



RULE  
ADOPTION  
NOTICE

**RAN-03-31**  
**November 7, 2003**

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

**FROM: Department of Regulatory Policy**

**SUBJECT: Contrary Exercise Advices**  
**(File No. SR-PCX-2003-47)**

On October 16, 2003, the Securities and Exchange Commission Noticed the filing and immediate effectiveness of the PCX proposal to modify its contrary exercise advice (“CEA”) rule, PCX Rule 6.24. The new rule extends by one hour the time for which Members and Member Organizations may submit CEAs to the Exchange. The Rule became effective upon filing.

The following is the text of the rule change and Amendment Nos. 1–3 thereto. Questions regarding this bulletin may be directed to Mai Shiver at (415) 393-4266.

## **EXHIBIT A**

### **PACIFIC EXCHANGE, INC.**

#### **RULES OF THE BOARD OF GOVERNORS**

##### **Text of the Proposed Rule Change:<sup>1</sup>**

##### **Rule 6** **Options Trading**

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##### **Exercise of Option Contracts**

RULE 6.24. (a) [Subject to the restrictions set forth in Rule 6.9 and to such restrictions as may be imposed pursuant to Rule 6.11 or pursuant to the Rules of the Options Clearing

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<sup>1</sup> New text is underscored; deleted text is in brackets.

Corporation ("OCC"), an outstanding option contract may be exercised during the time period specified in the Rules of the OCC by the tender to the OCC of an exercise notice in accordance with the Rules of the OCC.] An outstanding option contract may be exercised by the tender to the Options Clearing Corporation ("OCC") of an exercise notice made during the periods, and using the procedures, specified in OCC rules. An exercise notice may be tendered to the OCC only by the clearing member in whose account such option contract is carried with the OCC. Option exercises are also subject to restrictions that are established by or may be imposed by the Exchange in Rules 6.9, 6.11 and in this rule. Members and Member Organizations may establish fixed procedures as to the latest time they will accept exercise instructions from customers.

(b) [The exercise cut-off time for all non-cash settled options shall be such hour on the business day immediately prior to the expiration date as may be fixed from time to time by the Exchange. The exercise cut-off time, as so fixed by a member organization or as established pursuant to the preceding sentence, shall also apply in respect of option contracts carried in any proprietary account of such member organization as the latest time at which such member organization, if it is a clearing member, shall tender exercise notices to the OCC, or if it is not a clearing member, shall issue exercise instructions to its clearing member. Notwithstanding the foregoing, member organizations may receive and members may submit exercise instructions and tender exercise notices after the exercise cut-off time but prior to expiration (i) in the case of option contracts carried in an account maintained for another member organization in which only positions of customers of such other member organization are carried, (ii) in order to remedy mistakes or errors made in good faith, (iii) to take appropriate action as the result of a failure to reconcile unmatched Exchange transactions, or (iv) where exceptional circumstances relating to a customer's ability to communicate exercise instructions to the member organization (or the member organization's ability to receive exercise instructions) prior to such cut-off time warrant such action. This subparagraph (b) is intended as a means of providing for relatively uniform procedures in respect of exercise instructions and not to alter or affect in any way the expiration times for an option contract which are fixed in accordance with the Rules of the OCC or any other provision of an option contract, and the exercise prior to expiration of an option contract in contravention of this subparagraph (b) shall neither affect the validity of such exercise nor modify or otherwise affect any right or obligation of any holder or writer of any option contract of such series of options. As used herein with respect to any member organization, the word "customer" shall mean every person other than the member organization.] Special procedures apply to the exercise of equity options on the last business day before their expiration ("expiring options"). Unless waived by OCC, expiring options are subject to the Exercise by Exception ("Ex-by-Ex") procedure under OCC Rule 805. This rule provides that, unless contrary instructions are given, option contracts that are in-the-money by specified amounts shall be automatically exercised. In addition to OCC rules, the following Exchange requirements apply with respect to expiring options. Option holders desiring to exercise or not exercise expiring options must either: (i) take no action and allow exercise determinations to be made in accordance with OCC's Ex-by-Ex procedures where applicable; or (ii) submit a "Contrary Exercise Advice" to the Exchange by the deadline specified in paragraph (c) below. A Contrary Exercise Advice is a communication either (A) to not exercise an option that would be automatically exercised under OCC's Ex-by-Ex procedure, or (B) to exercise an option that would not be automatically exercised under OCC's Ex-by-Ex procedure. A Contrary Exercise Advice may be submitted by a Member or Member Organization by using the Exchange's Contrary Exercise Advice Form, OCC's ENCORE System, a Contrary Exercise Advice form of

