

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The Options Clearing Corporation ("OCC"), the issuer of all PCX-traded options contracts, has an established procedure for options holders wishing to automatically exercise in-the-money options⁶ before they expire. Known as Exercise by Exception or "Ex-by-Ex", the procedure provides for the automatic exercise at expiration of any equity option contract that is $\frac{3}{4}$ of a point or more in-the-money for customer accounts or $\frac{1}{4}$ point or more in-the-money for any other accounts.⁷ Option holders who wish to have their contracts exercised in accordance with the Ex-by-Ex procedure do not need to take any further action; the contracts that are in-the-money by the appropriate amount will be automatically exercised. Option holders who do not wish to have their options automatically exercised, or who wish their options to be exercised under different parameters than the Ex-by-Ex procedure, must file a CEA with the Exchange pursuant to PCX Rule 6.24, and instruct OCC of their "contrary intention".⁸ The Exchange believes that PCX Rule 6.24 is designed to deter individuals from taking improper advantage of late-breaking news by requiring evidence of an option holder's intention regarding whether to exercise an expiring equity option via the submission of a CEA. Members and Member Organizations satisfy the filing requirement by manually submitting a CEA or by electronically submitting the CEA through OCC's ENCORE system.

The Exchange states that the principal goal of PCX Rule 6.24 is to maintain a level playing field between persons holding long and short positions in expiring equity options. The PCX believes that after trading has ended on the final trading day before expiration, persons who are short in the option have no way to close out their short position. To put option holders on equal footing, PCX Rule 6.24 attempts to minimize the time period in which a holder can exercise the equity option after the close of trading on the last business day prior to expiration,

generally known as "Expiration Friday."⁹

The current exercise cut-off time for an option holder to decide whether to exercise an equity option is 2:30 p.m. (PST) on the business day immediately prior to the expiration date.¹⁰ Under the proposal, the exercise cut-off time set forth in amended PCX Rule 6.24(c) will not change except in cases of a modified trading session or due to "unusual circumstances." Current PCX Rule 6.24 imposes a uniform 2:30 p.m. cut-off time for the submission of CEAs for all accounts without differentiating between customer and non-customer accounts.

The Exchange states that the proposed rule change was prompted by concerns expressed by clearing firms that the deadline for submitting CEAs is problematic for customer accounts,¹¹ due to the logistical difficulties of receiving customer exercise instructions and processing them through their retail branch systems and back office areas before submitting them to the Exchange. Therefore, the Exchange proposes to adopt a cut-off time of 3:30 p.m. (PST) for Members and Member Organizations to submit CEAs for customer accounts. The Exchange also proposes to allow Members and Member Organizations to submit CEAs for non-customer accounts¹² by 3:30 p.m. (PST) provided such Member or Member Organization employs an electronic procedure with time stamp recording for the submission of exercise instructions by options holders. In those cases where Members or Member Organizations do not employ an electronic submission procedure for the submission of exercise instructions, CEAs for non-customer accounts must be submitted to the Exchange by 2:30 p.m. (PST). The different CEA submission deadlines are set forth in amended PCX Rule 6.24(c) and new Commentary .04.

⁹ "Expiration Friday" is generally the last business day prior to the expiration of an option contract.

¹⁰ The "expiration date" of an options contract generally is the Saturday immediately following the third Friday of the expiration month of such option. See OCC By-Laws Article I (E)(16).

¹¹ A "customer account" is defined in OCC By-Laws Article I (C)(28) as an account of a Clearing Member which is confined to Exchange transactions cleared and positions carried by the Clearing Member on behalf of its securities customers, other than those transactions of market-makers which are cleared through a market-makers account. OCC By-Laws define a "securities customer" as a person having a securities account at a broker or dealer other than a non-customer of such broker or dealer. See OCC By-Laws Article I (S)(1).

¹² A "non-customer account" generally means a person that is not a customer of a broker or dealer defined in Rule 8c-1 and 15c2-1 under the Act. See OCC By-Laws Article I (N)(2).

Although many Members and Member Organizations have electronic submission procedures, the Exchange is concerned that those firms that manually submit CEAs could have an opportunity to improperly extend the 2:30 p.m. (PST) deadline for option holders to submit their exercise instructions. This concern on the part of the Exchange is based on the difficulty in monitoring a manual procedure that has different times for deciding whether to exercise an option and to submit a CEA.

Accordingly, in the case of non-customer accounts, the Exchange has proposed to limit the 3:30 p.m. (PST) deadline for submitting CEAs to those Members and Member Organizations that have an electronic submission procedure for option holders communicating their decisions whether to exercise an option. In connection with the use of an electronic submission procedure by Members and Member Organizations, the Exchange proposes the addition of new Commentary .05 to PCX Rule 6.24 to require Members and Member Organizations employing electronic submissions to establish procedures to secure time stamps in connection with their electronic systems.

OCC on occasion will suspend the use of its Ex-by-Ex procedure, such as when trading in the underlying stock has been halted or if accurate price data is unavailable for the determination of closing prices. When this occurs and there is no automatic exercise, all options contract holders must send an exercise notice to OCC if they wish to exercise an option, regardless of whether the option is in or out-of-the-money. Currently, when OCC suspends its Ex-by-Ex procedure for an option class, PCX Rule 6.24 requires the submission of a CEA. Thus, when OCC has waived the Ex-by-Ex procedure, option holders must determine what price would have been used, even though the only available price might be a stale last sale price (a price OCC did not feel comfortable using). Option holders then must determine whether a CEA needs to be submitted to the Exchange evidencing the intention to exercise or not exercise.

In the PCX's view, the options exchanges have long viewed this process as cumbersome and confusing to option holders. Therefore, the PCX proposes to amend PCX Rule 6.24(d) to eliminate the requirement that a CEA be submitted if the holder does not want to exercise the option when OCC has suspended its Ex-by-Ex procedure for that options class. As a result, when the Ex-by-Ex procedure has been

⁶ "In-the-money" for a call option occurs if the current market value of the underlying security is above the exercise price of the option. For put options, "in-the-money" means the current value of the underlying security is below the exercise price of the option.

⁷ See OCC Rule 805(d).

⁸ A CEA may be canceled by filing an "Advice Cancel" with the Exchange at any time up to the submission cut-off deadline specified in proposed amended PCX Rule 6.24.