

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-48342; File No. SR-PCX-2002-01]

### Self Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment Nos. 1 and 2 Thereto by the Pacific Exchange, Inc., Relating to Procedures for Obvious Errors in Options Transactions

August 14, 2003.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on January 3, 2002, the Pacific Exchange, Inc. ("PCX" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. On July 28, 2003, the Exchange submitted Amendment No. 1 to the proposed rule change.<sup>3</sup> On August 8, 2003, the Exchange submitted Amendment No. 2 to the proposed rule change.<sup>4</sup> The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

#### I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The Exchange is proposing to define an "obvious error" for options transactions and establish a procedure to follow in the event of an obvious error. Proposed new language is *italicized*; proposed deletions are in brackets.

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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 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 tracks 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), or, in the event where the bid/ask spread in the underlying is greater than the bid/ask spread set forth in Rule 6.37(b)(1), by an amount as set forth in Rule 6.37(b)(3). For the purpose of this calculation, the Exchange will not apply a wider bid/ask spread as provided for LEAPS or for options subject to unusual market conditions;*

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 the strike price of an underlying security minus its bid price in the primary market at the time of the transaction.*

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Letter from Mai S. Shiver, Senior Attorney, Regulatory Policy, Exchange, to Nancy J. Sanow, Assistant Director, Division of Market Regulation ("Division"), Commission, dated July 25, 2003 ("Amendment No. 1"). Amendment No. 1 supersedes and replaces the proposed rule change in its entirety.

<sup>4</sup> See Letter from Mai S. Shiver, Senior Attorney, Regulatory Policy, Exchange, to Nancy J. Sanow, Assistant Director, Division, Commission, dated August 7, 2003 ("Amendment No. 2"). Amendment No. 2 supersedes and replaces the proposed rule change and Amendment No. 1 in their entirety.