

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-49455; File No. SR-PCX-2003-60)

March 22, 2004

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of a Proposed Rule Change and Amendment Nos. 1, 2, and 3 by the Pacific Exchange, Inc. Relating to Rules for Trading Index Options

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 October 28, 2003, the Pacific Exchange, Inc. (“PCX” or “Exchange”) filed with the Securities and Exchange Commission (“Commission” or “SEC”) the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. On December 18, 2003, the Exchange submitted Amendment No. 1 to the proposed rule change.<sup>3</sup> On March 2, 2004, the Exchange submitted Amendment No. 2 to the proposed rule change.<sup>4</sup> On March 22, 2004, the Exchange submitted Amendment No. 3 to the proposed rule

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

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

<sup>3</sup> See letter from Tania J.C. Blanford, Staff Attorney, Regulatory Policy, PCX to Nancy J. Sanow, Assistant Director, Division of Market Regulation (“Division”), Commission, dated December 17, 2003. Amendment No. 1 replaced the original rule filing in its entirety.

<sup>4</sup> See letter from Tania J.C. Blanford, Staff Attorney, Regulatory Policy, PCX to Nancy J. Sanow, Assistant Director, Division, Commission, dated March 1, 2004 (“Amendment No. 2”). In Amendment No. 2, the PCX made several changes to the proposed rule change to conform the proposed rule text to the existing Chicago Board Options Exchange, Inc. (“CBOE”) and International Securities Exchange, Inc. (“ISE”) rules. In addition, the Exchange clarified the classes of broad-based index options for which the CBOE Rules prescribe no position limits, and described that its proposed Rule 6.11(b) provided for the procedure that underwriters follow when requesting restrictions on uncovered opening writing transactions during public distributions.

change.<sup>5</sup> The Commission is publishing this notice to solicit comments on the proposed rule, as amended, from interested persons and is approving the proposed rule change, as amended, on an accelerated basis.

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

The PCX is proposing to amend the position and exercise limits with respect to broad-based index options, as well as a number of conforming changes in order to bring the PCX index option rules up to date with those of other Self-Regulatory Organizations (“SRO”). The proposed rule change is substantially similar to the proposed rules recently filed by the ISE, which were approved by the Commission.<sup>6</sup>

The text of the proposed rule change appears below. Additions are italicized; deletions are in [brackets].

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**Rule 6 Options Trading**

**Rule 6.8 Position Limits**

(a) (No change.)

Commentary:

.01 - .03 – (No change.)

.04 The Exchange may establish higher position limits for Market Maker transactions than those applicable with respect to other accounts. Whenever a Market Maker

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<sup>5</sup> See letter from Tania J.C. Blanford, Staff Attorney, Regulatory Policy, PCX to Nancy J. Sanow, Assistant Director, Division, Commission, dated March 22, 2004 (“Amendment No. 3”). In Amendment No. 3, the PCX corrects certain typographical errors.

<sup>6</sup> See Securities Exchange Act Release No. 48405 (August 25, 2003), 68 FR 52257 (September 2, 2003) (SR-ISE-2003-05) (Order approving the ISE’s proposed rules).

reasonably anticipates that he or she may exceed such position limits in the performance of his or her function of assisting in the maintenance of a fair and orderly market, he or she must consult with and obtain the prior approval of an Options Floor Official. An exemption will generally be granted only to a Market Maker who has requested an exemption, who is appointed to the options class in which the exemption is requested, whose positions are near the current position limit, and who is significant in terms of daily volume. The positions must generally be within ten percent (10%) of the limits contained in Rule 6.8, Commentary .05 for equity options and twenty percent (20%) of those limits for broad-based index options.<sup>7</sup>

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**Rule 6.11 Other Restrictions on Exchange Option Transactions and Exercises**

- (a). The Exchange shall have the power to impose, from time to time in its discretion, such restrictions on Exchange option transactions or the exercise of option contracts in one or more series of options of any class dealt in on the Exchange as it deems advisable in the interests of maintaining a fair and orderly market in option contracts or in the underlying stocks or Exchange-Traded Fund Shares covered by such option contracts, or otherwise deems advisable in the public interest or for the protection of investors.
- (1) During the effectiveness of any such restriction, no member organization shall effect any Exchange option transaction or exercise any option contract in contravention of such restriction.

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<sup>7</sup> See supra note 4.

- (2) Notwithstanding the foregoing, during the ten (10) business days prior to the expiration date of a given series of options, other than index options, no restriction on the exercise of option contracts under this Rule shall remain in effect with respect to that series of options. With respect to index options, restrictions on exercise may be in effect until the opening of business on the last business day before the expiration date.
- (3) Exercises of American-style, cash-settled index options shall be prohibited during any time when trading in such options is delayed, halted, or suspended, subject to the following exceptions:
- (A) The exercise of an American-style, cash-settled index option may be processed and given effect in accordance with and subject to the Rule of the Options Clearing Corporation while trading in the option is delayed, halted or suspended if it can be documented, in a form prescribed by the Exchange, that the decision to exercise the option was made during allowable time frames prior to the delay, halt, or suspension;
- (B) Exercises of expiring American-style, cash-settled index options shall not be prohibited on the last business day prior to their expiration;
- (C) Exercises of American-style, cash-settled index options shall not be prohibited during a trading halt that occurs at or after 1:00 p.m. Pacific Time. In the event of such a trading halt, exercises may occur through 1:20 p.m. Pacific Time. In addition, if trading resumes following such a trading halt (such as by closing rotation), exercises may occur during the resumption of trading and for five (5) minutes after the close of the resumption of trading. The provisions of this

subsection (a)(3)(C) are subject to the authority of the Board to impose restrictions on transactions and exercises pursuant to subsection (a) of this Rule; and

(D) An Exchange officer designated by the Board may determine to permit the exercise of American-style, cash-settled index options while trading in such options is delayed, halted, or suspended. In the case of an American-style, cash-settled FLEX Index Option, the references in this paragraph (a)(3) to a trading delay, halt, suspension, resumption, or closing rotation shall mean the occurrence of the applicable condition in the standardized option on the index underlying the FLEX Index Option (rather than the occurrence of the applicable condition in the FLEX Index Option itself).<sup>8</sup>

