



RULE
ADOPTION
NOTICE

RAN-03-04
February 7, 2003

TO: All PCX Members and Member Organizations
FROM: Department of Regulatory Policy
SUBJECT: Options Linkage
(File No. SR-PCX-2002-64)

On January 31, 2003, the Securities and Exchange Commission granted an Order approving a proposed rule change by the Exchange relating to rules governing the Intermarket Linkage Plan ("Plan"). The rules, effective immediately, provide for an options intermarket communications linkage for the purpose of linking the various options markets in the U.S. The purpose of the Plan and related Options Linkage rules is to enable the options exchanges to establish and implement Linkage consistent with the objectives set forth in section 11A of the Exchange Act. In general, the proposed rules contain relevant definitions, establish the conditions pursuant to which market makers may enter Linkage orders, impose obligations on the Exchange regarding how it must process incoming Linkage orders, and establish a general standard that members should avoid trade-throughs.

The following is the text of the rule change and Amendment No. 1. Questions regarding this bulletin may be directed to Mai Shiver at (415) 393-4266.

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EXHIBIT A

Text of the Rule Change:¹

INTERMARKET LINKAGE

Definitions

Rule 6.92(a). The following terms have the meaning specified in this Rule solely for the purposes of Rules 6.92 – 6.95.

(1) "Aggrieved Party" means a Member of a Participant Exchange whose bid or offer was traded-through.

(2) "Block Trade" means a trade on a Participant Exchange that:

(i) involves 500 or more contracts and has a premium value of at least \$150,000;

(ii) is effected at a price outside of the NBBO; and

(iii) involves either:

(A) a cross (where a Member of the Participant Exchange represents all or a portion of both sides of the trade), or

(B) any other transaction (i.e., in which such Member represents an order of block size on one side of the transaction only) that is not the result of an execution at the current bid or offer on the Participant Exchange.

Contemporaneous transactions at the same price on a Participant Exchange will be considered a single transaction for the purpose of this definition.

(3) "Broker/Dealer" means an individual or organization registered with the United States Securities and Exchange Commission in accordance with Section 15(b)(1) of the Exchange Act or a foreign broker or dealer exempt from such registration pursuant to Rule 15a-6 under the Exchange Act.

(4) "Complex Trade" means the execution of an order in an option series in conjunction with the execution of one or more related orders in different option series in the

¹ New text is underscored.

same underlying security occurring at or near the same time for the equivalent number of contracts and for the purpose of executing a particular investment strategy.

(5) "Crossed Market" means a quotation in which the Exchange disseminates a bid (or offer) in a series of an Eligible Option Class at a price that is greater than (or less than) the price of the offer (or bid) for the series then being displayed by another Participant Exchange.

(6) "Customer" means an individual or organization that is not a Broker/Dealer. Used with reference to a Linkage Order, it means an order which, if executed, would result in the purchase or sale for an account in which no Broker/Dealer has an interest.

(7) "Eligible Market Maker," with respect to an Eligible Option Class, means a market maker that:

(i) is assigned to, and is providing two-sided quotations in, the Eligible Option Class;

(ii) is logged on to participate in Auto-Ex in such Eligible Option Class;
and

(iii) is in compliance with the requirements of Rule 6.95 (relating to limitation on principal order access).

(8) "Eligible Option Class" means all option series overlying a security (as that term is defined in Section 3(a)(10) of the Exchange Act) or group of securities, including both put options and call options, which class is traded on the Exchange and at least one other Participant Exchange.

(9) "Firm Customer Quote Size" with respect to a P/A Order means the lesser of (a) the number of option contracts that the Participant Exchange sending a P/A Order guarantees it

will automatically execute at its disseminated quotation in a series of an Eligible Option Class for Customer orders entered directly for execution in that market; or (b) the number of option contracts that the Participant Exchange receiving a P/A Order guarantees it will automatically execute at its disseminated quotation in a series of an Eligible Option Class for Customer orders entered directly for execution in that market. This number will be at least 10.

(10) "Firm Principal Quote Size" means the number of option contracts that a Participant Exchange guarantees it will execute at its disseminated quotation for incoming Principal Orders in an Eligible Option Class. This number will be at least 10.

