will be entitled to guaranteed participation on that transaction.

(5) Parity Due to Simultaneous Bidding or Offering.

(A) If the bids or offers of more than one member are made simultaneously, such bids or offers will be deemed to be on parity and priority will be afforded to them, insofar as practicable, on an equal basis, pursuant to Rule 6.75(c). Accordingly, efforts will be made to assure that each member on parity receives an equal number of contracts, to the extent mathematically possible. One or more members on parity may waive their rights to some of their share (or shares) of contracts, but only to the extent that doing so is permissible under Rule 6.86 ("Firm Quotes"). In such circumstances the remaining number of contracts will be allocated, to the extent practicable, on an equal basis. However, an LMM who has received guaranteed participation on a transaction may not participate in the waived portion of the order unless there are contracts remaining to be allocated after all other members have been satisfied.

(B) If the bids and offers of more than one member, including the LMM, are on parity, then the LMM's guaranteed participation will first be applied to the entire order and the remainder of the order will be allocated, to the extent practicable, on an equal basis among the members other than the LMM who are on parity. The LMM may participate in such remainder of the order only if there are contracts remaining after all members other than the LMM have first been satisfied.

(C) If the LMM waives priority or guaranteed participation when the LMM and one or more other members are on parity, then the portion of the order that the LMM has waived will be made available to the other members who are on parity. For example, assume that there are 100 contracts available to trade, the LMM has guaranteed participation on 25 contracts, and two other members are on parity with the LMM. If the LMM waives guaranteed participation (but claims priority), the order will be divided into three shares (consisting of 34 contracts, 33 contracts and 33 contracts). If the LMM waives all rights to participate in the trade, the order will be divided among the two other members who are on parity, in equal shares, each comprising 50 contracts.

(6) Size Pro Rata Allocations

(A) If the members of the trading crowd provide a collective response to a member's request for a market in order to fill a large order, pursuant to Rule 6.37(f)(2), then:

(i) if the size of the trading crowd's market, in the aggregate, is less than or equal to the size of the order to be filled, the members of the trading crowd will each receive a share of the order that is equal to the size of their respective bids or offers; and

(ii) if the size of the trading crowd's market exceeds the size of the order to be filled, that order will be allocated on a size pro rata basis, with the members of the trading crowd each receiving, to the extent practicable, the percentage of the order that is the ratio of the size of their respective bids or offers to the total size of all bids or offers. Specifically, in such circumstances, the size of the order to be allocated is multiplied by the size of an individual market participant's quote divided by the aggregate size of all market participants' quotes. For example, assume there are 200 contracts to be allocated, Market Maker #1 is bidding for 100, Market Maker #2 is bidding for 200 and Market Maker #3 is bidding for 500. Under the "size pro rata" allocation formula, Market Maker #1 will be allocated 25 contracts ($200 \times 100 \div 800$); Market Maker #2 will be allocated 50 contracts ($200 \times 200 \div 800$); and Market Maker #3 will be allocated 125 contracts ($200 \times 500 \div 800$).

Com. .01 - .04 – No change.

Rule 6.76(a) – (b) – No change.

(a) Two or more members entitled to priority. If the bids or offers of two or more members are both entitled to priority in accordance with paragraph (a) or paragraph (b), it shall be afforded to them, insofar as practicable, on an equal basis.

Com. .01 – No change.

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LEAD MARKET MAKERS

Rule 6.82(a) – (c) – No change.

(d) Rights of Lead Market Makers

(1) – No change.

(2) *Guaranteed Participation*. Except as provided in subsections (A) and (B), below, LMMs shall be allocated 50% participation (or such lesser percentage as the Options Allocation Committee may establish as a condition in allocating an issue to an LMM) in transactions occurring at their disseminated bids and/or

offers in their allocated issue(s). LMM participation may be greater than 50% as a result of successful competition by means of “public outcry.” LMMs at their own discretion may direct some or all of their participation to competing public orders in the crowd. Public orders placed in the book shall take priority pursuant to Exchange rules. Oversight and enforcement shall be the responsibility of the OBO.

(A) – (C) – No change.

(e) - (h)(1) – No change.

(2) LMM Performance of Market Maker Function

(a) LMMs must perform all obligations provided in Rules 6.35 through 6.40 and 6.82(c). In addition, in executing transactions for their own accounts as Market Makers, LMMs ~~shall~~ have a right to participate ~~pro-rata~~ with the trading crowd in trades that take place at the LMM’s principal bid or offer, pursuant to the priority rules set forth in Rule 6.75.

(2) – No change.

Commentary:

.01 - .03 – No change.