(b) Except with respect to index options trading pursuant to Rule 7, whenever, the issuer of a security underlying a call option traded on the Exchange is engaged or proposes to engage in a public underwritten distribution (“public distribution”) of such underlying security or securities exchangeable for or convertible into such underlying security, the underwriters may request that the Exchange impose restrictions upon all opening writing transactions in such options at a “discount” where the resulting short position will be uncovered (“uncovered opening writing transactions”). Upon receipt of such a request, the Exchange shall impose the requested restrictions as promptly as possible but no earlier than 15 minutes after it has been announced on the floor of the Exchange and shall terminate such restrictions upon request of the underwriters or when the Exchange otherwise discovers that the stabilizing transaction by

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<sup>8</sup> See supra note 4.

the underwriters has been terminated. In addition to a request, the following conditions are necessary for the imposition of restrictions:

(1) less than a majority of the securities to be publicly distributed in such distribution are being sold by existing security holders;

(2) the underwriters agree to notify the Exchange upon the termination of their stabilization activities; and

(3) the underwriters initiate stabilization activities in such underlying security on a national securities exchange when the price of such security is either at a "minus" or "zero minus" tick.

(c) For purposes of subsection (b) above, an uncovered opening writing transaction in a call option will be deemed to be effected at a "discount" when the premium in such transaction is either:

(1) in the case of a distribution of the underlying security not involving the issuance of rights and in the case of a distribution of securities exchangeable for or convertible into the underlying security, less than the amount by which the underwriters' stabilization bid for the underlying security exceeds the exercise price of such option; or

(2) in the case of a distribution being offered pursuant to rights, less than the amount by which the underwriters' stabilization bid in the underlying security at the Subscription Price exceeds the exercise price of such option.

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**Rule 6.37      Obligation of Market Makers**

(a)      (No change.)

- (b) (1) (No change.)
- (2) Bidding no more than \$1 lower and/or offering no more than \$1 higher than the last preceding transaction price for the particular option contract. However, this standard shall not ordinarily apply if the price per share (or other unit of trading) of the underlying security or Exchange-Traded Fund Share has changed since the last preceding transaction for the particular option contract, in which even a Market Maker may then bid no lower than or offer no more than \$1 plus the aggregate change in the price per share (or other unit of trading) of the underlying security or Exchange-Traded Fund Share since the time of the last preceding transaction for the particular option contract. This provision applies from one day's close to the next day's opening and from one transaction to the next in intra-day transactions. With respect to inter-day transactions, this provision applies if the closing transaction occurred within one hour of the close and the opening transaction occurred within one hour after the opening. With respect to intra-day transactions, this provision applies to transactions occurring within one hour of one another.<sup>9</sup> Two Floor Officials may waive the provisions of this paragraph in an index option when the primary underlying securities market for that index is not trading. Nothing in this subparagraph (b)(2) shall alter the maximum bid/ask differentials established by subparagraph (b)(1) of Rule 6.37.
- (3) – (4) (No change.)
- (c) – (h) (No change.)

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<sup>9</sup> See supra note 4.

Commentary:

.01 - .08 (No change.)

.09 The Exchange or its authorized agent may calculate bids and asks for various indices for the sole purpose of determining permissible bid/ask differentials on options on these indices. These values will be calculated by determining the weighted average of the bids and asks for the components of the corresponding index. These bids and asks will be disseminated by the Exchange at least every fifteen (15) seconds during the trading day solely for the purpose of determining the permissible bid/ask differential that market-makers may quote on an in-the-money option on the indices. For in-the-money series in index options where the calculated bid/ask differential is wider than the applicable differential set out in subparagraph (b)(1) of this Rule, the bid/ask differential in the index option series may be as wide as the calculated bid/ask differential in the underlying index. The Exchange will not make a market in the basket of stock comprising the indices and is not guaranteeing the accuracy or the availability of the bid/ask values.

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**Rule 6.64 Trading Rotations**

(a) – (d) (No change.)

(e) Closing Rotations. Transactions may be effected in a class of options after 1:02 p.m. (Pacific Time) or, 1:15 p.m. (Pacific Time) for certain index options, if they occur during a trading rotation. Such a trading rotation may be employed in connection with the opening or reopening of trading in the underlying security or Exchange Traded Fund Share after 12:30 p.m. (Pacific Time) or due to the declaration of a "fast market" pursuant to Rule 6.28.



The decision to employ a trading rotation after 12:30 p.m. will be publicly announced on the Trading Floor prior to the commencement of such rotation and Book Staff should notify Floor Brokers by 12:50 p.m., if possible, that a closing rotation may be necessary. The closing rotation should commence at least ten minutes after the Trading Floor has been notified. No more than one trading rotation may be commenced after 1:02 p.m. If a trading rotation is in progress and Floor Officials determine that a final trading rotation is needed to assure a fair and orderly close, the rotation in progress will be halted and a final rotation begun as promptly as possible after 1:02 p.m. Any trading rotation conducted after 1:02 p.m. may not begin until ten minutes after news of such rotation is disseminated. Only orders that have been entered before 1:02 p.m. are eligible for execution during the closing rotation.

(f) – (h) (No change.)

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## **Rule 7 Index Options**

### **Introduction**

In general, the Rules of the PCX's Board of Governors applicable to the trading of stock options, in particular Rule 6, shall be applicable to the trading of index options as that term is defined below.

Rule 7 supplements or replaces those rules relating to stock options where required by the nature of index options. In cases where Rule 7 is silent on an issue, the applicable section of the rules relating to stock options shall be read so as to apply to index option. Where the rule in this section indicate that particular indices or requirements with respect to particular indices will be "Specified," the Exchange shall file a proposed rule change with the Commission to specify such indices or requirements.