(11) "Linkage" means the systems and data communications network that link electronically the Participant Exchanges for the purposes specified in the Plan.

(12) "Linkage Order" means an order routed through the Linkage as permitted under the Plan. There are three types of Linkage Orders:

(i) "Principal Acting as Agent ("P/A") Order," which is an order for the principal account of a Lead Market Maker (or equivalent entity on another Participant Exchange that is authorized to represent Customer orders), reflecting the terms of a related unexecuted Customer order for which the Lead Market Maker is acting as agent;

(ii) "Principal Order," which is an order for the principal account of an Eligible Market Maker (or equivalent entity on another Participant Exchange) and is not a P/A Order; and

(iii) "Satisfaction Order," which is an order sent through the Linkage to notify a Participant Exchange of a Trade-Through and to seek satisfaction of the liability arising from that Trade-Through.

(13) "Locked Market" means a quotation in which the Exchange disseminates a bid (or offer) in a series of an Eligible Option Class at a price that equals the price of the offer (or bid) for the series then being displayed from another Participant Exchange.

(13A) "Member" has the meaning as set forth in Section (3)(a)(3)(A) of the Exchange Act.

(14) "NBBO" means the national best bid and offer in an option series as calculated by a Participant Exchange.

(15) "Non-Firm" means, with respect to quotations, that Members of a Participant Exchange are relieved of their obligation to be firm for their quotations pursuant to Rule 11Ac1-1 under the Exchange Act.

(16) "Participant Exchange" means a registered national securities exchange that is a party to the Plan.

(17) "Plan" means the Plan for the Purpose of Creating and Operating an Intermarket Option Linkage, as such plan may be amended from time to time.

(18) "Reference Price" means the limit price attached to a Linkage Order by the sending Participant Exchange. Except with respect to a Satisfaction Order, the Reference Price is equal to the bid disseminated by the receiving Participant Exchange at the time that the Linkage Order is transmitted in the case of a Linkage Order to sell and the offer disseminated by the receiving Participant Exchange at the time that the Linkage Order is transmitted in the case of a Linkage Order to buy. With respect to a Satisfaction Order, the Reference Price is the bid or offering price disseminated by the sending Participant Exchange that was traded-through, except

in the case of a Trade-Through that is a Block Trade, in which case the Reference Price will be the price of the Block Trade that caused the Trade-Through.

(19) "Trade-Through" means a transaction in an option series at a price that is inferior to the NBBO.

(20) "Third Participating Market Center Trade-Through" means a Trade-Through in a series of an Eligible Option Class that is effected by executing a Linkage Order, and such execution results in a sale (or purchase) at a price that is inferior to the best bid (or offer) being disseminated by another Participant Exchange.

(21) "Verifiable Number of Customer Contracts" means the number of Customer contracts in the book of a Participant Exchange.

Operation of the Linkage

Rule 6.93 By subscribing to the Plan, the Exchange has agreed to comply with, and enforce compliance by its Members with, the Plan. In this regard, the following will apply:

(a) Pricing. Members may send P/A Orders and Principal Orders through the Linkage only if such orders are priced at the NBBO.

(b) P/A Orders.

(1) Sending of P/A Orders for Sizes No Larger than the Firm Customer Quote Size. A Lead Market Maker may send through the Linkage a P/A Order for execution in the automatic execution system of a Participant Exchange if the size of such P/A Order is no larger than the Firm Customer Quote Size. Except as provided in subparagraph (b)(2)(ii) below, an LMM may not break up an order of a Customer that is

larger than the Firm Customer Quote Size into multiple P/A Orders, one or more of which is equal to or smaller than the Firm Customer Quote Size, so that such orders could be represented as multiple P/A Orders through the Linkage.

(2) *Sending of P/A Orders for Sizes Larger than the Firm Customer Quote Size.* If the size of a P/A Order is larger than the Firm Customer Quote Size, a Lead Market Maker may send through the Linkage such P/A Order in one of two ways:

(i) The Lead Market Maker may send a P/A Order representing the entire Customer Order. If the receiving Participant Exchange's disseminated quotation is equal to or better than the Reference Price when the P/A Order arrives at that market, that exchange will execute the P/A Order at its disseminated quotation for at least the Firm Customer Quote Size. Within 15 seconds of receipt of such order, the receiving Participant Exchange will inform the Lead Market Maker of the amount of the order executed and the amount, if any, that was canceled.