any other national securities exchange of which the firm is a Member and where the option is listed, or such other method as the Exchange may prescribe. A Contrary Exercise Advice may be canceled by filing an "Advice Cancel" with the Exchange or resubmitted at any time up to the submission cut-off times specified below.

(c) Exercise cut-off time. Option holders have until 2:30 p.m. (PST) on the business day immediately prior to the expiration date to make a final decision to exercise or not exercise an expiring option. For customer accounts, Members and Member Organizations may not accept exercise instructions after 2:30 p.m. (PST) but have until 3:30 p.m. (PST) to submit a Contrary Exercise Advice. For non-customer accounts, Members and Member Organizations may not accept exercise instructions after 2:30 p.m. (PST) but have until 3:30 p.m. (PST) to submit a Contrary Exercise Advice if such Member or Member Organization employs an electronic submission procedure with time stamp for the submission of exercise instructions by option holders. Consistent with Commentary .04, Members and Member Organizations are required to submit a Contrary Exercise Advice by 2:30 p.m. (PST) for non-customer accounts if such Members and/or Member Organization do not employ an electronic submission procedure with time stamp for the submission of exercise instructions by option holders.

(d) If OCC has waived the Ex-by-Ex procedure for an options class, Members and Member Organizations must either:

(i) submit to the Exchange, a Contrary Exercise Advice, in a manner specified by the Exchange, within the time limits specified in paragraph (c) above if the holder intends to exercise the option, or

(ii) take no action and allow the option to expire without being exercised.

The applicable underlying security price in such instances will be as described in OCC Rule 805(j). In cases where the Ex-by-Ex procedure has been waived, OCC rules require that Members and Member Organizations wishing to exercise such options must submit an affirmative Exercise Notice to OCC, whether or not a Contrary Exercise Advice has been filed with the Exchange.

(e) An Exchange Member Organization that has accepted the responsibility to indicate final exercise decisions on behalf of another Member or non-Member firm shall take the necessary steps to ensure that such decisions are properly indicated to the Exchange. Such Member Organization may establish a processing cut-off time prior to the Exchange's exercise cut-off time at which it will no longer accept final exercise decisions in expiring options from option holders for whom it indicates final exercise decisions. Each Member or Member Organization that indicates final exercise decisions through another broker-dealer is responsible for ensuring that final exercise decisions for all of its proprietary (including market maker) and public customer account positions are indicated in a timely manner to such broker-dealer.

(f) Members and Member Organizations may receive and submit final exercise decisions after the exercise cut-off time but prior to expiration without having submitted a Contrary Exercise Advice: (i) in order to remedy mistakes made in good faith; (ii) to take appropriate action as the result of a failure to reconcile unmatched Exchange option transactions; or (iii) where exceptional circumstances have restricted an option holder's ability to inform a

Member organization of a decision regarding exercise, or a Member organization's ability to receive an option holder's decision by the cut-off time. The burden of establishing any of the above exceptions rests solely on the Member or Member Organization seeking to rely on such exceptions.