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**Rule 7.1 Definitions**

- (a) – (b) (No change.)
- (c) The term “ A.M.-settled index option” means an index option contract for which the current index value at expiration shall be determined as provided in Rule 7.9(a)(7). [The term “index” shall mean the sum of the reported last sales on their primary market of those underlying securities which, as a group, have been designated by the Exchange as underlying an option contract, divided by the Divisor.]
- (d) – (f) (No change.)
- (g) The term “index multiplier” means the amount specified in the contract by which the current index value [designated by the Exchange by which the index] is to be multiplied to arrive at the value required to be delivered to the holder of a call or by the holder of a put option valid exercise of the contract.
- (h) The term “current index value” [in] with respect to a particular index option contract [shall] means the level of the underlying index reported by the reporting authority for the index, or any multiple or fraction of such reported level specified by the Exchange. The current index value with respect to a reduced-value LEAP is one-tenth of the current index value of the related index option. The “closing index value” shall be the last index value reported on a business day [sum of the prices of the underlying securities divided by the Divisor, and as reported by the reporting authority for the index].
- (i) Reserved. [The term “closing index value” shall be the last index value reported by the reporting authority on a business day. The reporting authority shall use the closing last sales of the underlying securities on their primary market to calculate the closing index value.]

- (j) (No change.)
- (k) The term “underlying security” or “underlying securities” with respect to an index option contract means any of the securities [all of the stocks] that are the basis for the calculation of the index.
- (l) The term “reporting authority” [in] with respect [of] to a particular index means the institution or reporting service designated by the Exchange as the official source for (1) calculating the level of the index from the reported prices of the underlying securities that are the basis of the index and (2) reporting such level. [and disseminating the value of the index.] The reporting authority for each index approved for options trading on the Exchange shall be specified in Rule 7.13.
- (m) – (u) (No change.)
- (v) The terms “industry index” and “narrow-based index” means an index designed to be representative of a particular industry or a group of related industries.
- (w) The term “market index” and “broad-based index” mean an index designed to be representative of a stock market as a whole or of a range of companies in unrelated industries.

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**[Index Multiplier]**

[Rule 7.2 The index multiplier shall be 100 unless otherwise determined by the Exchange.]

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**Designation of the Index**

**Rule 7.2[7.3] Broad-Based Index Options**

- (a) (No change.)

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## Designation of the Index

### Rule 7.3 Narrow-Based Index Options

[(b) – (c)] (a) – (b) (No substantive change to the rule text).<sup>10</sup>

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### Rule 7.4 Dissemination of Information

- (a). The Exchange shall assure that the current index value is disseminated, [to the public] after the close of business and from time-to-time on days on which transactions in index options are made [traded] on the Exchange.
- (b). The Exchange shall maintain, in files available to the public, information identifying the stocks whose prices are the basis for calculation of the index and the method used to determine the current index value.

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### [Adjustments in the Divisor

Rule 7.5. The Divisor ordinarily will be adjusted in the event of a stock dividend, stock distribution, stock split or reverse split, rights offering, distribution, reorganization, recapitalization or reclassification or similar event in respect of any component stock, or in the event a stock is added to or deleted from the index, or one stock is substituted for another. The purpose of adjusting the Divisor in the context of such events is to maintain continuity of index values; the Divisor will not be revised for any other purpose.]

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<sup>10</sup> Telephone conversation between Tania Blanford, Attorney, PCX, and Tim Fox, Attorney, Division, Commission on March 18, 2004.

**Rule 7.5**      **Position Limits for Broad-Based Index Options**

- (a).    Rule 6.8 generally shall govern position limits for broad-based index options, as modified by this Rule 7.5. Except otherwise indicated below, the position limit for a broad-based index option shall be 25,000 contracts. There may be no position limit for certain Specified (as provided in Rule 7) broad-based index option contracts.
- (b)    Index option contracts shall not be aggregated with option contracts on any stocks whose price are the basis for calculation of the index.
- (c)    Positions in reduced-value index options shall be aggregated with positions in full-value index options. For such purposes, ten (10) reduced-value options shall equal one (1) full-value contract.
- (d)    Capped-style index options shall be aggregated with standard option contracts on the same stock index group.

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**Position Limits for Index Options**

**Rule 7.6**      **Narrow-Based Index Options**

- (a) – (c)      (No change.)

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**[Broad-Based Index Options**

- (d)    The position limit for a broad based index option shall be 15,000 contracts, except as follows:

- (1) The position limit for options on the Wilshire Small Cap Index shall be 37,500 contracts on the same side of the market, with no more than 22,500 of such contracts in the series with the nearest expiration date.
- (2) Quarterly Index Expirations (QIXs) on the Wilshire Small Cap Index shall be excluded from the aggregation of options on such indexes for purposes of subsection (d)(1). In determining compliance with applicable position limits, QIXs on the Wilshire Small Cap Index shall be subject to a contract limitation fixed by the Exchange, which shall not be larger than 37,500 contracts on the same side of the market. For purposes of determining compliance with this subsection (d)(2), all Wilshire Small Cap Index options (including all QIXs on the Wilshire Small Cap Index) shall be aggregated. In no event shall the aggregate of all option contracts on the Wilshire Small Cap Index exceed 37,500 contracts on the same side of the market.
- (3) The position limit for options on the PCX Technology Index shall be 37,500 contracts on the same side of the market, with no more than 22,500 of such contracts in the series with the nearest expiration date.
- (4) The position limit for options on the Dow Jones & Co. Taiwan Index shall be 50,000 contracts on the same side of the market, with no more than 30,000 contracts in the series with the nearest expiration date.
- (5) The position limit for options on the Morgan Stanley Emerging Growth Index shall be 37,500 contracts on the same side of the market, with no more than 22,500 contracts in the series with the nearest expiration date.

- (e) Capped-style index options shall be aggregated with standard option contracts on the same stock index group.

Commentary:

- .01. All members and member organizations acquiring positions of 200 contracts or more in index options shall report such information to the Department of Options Surveillance. The report shall be filed in accordance with the provisions of Rule 6.6(a).]

