



RULE
ADOPTION
NOTICE

RAN-02-13
May 30, 2002

TO: All PCX Members and Member Organizations

FROM: Department of Regulatory Policy

SUBJECT: Auto-Ex Procedures for Unusual Market Activity
File No. SR-PCX-2001-13

On May 15, 2002, the Securities and Exchange Commission approved the PCX's rule proposal that describes circumstances and Exchange procedures for disengaging the Exchange's Automatic Execution System for Options ("Auto-Ex") and increasing or decreasing Auto-Ex order size. The rule changes also establish circumstances and procedures for declaring away markets unreliable.

Following is the text of the approved rule change. Questions regarding this bulletin may be directed to Cindy Sink at (415) 393-7926.

EXHIBIT A

Text of the Rule Change:¹

PACIFIC EXCHANGE, INC.

RULES OF THE BOARD OF GOVERNORS

Rule 6.28 (a)-(b) - No change.

(c)(1)-(5) - No change.

¹ New text is underscored; deleted text in brackets.

(6) Suspend the Automatic Execution System (“Auto-Ex”) pursuant to Rule 6.87(h)(3)(B). [for a period of time not to exceed five minutes if, because of an influx of orders or unusual market conditions or circumstances, the Floor Officials determine that such action is appropriate in maintaining a fair and orderly market. Whenever such action is taken, Floor Officials or senior Exchange Staff must immediately notify a Floor Governor. Thereafter, the suspension of Auto-Ex may be ended, or may be continued for more than five minutes, based on a determination of two Floor Officials and one Floor Governor (or a senior operations officer if no Floor Governor is available), with a 2/3 majority prevailing.]

(7) - No change.

(8) The Exchange may increase the permissible size of orders that may be automatically executed over the Auto-Ex system pursuant to Rule 6.87(h)(3)(C). [to up to 50 contracts, to be effected on a case-by-case basis in a particular option issue, or for all option issues, when two floor officials and one Floor Governor deem such an increase to be appropriate. Pursuant to this Rule, the ability to execute order of up to 50 contracts will only occur during high volume or high volatility emergency situations. At all other times, the order size for Auto-Ex will remain to be the number of contracts permitted under Rule 6.87.]

* * *

Rule 6.87

(a)-(g) - No change.

(h) Suspension and Unusual Use of Auto-Ex.

(1) *Floor-Wide POETS System Malfunction.* - No change.

(2) *Non-Floor-Wide POETS System Malfunction.* If POETS is inoperable and Market Makers are physically unable to update their quotations in an issue or issues at the same trading post or trading quad, two Floor Officials may declare a "fast market" and direct the OBO to turn off the Auto-Ex system in the affected issue or issues. Once the system malfunction has been corrected, two Floor Officials may re-start Auto-ex. If a POETS malfunction occurs but the Exchange is able to process and disseminate quotes accurately, two Floor Officials may decrease the guaranteed Auto-Ex size in one or more option issues pursuant to the procedures set forth in subsection (h)(3)(B).

(3) *Other Unusual Conditions.*

(A) Unusual Market Conditions. The unusual market conditions that may permit increasing or decreasing the size of orders that may be automatically executed over the Auto-Ex or suspending Auto-Ex pursuant to subsections (B) and (C) are caused by news announcements (e.g. announcements relating to earnings speculation, economic news, reports of mergers or takeovers, disasters, etc.). Unusual market conditions that would permit unusual use of Auto-Ex

under this Rule include:

(i) High Volatility. High volatility occurs generally when a stock or the entire market is experiencing rapid and extreme price fluctuations usually accompanied by doublewide spreads.

(ii) Large Influx of Orders. A large influx of orders occurs when volume is two or more times the average daily volume in an issue. It may also occur when an extraordinarily large options order is executed on the PCX and reported.

(iii) Unreliable Quote Feed. The underlying quote feed is unreliable when the Exchange is unable to accurately collect, process and/or disseminate quotation data.

(B) Suspension of Auto-Ex. If there are other unusual market conditions not involving a POETS System malfunction, two Floor Officials may suspend Auto-Ex [in accordance with Rule 6.82(b).] for a period of time not to exceed five minutes if, because of unusual market conditions or circumstances, the Floor Officials determine that such action is appropriate in maintaining a fair and orderly market. Whenever such action is taken, Floor Officials or senior Exchange Staff must immediately notify a Floor Governor. Thereafter, the suspension of Auto-Ex may be ended, or may be continued for more than five minutes, based on a determination of two Floor Officials and one Floor Governor (or a senior operations officer if no Floor Governor is available), with a 2/3 majority prevailing.