(ii) Alternatively, the Lead Market Maker may send an initial P/A Order for the Firm Customer Quote Size pursuant to subparagraph (b)(1) above. If the Participant Exchange executes the P/A Order and continues to disseminate the same quotation at the NBBO 15 seconds after reporting the execution of the initial P/A Order, the Lead Market Maker may send an additional P/A Order to the same Participant Exchange. If sent, such additional P/A Order must be for at least the lesser of 100 contracts or the entire remainder of the Customer order.

In any situation where a receiving Participant Exchange does not execute a P/A Order in full, such exchange will be required to move its quotation to a price inferior to the Reference Price of the P/A Order.

(c) Principal Orders.

(1) Sending of an Initial Principal Order. An Eligible Market Maker may send a Principal Order through the Linkage at a price equal to the NBBO. If the Principal Order is not larger than the Firm Principal Quote Size, the receiving Participant Exchange will execute the order in its automatic execution system, if available, if its disseminated quotation is equal to or better than the price specified in the Principal Order when that order arrives at the receiving Participant Exchange. If the Principal Order is larger than the Firm Principal Quote Size, the receiving Participant Exchange will (a) execute the Principal Order at its disseminated quotation for at least the Firm Principal Quote Size and (b) within 15 seconds of receipt of such order, reply to the sending Participant Exchange, informing such Participant Exchange of the amount of the order that was executed and the amount, if any, that was canceled. If the receiving Participant Exchange does not execute the Principal Order in full, it will move its quote to a price inferior to the Reference Price of the Principal Order.

(2) Receipt of Multiple Principal Orders. Once the Exchange provides an automatic execution of a Principal Order in a series of an Eligible Option Class (the “initial execution”), the Exchange may reject any Principal Order(s) in the same Eligible Option Class sent by the same Participant Exchange for 15 seconds after the initial execution unless: (a) there is a change of price in the Exchange’s disseminated offer (bid) in the series of the Eligible Option Class in which there was the initial execution; and (b) such price continues to be the NBBO. After this 15 second period, and until the sooner of (y) one minute after the initial execution or (z) a change in the Exchange’s disseminated bid (offer), the Exchange is not obligated to provide an automatic execution for any Principal

Orders in the same Eligible Option Class received from the Participant Exchange that sent the order resulting in the initial execution, and thus may treat any such Principal Orders as being greater than the Firm Principal Quote Size.

(d) Responses to Linkage Orders.

(1) Failure to Receive a Timely Response. A Member who does not receive a response to a P Order or a P/A Order within 20 seconds of sending the order may reject any response received thereafter purporting to report an execution of all or part of that order. The Member so rejecting the response will inform the Exchange Participant sending that response of the rejection within 15 seconds of receipt of the response.

(2) Failure to Send a Timely Response. If a Member responds to a P Order or P/A Order more than 20 seconds after receipt of that order, and the Participant Exchange to whom the Member responded cancels such response, the Member will cancel any trade resulting from such order and will report the cancellation to OPRA.

(e) Receipt of Linkage Orders. The Exchange will provide for the execution of P/A Orders and Principal Orders if its disseminated quotation is (i) equal to or better than the Reference Price, and (ii) equal to the then-current NBBO. Subject to paragraph (c), above, if the size of a P/A Order or Principal Order is not larger than the Firm Customer Quote Size or Firm Principal Quote size, respectively, the Exchange will provide for the execution of the entire order, and will execute such order in its automatic execution system if that system is available. If the size of a P/A Order or Principal Order is larger than the Firm Customer Quote Size or Firm Principal Quote Size, respectively, the Lead Market Maker must address the order within 15 seconds to provide an execution for at least the Firm

Customer Quote Size or Firm Principal Quote Size, respectively. If the order is not executed in full, the Exchange will move its disseminated quotation to a price inferior to the Reference Price.

Order Protection

Rule 6.94 (a) Avoidance and Satisfaction of Trade-Throughs.