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### **Exemptions from Position Limits**

#### **Rule 7.7** [Broad-Based Index Hedge Exemption]

- (a). Broad-based Index Hedge Exemptions. [.02.] The broad-based index hedge exemption is in addition to the standard limit and other exemptions available under Exchange rules, interpretations and policies. The following procedures and criteria must be satisfied to qualify for a broad-based index hedge exemption:

- (1) [(a)] The account in which the exempt option positions are held (the “hedge exemption account”) must has received prior Exchange approval for the hedge exemption specifying the maximum number of contracts that may be exempt under this Rule [Commentary]. The hedge exemption account must have provided all information required on Exchange-approved forms and must have kept such information current. [The] Exchange [may grant]approval may be granted on the basis of verbal representations, in which event [case] the hedge exemption account must, within two business days (or such other time designated by the Exchange), furnish the Exchange with appropriate forms and documentation substantiating the

basis for the exemption. The [A] hedge exemption account may apply from time to time for an increase in the maximum number of contracts exempt from the position limits.

[(b) The hedge exemption account has provided all information required on Exchange-approved forms and has kept such information current.]

(2) [(c)] A hedge exemption account that is not carried by an Exchange Member Organization must be carried by a member of a self-regulatory organization participating in the Intermarket Surveillance Group.

(3) [(d)] The hedge exemption account maintains a qualified portfolio, or will effect transactions necessary to obtain a qualified portfolio concurrent with or at or about the same time as the execution of the exempt options positions, of:

(A) [(1)] a net long or short position in common stocks in at least four industry groups and contains at least twenty (20) stocks, none of which accounts for more than fifteen percent (15%) of the value of the portfolio or in securities readily convertible, and additionally in the case of convertible bonds, economically convertible, into common stocks which would comprise a portfolio, [and/]or

(B) [(2)] – No change.

(4) [(e)] The exemption applies to positions in broad-based index options dealt in on the Exchange and is applicable to the unhedged value of the qualified portfolio. The unhedged value will be determined as follows:

(A) [(1)] the values of the net long or short positions of all qualifying products in the portfolio are totaled;



(B) [(2)] for positions in excess of the standard limit, the underlying market value (i)[(A)] of any economically equivalent opposite side of the market calls and puts in broad-based index options, and (ii)[(B)] of any opposite side of the market positions in stock index futures, options on stock index futures, and any economically equivalent opposite side of the market positions, assuming no other hedges for these contracts exist, is subtracted from the qualified portfolio; and

(C) [(3)] – No change.

(5) [(f)] Positions in broad-based index options that are traded on the Exchange are exempt from the standard limits to the extent specified in this subsection (a)(5).

[The hedge exemption customer shall agree to, and any Member Organization carrying an account for the customer, shall

(1) liquidate and establish option and stock positions or their equivalent in an orderly fashion; not initiate or liquidate positions in a manner calculated to cause unreasonable price fluctuations or unwarranted price changes; and not initiate or liquidate a stock position or its equivalent with an equivalent index option position with a view toward taking advantage of any differential in price between a group of securities and an overlying stock index option.

(2) liquidate any options prior to or contemporaneously with a decrease in the hedged value of the qualified portfolio which options would thereby be rendered excessive.

- (3) promptly notify the Exchange of any material change in the stock portfolio or its equivalent or stock index futures positions which materially affects the unhedged value of the qualified portfolio.
  - (4) abide by prevailing exercise limits allowed pursuant to Rule 7.7, without regard to the exemption provision, except in expiring series from the last business day prior to expiration until expiration. ]
- (6) [(g)] Only the following qualified hedging transactions and positions are eligible for purposes of hedging a qualified portfolio (i.e., stocks, futures, options and warrants) pursuant to this Rule [Commentary]:
- (A) [(1)] Long put(s) used to hedge the holding of a qualified portfolio;
  - (B) [(2)] Long call(s) used to hedge a short position in a qualified portfolio;
  - (C) [(3)] Short call(s) used to hedge the holding of a qualified portfolio; and
  - (D) [(4)] Short put(s) used to hedge a short position in a qualified portfolio. The following strategies may be effected only in conjunction with a qualified stock portfolio for non-P.M. settled, European style index options only:
    - (i) [(5) For non-P.M. settled, European-style index options only—a] A short call position accompanied by long put(s), where the short call(s) expire with the long put(s), and the strike price of the short call(s) equals or exceeds the strike price of the long put(s)(a “collar”). Neither side of the collar

transaction can be in-the-money at the time the position is established. For purposes of determining compliance with Rules 6.8, 7.5 and 7.7[6], a collar position will be treated as one (1) contract;

(ii) [(6) For non-P.M. settled, European-style index options only—a] A long put position coupled with a short put position overlying the same broad-based index and having an equivalent underlying aggregate index value, where the short put(s) expire with the long put(s), and the strike price of the long put(s) exceeds the strike price of the short put(s)(a “debit put spread position”); and

(iii) [(7) For non-P.M. settled, European-style index options only—a] A short call position accompanied by a debit put spread position, where the short call(s) expire with the puts and the strike price of the short call(s) equals or exceeds the strike price of the long put(s). Neither side of the short call, long put transaction can be in-the-money at the time the position is established. For purposes of determining compliance with Rules 6.8, 7.5 and 7.7[6], the short call and long put positions will be treated as one (1) contract.

(7) The hedge exemption account shall:

(A) liquidate and establish options, stock positions, their equivalent or other qualified portfolio products in an orderly fashion; not initiate or liquidate

positions in a manner calculated to cause unreasonable price fluctuations or unwarranted price changes; and not initiate or liquidate a stock position or its equivalent with an equivalent index option position with a view toward taking advantage of any differential in price between a group of securities and an overlying stock index option;

(B) liquidate any options prior to or contemporaneously with a decrease in the hedged value of the qualified portfolio which options would thereby be rendered excessive.

(C) promptly notify the Exchange of any material change in the qualified portfolio which materially affects the unhedged value of the qualified portfolio.

(8) If an exemption is granted, it will be effective at the time the decision is communicated. Retroactive exemptions will not be granted.

[h) Compliance]

(9) [(1)] The hedge exemption account shall promptly provide to the Exchange any information requested concerning the qualified portfolio.

(10) [(2)] Positions included in a qualified portfolio that serve to secure an index hedge exemption may not also be used to secure any other position limit exemption granted by the Exchange or any other self regulatory organization or futures contract market.