(g) In the event the Exchange provides advance notice on or before 2:30 p.m. (PST) on the business day immediately prior to the last business day before the expiration date indicating that a modified time for the close of trading in equity options on such last business day before expiration will occur, then the deadline to make a final decision to exercise or not exercise an expiring option shall be 1 hour 28 minutes following the time announced for the close of trading on that day instead of the 2:30 p.m. (PST) deadline found in Rule 6.24(c). However, Members and Member Organizations may deliver a Contrary Exercise Advice or Advice Cancel to the Exchange within 2 hours 28 minutes following the time announced for the close of trading in equity options on that day instead of the 3:30 p.m. (PST) deadline found in Rule 6.24(c) for customer accounts and non-customer accounts where such Member firm employs an electronic submission procedure with time stamp for the submission of exercise instructions. For non-customer accounts, Members and Member Organizations that do not employ an electronic procedure with time stamp for the submission of exercise instructions are required to deliver a Contrary Exercise Advice or Advice Cancel within 1 hour and 28 minutes following the time announced for the close of trading on that day instead of the 2:30 p.m. (PST) deadline found in Rule 6.24(c).

(h)(1) The Exchange may establish extended cut-off times for decision to exercise or not exercise an expiring option and for the submission of Contrary Exercise Advices on a case by case basis due to unusual circumstances.

(2) The Exchange with at least one (1) business day prior advance notice, by 9:00 a.m. (PST) on such day, may establish a reduced cut-off time for the decision to exercise or not exercise an expiring option and for the submission of Contrary Exercise Advices on a case-by-case basis due to unusual circumstances; provided, however, that under no circumstances should the exercise cut-off time and the time for submission of a Contrary Exercise Advice be before the close of trading.

Commentary:

[.01 The exercise cut-off time pursuant to Rule 6.24(b) for option contracts shall be 2:30 P.M. (PT) on the business day immediately prior to the expiration date. In the event a member organization does not carry accounts for customers, it shall nevertheless be subject to such exercise cut-off time for the purposes of the third and fourth sentences of Rule 6.24(b).

.02 Each member organization shall prepare a memorandum of every exercise instruction received from a customer showing the time when such instruction was so received. Such memoranda shall be subject to the requirements of SEC Rules 17a-3(a)(6) and 17a-4(b).

.03 In the event a member submits an exercise instruction or tenders an exercise notice pursuant to an exception set forth in clause (ii), (iii) or (iv) of Rule 6.24(b), the member shall maintain a memorandum setting forth the circumstances giving rise to such exception. If the

member is relying on clause (ii) or clause (iv) as the basis of an exception, it shall promptly file a copy of the memorandum with the Exchange.

.04 Clearing Members must follow the procedures of the OCC when exercising expiring non-cash settled equity option contracts. Members must also follow the procedures set forth below with respect to the exercising of non-cash settled equity option contracts that would otherwise not be exercised, or the non-exercising of option contracts that otherwise would be exercised by operation of the OCC Rule 805.

(a) for all such contracts exercised or not exercised, a "contrary exercise advice" must be delivered by the member in such form or manner prescribed by the Exchange to a place designated by the Exchange no later than 2:30 p.m. (PT) on the business day immediately prior to the expiration date;

(b) subsequent to the delivery of a "contrary exercise advice," should the Market Maker, Floor Broker, customer or firm determine to act other than as reflected on the original advice form, the Member must also deliver an "advice cancel" in such form or manner prescribed by the Exchange to a place designated by the Exchange no later than 2:30 p.m. (PT) on the business day immediately prior to the expiration date;

(c) the preparation, time stamping or submission of a "contrary exercise advice" prior to the purchase of the contracts to be exercised or not exercised shall be deemed a violation of this Rule.