(1) General Provisions. Absent reasonable justification and during normal market conditions, Members should not effect Trade-Throughs. Except as provided in paragraph (b) below, if a Member effects a Trade-Through with respect to the bid or offer of a Participant Exchange in an Eligible Option Class and the Exchange receives a Satisfaction Order from an Aggrieved Party, either:

(i) the Member who initiated the Trade-Through must satisfy, or cause to be satisfied, the Aggrieved Party by filling the Satisfaction Order in accordance with subsection (a)(2) below; or

(ii) if the Member elects not to do so (and, in the case of Third Participating Market Center Trade-Through, the Member obtains the agreement of the contra party that received the Linkage Order that caused the Trade-Through), then the price of the transaction that constituted the Trade-Through will be corrected to a price at which a Trade-Through would not have occurred. If the price of the transaction is corrected, the Member correcting the price must report the corrected price to OPRA, notify the aggrieved party of the correction and cancel the Satisfaction Order.

(2) Price and Size. The price and size at which the Satisfaction Order will be filled are as follows:

(i) Price. A Satisfaction Order will be filled at the Reference Price. However, if the Reference Price is the price of an apparent Block Trade that caused the Trade-Through, and such trade was not, in fact, a Block Trade, then the Member may cancel the Satisfaction Order. In that case, the Member will inform the Aggrieved Party within three minutes of receipt of the Satisfaction Order of the reason for the cancellation. Within three minutes of receipt of such cancellation, the Aggrieved Party may resend the Satisfaction Order with a Reference Price of the bid or offer that was traded-through.

(ii) Size. An Aggrieved Party may send a Satisfaction Order up to the size of the Verifiable Number of Customer Contracts that were included in the disseminated bid or offer that was traded through. Subject to subparagraph (2)(i) above and paragraph (b) below, a Member will fill in full all Satisfaction Orders it receives following a Trade-Through, subject to the following limitations:

(A) If the number of contracts to be satisfied exceeds the size of the transaction that caused the Trade-Through, the size of the Satisfaction Order(s) that must be filled with respect to each Participant Exchange(s) will be limited to the size of the transaction that caused the Trade-Through, and the remainder of any Satisfaction Order(s) will be canceled;

(B) If the transaction that caused the Trade-Through was for a size larger than the Firm Customer Quote Size with respect to any of the Participant Exchange(s) traded through, the total number of contracts to be filled, with respect to all Satisfaction Orders received, will not exceed the size of the transaction that caused the Trade-Through. In that case, the

Member will fill the Satisfaction Orders pro rata based on the Verifiable Number of Customer Contracts traded through on each Participant Exchange, and will cancel the remainder of such Satisfaction Order(s); and

(C) Notwithstanding paragraphs (A) and (B) above, if the transaction that caused the Trade-Through occurred during the five minutes prior to the regularly-scheduled close of trading in the principal market in which the underlying security is traded, the maximum number of contracts to be satisfied with respect to any one Participant Exchange is 10 contracts.

(3) Rejection of Fills of Satisfaction Orders. Within 30 seconds of receipt of notification that another Participant Exchange has filled a Member's Satisfaction Order, the Member that sent the Satisfaction Order may reject such fill, but only to the extent that either: (i) the order(s) for the customer contracts underlying the Satisfaction Order already have been filled; or (2) the customer order(s) to buy (sell) the contracts underlying the Satisfaction Order were canceled.

(4) Protection of Customers. Whenever subsection (a)(1) applies, if Customer orders (or P/A Orders representing Customer orders) constituted either or both sides of the transaction involved in the Trade-Through, each such Customer order (or P/A Order) will receive:

(i) the price that caused the Trade-Through; or

(ii) the price at which the bid or offer traded through was satisfied, if it was satisfied pursuant to subsection (a)(1)(i), or the adjusted price, if there was an adjustment, pursuant to subsection (a)(1)(ii),

whichever price is most beneficial to the Customer order. Resulting differences in prices will be the responsibility of the Member who initiated the Trade-Through.