(11) [(3)] Any member or member organization that maintains a broad-based index option position in such member's or member organization's own account or in a customer account, and has reason to believe that such position is in excess of the

applicable limit, shall promptly take the action necessary to bring the position into compliance. Failure to abide by this provision shall be deemed to be a violation of Rules 6.8, 7.5 and this Rule 7.7[6] by the member or member organization.

- (12) [(4)] Violation of any of the provisions of this Rule [7.6 and the commentaries thereunder], absent reasonable justification or excuse, shall result in withdrawal of the index hedge exemption and may form the basis for subsequent denial of an application for an index hedge exemption hereunder.
- (13) Each member (other than Exchange market makers) that maintains a broad-based index options position on the same side of the market in excess of a Specified (as provided in Rule 7)<sup>11</sup> number of contracts for its own account or for the account of a customer, shall report information as to whether the positions are hedged and provide documentation as to how such contracts are hedged, in the manner and form required by the Exchange. The Exchange may impose other reporting requirements.
- (14) Whenever the Exchange determines that additional margin is warranted in light of the risks associated with an under-hedged options position in Specified (as provided in Rule 7)<sup>12</sup> broad-based indices, the Exchange may impose additional margin upon the account maintaining such under-hedged position pursuant to its authority under Rule 7.16. The clearing firm carrying the account also will be subject to capital charges under Rule 15c3-1 under the Exchange Act to the extent of any margin deficiency resulting from the higher margin requirements.

**[Narrow-Based Index Hedge Exemption]**

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<sup>11</sup> See supra note 4.

<sup>12</sup> See supra note 4.

(b) Industry (Narrow-Based) Index Hedge Exemptions. [.03.] – (No substantive change to the rule text).

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**Rule 7.8[7.7] Exercise Limits**

- (a) In determining compliance with Rule 6.9, exercise limits for index option contracts shall be equivalent to the position limits prescribed for option contracts with the nearest expiration date in Rule 7.5 and 7.6. [subject to the same exercise limit as the established position limit for that particular index option contract.]
- (b) For a market maker granted an exemption to position limits pursuant to Rule 6.8(a), Commentary .04, the number of contracts that can be exercised over a five business day period shall equal the market maker's exempted position.
- (c) In determining compliance with exercise limits applicable to stock index options, option contracts on a stock index group shall not be aggregated with options contracts on an underlying stock or stocks included in such group, and option contracts on one stock index group shall not be aggregated with option contracts on any other stock index group.
- (d) With respect to index option contracts for which an exemption has been granted in accordance with the provisions of Rule 7.7, the exercise limit shall be equal to the amount of the exemption.
- (e) [(b)] Capped-style index options shall not be aggregated with standard option contracts on the same stock index group.

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**Rule 7.9[7.8] Terms of Index Option Contracts**

- (a) General.

- (1) Meaning of Premium Bids and Offers. Bids and offers shall be expressed in terms of dollars and cents per unit of the index.
- (2) Exercise Prices. The Exchange shall determine fixed point intervals of exercise prices for call and put options.
- (3) [(b)] Expiration Months. Index Option contracts may expire at three (3) month intervals or in consecutive months. The Exchange may list up to six (6) months at any one time, but will not list index options that expire more than twelve (12) months out.
- (4) “European-Style Exercise.” Specified European-style index options, some of which may be A.M.-settled as provided in subsection (a)(7) below, may be approved for trading on the Exchange.
- (5) [(c)] Capped-style index options. [(1)] Capped-style index options that are approved for trading on the Exchange shall be Specified in this subsection (a)(5).<sup>13</sup> [on the following indexes are approved for trading on the Exchange:(A) Wilshire Small Cap Index. (B) PSE Technology Index.]
- (A) [(2)] Unless modified by the Exchange, the cap interval shall be \$20.
- (B) [(3)] Initially, one at-the-money call and put will be listed with an expiration of up to one year in the future. Additional at-the-money series may be listed every two months with expirations up to one year in the future.

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<sup>13</sup>

See supra note 4.

- (C) [(4)] Series may be added to expiration months with three or more months remaining to their expiration, if there has been a move of ten or more points in the index value.
- (6) [(d)] Quarterly Index Options (QIXs). The Exchange may open for trading up to eight near-term quarterly index expirations at any one time. The index multiplier for QIXs shall be 100. Unless otherwise specified, QIXs shall be p.m. settled. QIXs that are approved for trading on the Exchange shall be Specified in this subsection (a)(6). [on the following indexes are approved for trading on the Exchange: (1) Wilshire Small Cap Index.]
- (7) [(e)] A.M.-Settled Index Options. [(1)(A)] The last day of trading for A.M.-settled index options shall be the business day preceding the last day of trading in the underlying securities prior to expiration. The current index value at the expiration of A.M.-settled index option shall be determined, for all purposes under these Rules and the Rules of the Options Clearing Corporation, on the last day of trading in the underlying securities prior to expiration. The current index value shall be determined ] by reference to the reported level of such index as derived from first reported sale (opening) prices of the underlying securities on such day, except that [I]in the event [in any case where the] that the primary market for an underlying security does not open for trading [on that day], halts trading prematurely, or otherwise experiences a disruption of normal trading on that day, or in the event that the primary market for an underlying security is open for trading on that day, but that particular security does not open for trading, halts trading prematurely, or otherwise experiences a disruption of normal trading on that day the last reported



sale price of that security shall be [used] determined, for the purposes of calculating the current index value at expiration, as set forth in Rule 7.10(f). [unless the exercise settlement amount is fixed in accordance with the Rules and By-Laws of the Options Clearing Corporation; and]

[(B) In any case where an exercise settlement amount is fixed for any series of index options pursuant to the Rules and By-Laws of The Options Clearing Corporation, the amount so fixed shall be the amount required to be paid upon exercise of options of that series notwithstanding any difference between the current index value used by The Options Clearing Corporation in fixing that amount and the index value determined pursuant to Exchange Rules or practices.]

(A)[(2)] The following A.M.-settled index options are approved for trading on the Exchange: [(A) PSE Technology Index. (B) Wilshire Small Cap Index (C) Dow Jones & Co. Taiwan Index (D) Morgan Stanley Emerging Growth Index]

(i) Reserved.<sup>14</sup>

(b) Index LEAPS Options Series.

