

## 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.

(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.

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

In its filing with the Commission, the Exchange included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

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

#### 1. Purpose

While the Exchange believes that it would be detrimental to allow market participants to adjust or nullify trades simply because they are based on poor trading decisions, it does believe that just and equitable principles of trade permit such adjustments or trade nullifications where one market participant would receive a windfall at the expense of another market participant that made an obvious error. In promulgating the basis for determining whether to adjust or nullify trades based upon obvious error, the Exchange believes that it must rely on objective standards to establish when a transaction was clearly the result of an obvious error, under what circumstances a trade will be adjusted or nullified, and to what price a trade will be adjusted if adjustment is appropriate under the circumstances.

As proposed, the affected parties to a particular transaction may determine, by mutual agreement, that an electronic trade was executed at an erroneous price and they may adjust the terms or nullify the trade as they agree. In the absence of mutual agreement by the parties, the proposed rule provides that two trading officials may nullify or adjust a trade if an affected party provides a documented request for relief within five minutes of the execution (or 20 minutes if the request is on behalf of a public customer) of the trade so long as one of following conditions is met:

- 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

- 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
- 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 the proposed 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

- 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 purposes of the proposed 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

- 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; or

- 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; or

- 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.

Under the proposed rule change, when a Market Maker on the Exchange believes that it participated in a transaction that was the result of an obvious error, it must notify two Floor Officials<sup>5</sup> within five 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 the proposed rule change unless notification is made within the prescribed time periods.

As proposed, 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 above-stated conditions has occurred, and the complaining party has timely documented a request for relief, then the Floor Officials will take one of the following actions:

- (1) Where each party to the transaction is a Market Maker on the Exchange or the trade involves a limit order than may be adjusted to its limit, the execution price of the transaction will be adjusted within ten minutes of the Floor Officials making such a determination. In such case, the adjusted price will be the last bid (offer) price just prior to trade from the

exchange providing the highest total contract volume for the previous sixty (60) days in the option with respect to an erroneous bid (offer) entered on the Exchange. If there is no quote for comparison purposes, then the adjusted price of the option will be determined by two Floor Officials.

- (2) If 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 trade will be nullified within ten (10) minutes of two Floor Officials making such determination.

All determinations made by the two Floor Officials under the proposed rule change will be rendered without prejudice as to the rights of the parties to the transaction to submit a dispute to arbitration. The Exchange believes that the rule proposal promotes fair and equitable resolutions of erroneous trades.

## 2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Act<sup>6</sup> in general, and furthers the objectives of Section 6(b)(5)<sup>7</sup> in particular, in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism for a free and open market and a national market system, and, in general, to protect investors and the public interest.

### B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

### C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The Exchange did not solicit or receive written comments on the proposed rule change.

### III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and

publishes its reasons for so finding or (ii) as to which the Exchange consents, the Commission will:

- (A) by order approve such proposed rule change, or

- (B) institute proceedings to determine whether the proposed rule change should be disapproved.

## IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying at the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to File No. SR-PCX-2002-01 and should be submitted by September 12, 2003.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>8</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-48351; File No. SR-PCX-2003-34]

### Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change by the Pacific Exchange, Inc., and Amendment No. 1 Thereto, Relating to its Arbitration Program

August 15, 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 July 9,

<sup>5</sup> 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.

<sup>6</sup> 15 U.S.C. 78f(b).

<sup>7</sup> 15 U.S.C. 78f(b)(5).

<sup>8</sup> 17 CFR 200.30-3(a)(12).

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

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