(b) *Exceptions to Trade-Through Liability.* The provisions of subsection (a) pertaining to the satisfaction of Trade-Throughs will not apply under the following circumstances:

(1) the Member who initiated the Trade-Through made every reasonable effort to avoid the Trade-Through, but was unable to do so because of a systems/equipment failure or malfunction;

(2) the Member traded through the market of a Participant Exchange to which such Member had sent a P/A Order or Principal Order, and within 20 seconds of sending such order the receiving Participant Exchange had neither executed the order in full nor adjusted the quotation traded through to a price inferior to the Reference Price of the P/A Order or Principal Order;

(3) the bid or offer traded through was being disseminated from a Participant Exchange whose quotes were Non-Firm with respect to such Eligible Option Class;

(4) the Trade-Through was other than a Third Participating Market Center Trade-Through and occurred during a period when, with respect to the Eligible Option Class, the Exchange's quotes were Non-Firm; provided, however, that unless one of the other conditions of this subsection (b) applies, during any such period: (i) Members must make every reasonable effort to avoid trading through the firm quotes of another Participant Exchange; and (ii) it will not be considered

an exception to paragraph (a) if a Member regularly trades through the firm quotes of another Participant Exchange during such period;

(5) the bid or offer traded through was being disseminated by a Participant Exchange during a trading rotation in the Eligible Option Class;

(6) the transaction that caused the Trade-Through occurred during a trading rotation;

(7) the transaction that caused the Trade-Through was the execution of a Complex Trade;

(8) in the case of a Trade-Through other than a Third Participating Market Center Trade-Through, a Satisfaction Order with respect to the Trade-Through was not received by the Exchange from the Aggrieved Party promptly following the Trade-Through and, in any event, (i) except in the final five minutes of trading, within three minutes from the time the report of the transaction(s) that constituted the Trade-Through was disseminated over OPRA, and (ii) in the final five minutes of trading, within one minute from the time the report of the transaction(s) that constituted the Trade-Through was disseminated over OPRA; or

(9) in the case of a Third Participating Market Center Trade-Through, a Satisfaction Order with respect to the Trade-Through was not received by the Exchange promptly following the Trade-Through. In applying this provision, the Aggrieved Party must send the Exchange a Satisfaction Order within three minutes from the time the report of the transaction that constituted the Trade-Through was disseminated over OPRA. To avoid liability for the Trade-Through, the Member receiving such Satisfaction Order must cancel the Satisfaction Order and inform the

Aggrieved Party of the identity of the Participant Exchange that initiated the Trade-Through within three minutes of the receipt of such Satisfaction Order (within one minute in the final five minutes of trading). The Aggrieved Party then must send the Participant Exchange that initiated the Trade-Through a Satisfaction Order within three minutes of receipt of the cancellation of the initial Satisfaction Order (within one minute in the final five minutes of trading).

(c) Responsibilities and Rights Following Receipt of Satisfaction Orders.

(1) When a Member receives a Satisfaction Order, that Member must respond as promptly as practicable pursuant to Exchange procedures by either:

(i) specifying that one of the exceptions to Trade-Through liability specified in paragraph (b) above is applicable and identifying that particular exception; or

(ii) taking the appropriate corrective action pursuant to paragraph (a) above.

(2) If the Member who initiated the Trade-Through fails to respond to a Satisfaction Order or otherwise fails to take the corrective action required under paragraph (a) within three minutes of receiving notice of a Satisfaction Order, and the Exchange determines that:

(i) there was a Trade-Through; and

(ii) none of the exceptions to Trade-Through liability specified in subsection (b) above were applicable;

then, subject to the next paragraph, the Member who initiated the Trade-Through will be liable to the Aggrieved Party for the amount of the actual loss resulting from non-compliance with paragraph (a) and caused by the Trade-Through.

If either (a) the Aggrieved Party does not establish the actual loss within 30 seconds from the time the Aggrieved Party received the response to its Satisfaction Order (or, in the event that it did not receive a response, within four minutes from the time the Aggrieved Party sent the Satisfaction Order) or (b) the Aggrieved Party does not notify the Exchange Participant that initiated the Trade-Through of the amount of such loss within one minute of establishing the loss, then the liability will be the lesser of the actual loss or the loss caused by the Trade-Through that the Aggrieved Party would have suffered had that party purchased or sold the option series subject to the Trade-Through at the "mitigation price."