(1) Notwithstanding the provisions of subsection (a)(3) above, the Exchange may list index LEAPS options series that expire from twelve (12) to sixty (60) months from the date of issuance.

(A) Index LEAPS options series may be based on either the full or reduced value of the underlying index. There may be up to ten (10) expiration months, none further out than sixty (60) months. Strike price interval, bid/ask

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<sup>14</sup>

See supra note 4.

differential and continuity Rules shall not apply to such options series until the time to expiration is less than twelve (12) months.

(B) When a new Index LEAPS options series is listed, such series will be opened for trading either when there is buying or selling interest, or forty (40) minutes prior to the close, whichever occurs first. No quotations will be posted for such options series until they are open for trading.

(2) Reduced-Value LEAPS Options Series.

(A) Reduced-value LEAPS options series on the following stock indices are approved for trading on the Exchange:

(i) Reserved.<sup>15</sup>

(B) Expiration Months. Reduced-value LEAPS options series may expire at six-month intervals. When a new expiration month is listed, series may be near or bracketing the current index value. Additional series may be added when the value of the underlying index increases or decreases by ten (10) to fifteen (15) percent.

(c) Procedures for Adding and Deleting Strike Prices. The procedures for adding and deleting strike prices for index options are provided in Rule 6.4, as amended by the following:

(1) The interval between strike prices will be no less than \$5.00; provided, that in the case of the certain specified classes of index options, the interval between strike prices will be no less than \$2.50.

(2) New series of index option contracts may be added up to the fifth business day prior to expiration.

- (3) When a new series of index options with a new expiration date are opened for trading, or when additional series of index options in an existing expiration date are opened for trading as the current value of the underlying index to which such series relate moves substantially from the exercise prices of series already opened, the exercise prices of such new or additional series shall be reasonably related to the current value of the underlying index at the time such series are first opened for trading. In the case of all classes of index options, the term “reasonably related to the current value of the underlying index” shall have the meaning set forth in subsection (c)(4) below.
- (4) Notwithstanding any other provision of this subsection (c), the Exchange may open for trading additional series of the same class of index options as the current index value of the underlying index moves substantially from the exercise price of those index options that already have been opened for trading on the Exchange. The exercise price of each series of index options opened for trading on the Exchange shall be reasonably related to the current index value of the underlying index to which such series relates at or about the time such series of options is first opened for trading on the Exchange. The term “reasonably related to the current value of the underlying index” means that the exercise price is within thirty percent (30%) of the current index value. The Exchange may also open for trading additional series of index options that are more than thirty percent (30%) away from the current index value, provided that demonstrated customer interest exists for such series, as

expressed by institutional, corporate, or individual customers or their broker.

Market makers trading for their own account shall not be considered when

determining customer interest under this provision.

(d) Index Level on the Last Day of Trading. The reported level of the underlying index that is calculated by the reporting authority on the last day of trading in the underlying securities prior to expiration for purposes of determining the current index value at the expiration of an A.M.-settled index option may differ from the level of the index that is separately calculated and reported by the reporting authority and that reflects trading activity subsequent to the opening of trading in any of the underlying securities.

(e) Index Values for Settlement. The Rules of the Options Clearing Corporation specify that, unless the Rules of the Exchange provide otherwise, the current index value used to settle the exercise of an index option contract shall be the closing index for the day on which the index option contract is exercised in accordance with the Rules of the Options Clearing Corporation or, if such day is not a business day, for the most recent business day.

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### **[Meaning of Premium Bids and Offers**

Rule 7.9 Bids and offers shall be expressed in terms of dollars and fractions per unit of the index.]

\* \* \* \* \*

### **Trading Sessions**

#### **Rule 7.10 [Trading Rotations]**

(a). Days and Hours of Business. The Board of Governors has resolved that, except as otherwise provided in this Rule or under unusual conditions as may be determined by the Board or its designee, transactions in index options may be effected on the Exchange

between the hours of 6:30 a.m. and 1:15 p.m. Pacific time. With respect to options on foreign indexes, the Board or its designee shall determine the days and hours of business.

[Rule 7.10]

(b). Trading Rotations. The provisions of Rule 6.64 regarding trading rotations shall apply to index options, except as otherwise provided in Rule 7. [The Order Book Official shall open first those series of a class which have the nearest expiration. Thereafter the Order Book Official shall open the remaining series in a manner he deems appropriate under the circumstances. One and one-half hours after the opening rotation, trading shall become subject to Rule 7.11, unless the Exchange determines it is in the public interest to suspend trading at an earlier time.] Two Floor Officials may delay the commencement of the opening rotation in an index options whenever in their judgment such action is appropriate in the interests of a fair and orderly market. Among the factors that may be considered in making these determinations are:

- (1) unusual conditions or circumstances in other markets;
- (2) an influx of orders that has adversely affected the ability of the Lead Market Maker to provide and to maintain fair and orderly markets;
- (3) activation of opening price limits in stock index futures on one or more futures exchanges;
- (4) activation of daily price limits in stock index futures on one or more futures exchanges;
- (5) the extent to which either there has been a delay in opening or trading is not occurring in stocks underlying the index; and

- (6) circumstances such as those which would result in the declaration of a fast market under Rule 6.28.

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**[Trading Halts or Suspensions]**

(c) [Rule 7.11.] Instituting Trading Halts or Suspensions. Trading on the Exchange in any index option shall be halted or suspended whenever trading in underlying securities whose weighted value represents more than 20%, in the case of a broad based index, and 10% for all other indices, of the index value is halted or is suspended. Trading in an index option shall also be halted whenever Two Floor Officials or the Exchange deem[s] such action appropriate in the interests of a fair and orderly market or to protect investors. Among the factors that may be considered by the Exchange are the following:

- (1) [(i)] all trading has been halted or suspended in the market that is the primary market for a plurality of the underlying stocks;
- (2) [(ii)] the current calculation of the index derived from the current market prices of the stocks is not available; or
- (3) the extent to which the rotation has been completed or other factors regarding the status of the rotation.
- (4) [(iii)] other unusual conditions or circumstances detrimental to the maintenance of a fair and orderly market are present, including, but not limited to the activation of price limits on futures exchanges.

