



RULE
ADOPTION
NOTICE

RAN-03-24
September 30, 2003

TO: All PCX Members and Member Organizations
FROM: Department of Regulatory Policy
SUBJECT: Obvious Error
(File No. SR-PCX-2002-01)

On September 25, 2003, the Securities and Exchange Commission approved the proposed rule change relating to obvious errors for options transactions. The Commission has concluded that the new rule, included herein as Exhibit A, establishes specific and objective criteria for determining when a trade is an "obvious error." The rule also establishes specific and objective procedures governing the adjustment or nullification of such trades.

The following is the text of the rule change. You may direct questions regarding this bulletin to Mai Shiver at (415) 393-4266.

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Exhibit A

Text of the Rule Change¹

PACIFIC EXCHANGE, INC

RULES OF THE BOARD OF GOVERNORS

Rule 6.87 (g) Trade Nullification and Price Adjustment Procedures [Price Adjustments. Due to instantaneous execution, an incorrect quote appearing on a screen may result in an Auto-Ex trade at an incorrect price. An Auto-Ex trade executed at an erroneous quote should be treated as a trade reported at an erroneous price. The price of the Auto-Ex trade should be adjusted to reflect accurately the market quote at the time of execution. This will result in public customers and market makers receiving correct fills at prevailing market quotes through Auto-Ex.]

(1) Mutual Agreement: The determination as to whether an Auto-Ex trade was executed at an erroneous price may [is to] be made by mutual agreement of the affected parties to a particular transaction. A trade may be nullified or adjusted on the terms that all parties to a particular transaction agree. In the absence of mutual agreement by the

¹New text is underscored.

parties, a particular trade may only be nullified or adjusted when the transaction results from an Obvious Error as provided in this Rule. [two Floor Officials. In making their determination, the Floor Officials should consider such factors as:

(1) the length of time the allegedly incorrect quote was displayed;

(2) whether any non-Auto-Ex trades were effected at the same price as the Auto-Ex transaction; and

(3) whether any members of the trading crowd were aware of orders actively being represented in the trading crowd that appear to have been "printed through" by the Auto-Ex trade.]

(2) Obvious Error Subject to Trade Nullification or Price Adjustment: Absent mutual agreement as provided in Rule 6.87(g)(1), parties to a trade may have a trade nullified or its price adjusted if: (i) any such party makes a documented request within the time specified in Rule 6.87(g)(3); and (ii) one of the conditions below is met:

A. The trade resulted from a verifiable disruption or malfunction of an Exchange execution, dissemination, or communication system that caused a quote/order to trade in excess of its disseminated size (e.g. a quote/order that is frozen, because of an Exchange system error, and repeatedly traded) in which case trades in excess of the disseminated size may be nullified; or

B. The trade resulted from a verifiable disruption or malfunction of an Exchange dissemination or communication system that prevented a member from updating or canceling a quote/order for which the member is responsible where there is Exchange documentation providing that the member sought to update or cancel the quote/order; or

C. The trade resulted from an erroneous print disseminated by the underlying market which is later cancelled or corrected by the underlying market where such erroneous print resulted in a trade higher or lower than the average trade in the underlying security during the time period encompassing two minutes before and after the erroneous print, by an amount at least five times greater than the average quote width for such underlying security during the time period encompassing two minutes before and after the erroneous print. For purposes of this Rule, the average trade in the underlying security shall be determined by adding the prices of each trade during the four minute time period referenced above (excluding the trade in question) and dividing by the number of trades during such time period (excluding the trade in question); or

D. The trade resulted from an erroneous quote in the Primary Market (as defined in Rule 6.1(b)(27)) for the underlying security that has a width of at least \$1.00 and that width is at least five times greater than the average quote width for such underlying security during the time period encompassing two minutes before

and after the dissemination of such quote. For the purposes of this rule, the average quote width shall be determined by adding the quote widths of each separate quote during the four minute time period referenced above (excluding the quote in question) and dividing by the number of quotes during such time period (excluding the quote in question); or

E. The execution price of the trade is higher or lower than the mid-point of the Best Bid and Offer (among all of the exchanges other than the PCX) by an amount equal to at least the bid/ask spread provided in Rule 6.37(b)(1). The bid/ask spread set forth in Rule 6.37(b)(1) will also apply to LEAPS and options subject to unusual market conditions. In the event the bid/ask spread in the underlying is greater than the bid/ask spread set forth in Rule 6.37(b)(1), the Exchange will apply the bid/ask spread differential set forth in Rule 6.37 (b)(3).

F. The trade resulted in an execution price in a series quoted no bid and at least one strike price below (for calls) or above (for puts) in the same class were quoted no bid at the time of the erroneous execution.

G. The trade is automatically executed at a price where the Market Maker sells \$0.10 or more below parity. Parity describes an option contract's total premium when that premium is equal to its intrinsic value. Parity for calls is measured by reference to the offer price of the underlying security in the Primary Market at the time of the transaction minus the strike price for the call. Parity for puts is measured by reference to the strike price for the put minus the bid price of the underlying security in the Primary Market at the time of the transaction.

(3) Obvious Error Procedure. Two Floor Officials will administer the application of this Rule as follows:

A. Notification. If a Member on the Exchange believes that it participated in a transaction that was the result of an Obvious Error, it must notify two Floor Officials within five (5) minutes of the execution. If an Order Entry Firm representing a public customer believes an order it executed on the Exchange was the result of an Obvious Error, it must notify the Exchange within twenty (20) minutes of the execution. Absent unusual circumstances, two Floor Officials will not grant relief under this Rule unless notification is made within the prescribed time periods.

B. Adjust or Nullify. Two Floor Officials will determine whether the execution is subject to a trade nullification or price adjustment. If two Floor Officials determine that one of the conditions of Rule 6.87(g)(2) has been met and that the complaining party has timely documented a request for relief, then a trade will be adjusted or nullified as follows:

(1) Where each party to the transaction is a Market Maker on the Exchange, or the trade involves a limit order that may be adjusted to its limit, the Exchange will adjust the execution price of the transaction within ten (10) minutes of two Floor Officials making such determination. In such case, the adjusted price will be the last bid (offer) price, just prior to the trade, from the exchange providing the highest total contract volume in the option for the previous sixty (60) days with respect to an erroneous bid (offer) entered on the Exchange. If there is no quote for comparison purposes, then the adjusted price of an option will be determined by two Floor Officials; or

(2) Where at least one party to the transaction is not a Market Maker on the Exchange or where the trade does not involve a limit order that may be adjusted to its limit, the Exchange will nullify the transaction within ten (10) minutes of two Floor Officials making such determination.

(3) Upon taking final action, the two Floor Officials will promptly notify both parties to the trade.

Commentary:

.01 In no case will the two Floor Officials involved in an obvious error determination include a person related to a party to the trade in question.

.02 All determinations made by the two Floor Officials under subsection (g)(2) will be rendered without prejudice as to the rights of the parties to the transaction to submit a dispute to arbitration.

.03 Nothing in this rule prevents a potentially aggrieved party from appealing the decision of two Floor Officials pursuant to Rule 11 of the Exchange rules.