The "mitigation price" is the highest reported bid (in the case where an offer was traded through) or the lowest reported offer (in the case where a bid was traded through), in the series in question 30 seconds from the time the Aggrieved Party received the response to its Satisfaction Order (or, in the event that it did not receive a response, four minutes from the time the Aggrieved Party sent the Satisfaction Order). If the Participant Exchange receives a Satisfaction Order within the final four minutes of trading (on any day except the last day of trading prior to the expiration of the series which is the subject of the Trade-Through), then the mitigation price will be the price established at the opening of trading in that series on the Aggrieved Party's Participant Exchange on the next trading day. However, if the price of the opening transaction is below the opening bid or above the opening

offer as established during the opening rotation, then the mitigation price will be the opening bid (in the case where an offer was traded through) or opening offer (in the case where a bid was traded through). If the Trade-Through involves a series that expires on the day following the day of the Trade-Through and the Satisfaction Order is received within the four minutes of trading, the "mitigation price" will be the final bid (in the case where an offer was traded through) or offer (in the case where a bid was traded through) on the day of the trade that resulted in the Trade-Through.

(3) A Member that is an Aggrieved Party under the rules of another Participant Exchange governing Trade-Through liability must take steps to establish and mitigate any loss such Member might incur as a result of the Trade-Through of the Member's bid or offer. In addition, the Member must give prompt notice to the other Participant Exchange of any such action in accordance with subsection (c)(2) above.

(d) *Limitations on Trade-Throughs.* Members may not repeatedly trade through better prices available on other exchanges, whether or not the exchange or exchanges whose quotations are traded through are Participant Exchanges, unless one or more of the provisions of paragraph (b) above are applicable. In applying this provision:

(1) The Exchange will consider there to have been a Trade-Through if a Member executes a trade at a price inferior to the NBBO even if the Exchange does not receive a Satisfaction Order from an Aggrieved Party pursuant to subparagraph (a)(1);

(2) The Exchange will not consider there to have been a Trade-Through if a Member executes a Block Trade at a price inferior to the NBBO if such Member satisfied all Aggrieved Parties pursuant to subsection (a)(2) following the execution of the Block Trade; and

(3) The Exchange will not consider there to have been a Trade-Through if a Member executes a trade at a price inferior to the quotation being disseminated by an exchange that is not a Participant Exchange if the Member made a good faith effort to trade against the superior quotation of the non-Participant Exchange prior to trading through that quotation. A “good faith effort” to reach a non-Participant Exchange’s quotation requires that a Member at least had sent an order that day to the non-Participant Exchange in the class of options in which there is a Trade-Through, at a time at which such non-Participant Exchange was not relieved of its obligation to be firm for its quotations pursuant to Rule 11Ac1-1 under the Exchange Act, and that the non-Participant Exchange neither executed that order nor moved its quotation to a price inferior to the price of the Member’s order within 20 seconds of receipt of that order.

Locked and Crossed Markets

Rule 6.95 (a) *Eligible Market Maker Locking or Crossing a Market.* An Eligible Market Maker that creates a Locked Market or a Crossed Market will unlock (uncross) that market or will direct a Principal Order through the Linkage to trade against the bid or offer that the Eligible Market Maker locked (crossed).

(b) Members Other than an Eligible Market Maker Locking or Crossing a Market. A Member other than an Eligible Market Maker that creates a Locked Market or a Crossed Market will unlock (uncross) the market.

Limitation on Principal Order Access

Rule 6.96 A Market Maker will not be permitted to send Principal Orders in an Eligible Option Class through the Linkage for a given calendar quarter if the Market Maker effected less than 80 percent of its volume in that Eligible Option Class on the Exchange in the previous calendar quarter (that is, the Market Maker effected 20 percent or more of its volume by sending Principal Orders through the Linkage). This "80/20" is represented as follows:

$$\frac{X}{X+Y}$$

"X" equals the total contract volume the Market Maker effects in an Eligible Option Class against orders of Customers on the Exchange during a calendar quarter (a) including contract volume effected by executing P/A Orders sent to the Exchange through the linkage, but (b) excluding contract volume effected by sending P/A Orders through the Linkage for execution on another Participant Exchange. "Y" equals the total contract volume the Market Maker effects in such Eligible Option Class by sending Principal Orders through the Linkage during that calendar quarter.