(d) Resumption of Trading Following a Halt or Suspension. Trading in index options of a class or series that has been the subject of a halt or suspension by the Exchange may resume if the Exchange determines that the conditions which led to the halt or suspension are no

longer present, or that the interests of a fair and orderly market are best served by a resumption of trading. Among the factors to be considered in making this determination are whether the conditions that led to the halt or suspension are no longer present, and the extent to which trading is occurring in stocks underlying the index. Upon reopening, a rotation shall be held in each class of index options unless Two Floor Officials conclude that a different method of reopening is appropriate under the circumstances, including, but not limited to, no rotation, an abbreviated rotation or any other variation in the manner of the rotation.

(e) Circuit Breakers. Rule 4.22 applies to index options trading with respect to the initiation of a market-wide trading halt commonly know as a “circuit breaker.”

(f) Special Provisions for Foreign Indices. When the hours of trading of the underlying primary securities market for an index option do not overlap or coincide with those of the Exchange, all of the provisions as described in subsections (b) through (d) above shall not apply except for (b)(4).

(g) Pricing When Primary Market Does Not Open. When the primary market for a security underlying the current index value of an index option does not open for trading, halts trading prematurely, or otherwise experiences a disruption of normal trading on a given day, or if a particular security underlying the current index value of an index option does not open for trading, halts trading prematurely, or otherwise experiences a disruption of normal trading on a given day in its primary market, the price of that security shall be determined, for the purposes of calculating the current index value at expiration, in accordance with the Rules and By-Laws of the Options Clearing Corporation.

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**Rule 7.11 – Reserved.**

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**Debit Put Spread Cash Account Transactions**

Rule 7.12. [Reserved.]

Debit put spread positions in European-style, broad-based index options traded on the Exchange (hereinafter “debit put spreads”) may be maintained in a cash account as defined by Federal Reserve Board Regulation T Section 220.8 by a public customer, provided that the following procedures and criteria are met:

- (a) The customer has received Exchange approval to maintain debit put spreads in a cash account carried by an Exchange member organization. A customer so approved is hereinafter referred to as a “spread exemption customer.”
- (b) The spread exemption customer has provided all information required on Exchange-approved forms and has kept such information current.
- (c) The customer holds a net long position in each of the stocks of a portfolio that has been previously established or in securities readily convertible, and additionally in the case of convertible bonds economically convertible, into common stocks would comprise a portfolio. The debit put spread position must be carried in an account with a member of a self-regulatory organization participating in the Intermarket Surveillance Group.
- (d) The stock portfolio or its equivalent is composed of net long positions in common stocks in at least four industry groups and contains at least twenty (20) stocks, none of which accounts for more than fifteen percent (15%) of the value of the portfolio (hereinafter “qualified portfolio”). To remain qualified, a portfolio must at all times meet these standards notwithstanding trading activity in the stocks.



- (e) The exemption applies to European-style, broad-based index options dealt in on the Exchange to the extent the underlying value of such options positions does not exceed the unhedged value of the qualified portfolio. The unhedged value would be determined as follows:
- (1) the values of the net long or short positions of all qualifying products in the portfolio are totaled;
  - (2) for positions in excess of the standard limit, the underlying market value (A) of any economically equivalent opposite side of the market calls and puts in broad-based index options, and (B) of any opposite side of the market positions in stock index futures, options on stock index futures, and any economically equivalent opposite side of the market positions, assuming no other hedges for these contracts exist, is subtracted from the qualified portfolio; and
  - (3) the market value of the resulting unhedged portfolio is equated to the appropriate number of exempt contracts as follows: the unhedged qualified portfolio is divided by the correspondent closing index value and the quotient is then divided by the index multiplier or 100.
- (f) A debit put spread in Exchange-traded, broad-based index options with European-style exercises is defined as a long put position coupled with a short put position overlying the same broad-based index and having an equivalent underlying aggregate index value, where the short put(s) expires with the long put(s), and the strike price of the long put(s) exceeds the strike price of the short put(s). A debit put spread will be permitted in the cash account as long as it is continuously associated with a qualified portfolio of securities with a current

market value at least to the underlying aggregate index value of the long side of the debit put spread.

(g) The qualified portfolio must be maintained with either a member, another broker-dealer, a bank, or securities depository.

(h) The spread exemption customer shall agree promptly to provide the Exchange any information requested concerning the dollar value and composition of the customer's stock portfolio, and the current debit put spread positions.

(1) The spread exemption customer shall agree to and any member carrying an account for the customer shall:

(A) comply with all Exchange Rules and regulations;

(B) liquidate any debit put spreads prior to or contemporaneously with a decrease in the market value of the qualified portfolio, which debit spreads would thereby be rendered excessive; and

(C) promptly notify the Exchange of any change in the qualified portfolio or the debit put spread position which causes the debit put spreads maintained in the cash account to be rendered excessive.

(i) If any member carrying a cash account for a spread exemption customer with a debit put spread position dealt in on the Exchange has a reason to believe that as a result of an opening options transaction the customer would violate this spread exemption, and such opening transaction occurs, then the member has violated this Rule 7.12.

(j) Violation of any of these provisions, absent reasonable justification or excuse, shall result in withdrawal of the spread exemption and may form the basis for subsequent denial of an application for a spread exemption hereunder.

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## **Disclaimers**

### **Rule 7.13 [Limitation of Liability]**

- (a). Disclaimer. No reporting authority, no affiliate of a reporting authority (each such reporting authority, its affiliates, and any other entity identified in this Rule are referred to collectively as a “Reporting Authority”) makes any warranty, express or implied, as to the results to be obtained by any person or entity from the use of such index, any opening, intra-day or closing value therefor, or any data included therein or relating thereto, in connection with the trading of any option contract based thereon or for any other purpose. The Reporting Authority shall obtain information for inclusion in, or for use in the calculation of such index from sources it believes to be reliable, but the Reporting Authority does not guarantee the accuracy or completeness of such index, any opening, intra-day or closing value therefor, or any data included therein or related thereto. The Reporting Authority hereby disclaims all warranties of merchantability or fitness for a particular purpose or use with respect to such index, any opening, intra-day, or closing value therefor, any data included therein or relating thereto, or any option contract based upon thereon. The Reporting Authority shall have no liability for any damages, claims, losses (including any indirect or consequential losses), expenses, or delays, whether direct or indirect, foreseen or unforeseen, suffered by any person arising out of any circumstance or occurrence relating to the person’s use of such index, any opening, intra-day or closing value therefor, any data included therein or relating thereto, or any option contract based upon thereon, or arising out of any errors or delays in calculating or disseminating such index.