(d) all of the foregoing provisions of this Commentary .04 are in full force and effect whether or not the OCC waives the exercise-by-exception provisions of its Rule 805; in the event of such waiver, the procedures of this Commentary shall be followed as if such provisions of OCC Rule 805 were in full force and effect; and OCC rules may require the submission of an affirmative exercise notice even in circumstances where a contrary exercise advice is not required; and

(e) the failure of any Member to follow the provisions in this Commentary .04 may be referred to the Ethics and Business Conduct Committee and result in the assessment of a fine, which may include but is not limited to disgorgement of potential economic gain obtained or loss avoided by the subject exercise, as determined by the Committee.

.05 Members and member organizations shall properly communicate final exercise decisions to the Exchange in respect of positions for which they are responsible. Member organizations may establish a processing cut-off time prior to the Exchange's exercise cut-off time at which it will no longer accept final exercise decisions in expiring options for customers.

.06 Submitting or preparing an exercise instruction after the exercise cut-off time in any expiring option on the basis of material information released after the cut-off time is actively inconsistent with just and equitable principals of trade.]

.01 For purposes of this Rule 6.24, the terms “customer account” and “non-customer account” have the same meaning as defined in OCC By-Laws Article I(C)(28) and Article I (N)(2), respectively.

.02 Each Member Organization shall prepare a memorandum of every exercise instruction received showing the time when such instruction was received. Such memoranda shall be subject to the requirements of SEC Rule 17a-4(b).

.03 In the event of an “unusual circumstance,” Rule 6.24(h)(1) provides that the Exchange may extend the cut-off times for exercise instructions and the submission of a Contrary Exercise Advice beyond the normal time frames specified in Rule 6.24(c). For purposes of subparagraph (h)(1), an “unusual circumstance” includes, but is not limited to, increased market volatility; significant order imbalances; significant volume surges and/or systems capacity constraints; significant spreads between the bid and offer in underlying securities; internal system malfunctions affecting the ability to disseminate or update market quotes and/or deliver orders; or other similar occurrences. Rule 6.24(h)(2) specifies that the Exchange may also reduce such cut-off times for “unusual circumstances.” For purposes of subparagraph (h)(2), an “unusual circumstance” includes, but is not limited to, a significant news announcement concerning the underlying security of an option contract that is scheduled to be released just after the close on the business day immediately prior to expiration.

.04 Although the deadline for all option holders to make a final decision to exercise or not exercise is 2:30 p.m. (PST), the deadline for the submission of the Contrary Exercise Advice in the case of non-customer accounts will depend on the manner of the decision to exercise or not exercise.

- (i) For electronic timestamp submissions of the exercise decision by non-customer option holders, a Contrary Exercise Advice submitted by Members and Member Organizations must be received by the Exchange by 3:30 p.m. (PST).
- (ii) For manual submissions of the exercise decision by non-customer option holders, Members and Member Organizations must submit a Contrary Exercise Advice at the Exchange via the Contrary Exercise Advice Box by 2:30 p.m. (PST).

.05 Each Member Organization shall establish fixed procedures to insure secure time stamps in connection with their electronic systems employed for the recording of submissions to exercise or not exercise expiring options.

.06 In the event a Member or Member Organization receives and submits a final exercise decision after the exercise cut-off time pursuant to an exception set forth in clauses (i), (ii) or (iii) of paragraph (f) of Rule 6.24, the Member or Member Organization shall maintain a memorandum setting forth the circumstances regarding such exception and shall file a copy of the memorandum with the Exchange's Market Surveillance Department no later than 9:00 a.m. on the first business day following the respective expiration.

.07 The filing of a Contrary Exercise Advice required by this rule does not serve to substitute as the effective notice to OCC for the exercise or non-exercise of expiring options.

.08 The failure of any Member to follow the provisions in this Rule may be referred to the Ethics and Business Conduct Committee and result in the assessment of a fine, which may include but is not limited to disgorgement of potential economic gain obtained or loss avoided by the subject exercise, as determined by the Committee.

.09 Submitting or preparing an exercise instruction after the exercise cut-off time in any expiring option on the basis of material information released after the cut-off time is actively inconsistent with just and equitable principals of trade.