(C) Unusual use of Auto Ex. Two Floor Officials may increase the size of orders that may be automatically executed over the Auto-Ex system up to 100 contracts or decrease the size of orders eligible for automatic execution in one or more option issues when they believe that unusual market conditions exist, provided that the decision is made for no more than one trading day. To the extent the conditions exist on the following trading day, two Floor Officials must review the situation again and make an independent decision of whether to increase or decrease the Auto-Ex eligible order size for that subsequent day. Any decisions made by two Floor Officials to increase or decrease the Auto-Ex eligible order size for a particular option issue for two or more consecutive days will be reviewed by the Options Floor Trading Committee at its next regularly scheduled meeting. Whenever two Floor Officials decrease the size of orders eligible for automatic execution, the lowest number of contracts that may be established is five.

(D) Any suspension or unusual use of Auto-Ex must be documented pursuant to Rule 6.87(n).

(4) Declaring Away Markets Unreliable. When a Floor Official determines that quotes from one or more particular markets in one or more options series are not reliable, the Floor Official may direct the senior person in charge of the Exchange's control room to exclude the unreliable quotes from the Auto-Ex determination of the NBBO in the particular options series.

(A) Determining Unreliability. A Floor Official may determine that quotes in one or more particular options classes in a market are not reliable only under the following circumstances:

(i) A market's quotes in a particular options class are not firm based upon direct communication to the Exchange from the market or the dissemination through OPRA of a message indicating that disseminated quotes are not firm; or

(ii) A market has directly communicated to the Exchange or otherwise confirmed that the market is experiencing systems or other problems affecting the reliability of its disseminated quotes.

(B) Procedures to Follow. If one of the factors set forth in subsection (4)(A) occurs, then the following procedures must be followed.

(i) First, an LMM contacts an Order Book Official ("OBO") and requests that the away market be declared unreliable.

(ii) Second, the OBO contacts the control room and requests that the control room confirm with the away market that it is unreliable pursuant to subsection (4)(A).

(iii) Third, if the control room has confirmed that an away market is unreliable, then the OBO will contact a Floor Official and request a declaration that the away market is unreliable.

(iv) Fourth, the Floor Official reviews and verifies the circumstances and determines whether away market should be declared unreliable. The OBO notifies the control room that the away market is unreliable and should be removed from the NBBO calculation.

(v) Fifth, the Floor Surveillance Unit ("FSU") contacts the away exchange, and notifies the away market that one or more of its quotes have been removed from the NBBO calculation.

(vi) Sixth, the Floor Official will continue to monitor the away market that has been declared unreliable and notify the control room to return to firm mode when appropriate.

(C) Documentation Required. The following documentation is required when an away market is declared unreliable.

(i) The OBO must log the issues(s) and time of the LMM's request for a declaration that the away market was unreliable.

(ii) The OBO must prepare an Unusual Activity Report (“UAR”) documenting the facts giving rise to the LMM’s request, the date, time, and duration of the exclusion and the reasons for placing the away market back into the NBBO calculation.

(iii) The Floor Official must sign the UAR.

(iv) The control room will maintain a log of the time the away market was taken out of the NBBO calculation and the time that the away market was placed back into the NBBO calculation.

(D) Duration of the Declaration. Any determination to exclude a market or any of its quotes from the Auto-Ex determination of the NBBO pursuant to subsections (4)(A)(i) or (ii) will expire at the end of the trading day, or at the time that the quotes are confirmed by the market to be reliable again, whichever occurs first. Exclusion of a market or its quotes from the Auto-Ex determination of the NBBO will be reported to Exchange member firms.

(i)-(m) - No change.

(n) Documentation of Auto-Ex Use. The Exchange will document any action taken to suspend Auto-Ex, increase or decrease the size of Auto-Ex eligible orders or to operate Auto-Ex in a manner other than the usual manner with an Unusual Activity Report (UAR). The UAR will be signed by two Floor Officials and will state the system problem or market activity that led to the Floor Officials’ ruling. The UAR information will be recorded in the Floor Surveillance log, which will document the option issues affected by the action, the time the action was taken, the Exchange officials who undertook the action, and the reasons why the action was taken.