[Each reporting authority with respect to any index underlying an option traded on the Exchange, and any affiliate of such reporting authority (together, the “Reporting Authority”) does not guarantee the accuracy and/or completeness of such index or any data included therein. The Reporting Authority makes no warranty, express or implied, as to the results to be obtained by any person or any entity from the use of such index or any data included therein. The Reporting Authority makes no express or implied warranties, and expressly disclaims all warranties of merchantability and fitness for a particular purpose or use with respect to such index or any data contained therein. Without limiting any of the foregoing, in no event shall the Reporting Authority have any liability for any direct, special, punitive, indirect, or consequential damages (including lost profits), even if notified of the possibility of such damages. In addition, the Reporting Authority shall have no liability for any damages, claims, losses or expenses caused by any errors or delays in calculating or disseminating such index.]

(b) Applicability of Disclaimers. The disclaimers in subsection (a) shall apply to the reporting authorities identified in the Commentary to this Rule.

[Commentary:

.01 The disclaimers set forth in Rule 7.13 shall apply to Dow Jones & Company, Inc. with respect to the Dow Jones Taiwan Stock Index and the Dow Jones Asia Pacific ex-Japan Stock Index, and Morgan Stanley & Co. Incorporated with respect to the Morgan Stanley Emerging Growth Index, the Exchange in respect to the indexes for which it is the designated reporting authority, and any other index reporting authority in respect to any index for which it acts as such.]

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**Rule 7.14. – [Reserved]**

**Exercise of American-Style Options:**

No member may prepare, time stamp or submit an “exercise advice” for an American-style index option series if the Member knows or has reason to know that the exercise instruction calls for the exercise of more contracts than the then “net long position” of the account for which the exercise instruction is to be tendered. For purposes of this rule: (i) the term “net long position” shall mean the net position of the account in such option at the opening of business of the day of such exercise instruction, plus the total number of such options purchased that day in opening purchase transactions up to the time of exercise, less the total number of such options sold that day in closing sale transactions up to the time of exercise; (ii) the “account” shall be the individual account of the particular customer, Market Maker or “non-customer” (as that term is defined in the By-Laws of the Clearing Corporation) who wishes to exercise; and (iii) every transaction in an options series effected by a Market Maker in a Market Maker’s account shall be deemed to be a closing transaction in respect of the Market Maker’s then positions in such options series. No Member may adjust the designation of an “opening transaction” in any such option to a “closing transaction” except to remedy mistakes or errors made in good faith.<sup>16</sup>

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See supra note 4.

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**Rule 7.15 Exercise of Option Contracts**

(a) The provisions of Rule 6.24 shall apply to index options, except as follows:

(1) Clearing Members must follow the procedures of the Options Clearing Corporation when exercising American-style cash-settled index option contracts issued or to be issued in any account at the Options Clearing Corporation. [With respect to all index option contracts except European-style index option contracts, Clearing Members must follow the procedures of the Clearing Corporation for tendering exercise notices.] Members or Member Organizations also must follow the procedures set forth below with respect to American-style, cash-settled index options:

(A) or all contracts exercised by the member or by any customer of the member, an “exercise advice” must be delivered by the member in such form or manner prescribed by the Exchange no later than 1:20 p.m. Pacific time, or if trading hours are extended or modified in the applicable options class, [a memorandum to exercise any contract issued or to be issued in a customer or Market-Maker account at the Clearing Corporation must be received or prepared by the Member Organization] no later than five (5) minutes after the close of trading on that day, [, and must be time-stamped at the time it is received or prepared. Member Organizations must accept exercise instructions until five (5) minutes after the close of trading on that day;]

(B) Subsequent to the delivery of an “exercise,” should the member or a customer of the member determine not to exercise all or part of the advised contracts, the member must also deliver an “advice cancel” in such form or

manner prescribed by the Exchange no later than 1:20 p.m. Pacific time, or if trading hours are extended or modified in the applicable options class, [a memorandum to exercise any contract issue or to be issued in a firm account at the Clearing Corporation must be prepared by the Member Organization] no later than five (5) minutes after the close of trading on that day, and must be time-stamped at the time it is prepared;]

(C) An Exchange official designated by the Board may determine to extend the applicable deadline for the delivery of “exercise advice” and “advice cancel” notifications pursuant to this Rule if unusual circumstances are present.

(D) No Member may prepare, time stamp or submit an “exercise advice” prior to the purchase of the contracts to be exercised if the Member knew or had reason to know that the contracts had not yet been purchased.<sup>17</sup>

(E) [(C)] The failure of any member to follow the procedures in this Rule may 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 Exchange. [and meet the deadlines in this Section 15 may result in the assessment of fines in an amount determined by the Exchange, and further disciplinary action as may be appropriate;]

(F) Preparing or submitting an “exercise advice” or “advice cancel” after the applicable deadline on the basis of material information released after such

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<sup>17</sup>

See supra note 4.

deadline, in addition to constituting a violation of this Rule, is activity inconsistent with just and equitable principles of trade.

[(D) all memoranda of exercise instructions are subject to SEC Rules 17a-3(a)(6) and 17a-4(b); and

(E) any member or member organization that intends to submit an exercise notice for 25 or more contracts in the same series on the same business day on behalf of an individual customer, market maker or firm account must deliver an “exercise advice,” on a form prescribed by the Exchange, to a place designated by the Exchange, no later than five (5) minutes after the close of trading on that day. For purposes of this rule, exercises for all accounts controlled by same individual must be aggregated.]

[(F)] The procedures set forth in subsections (A) and (B) of this Rule do not apply (i) on the business day prior to expiration in series expiring on a day other than a business day or (ii) on the expiration day in series expiring on a business day. [The above provisions specified in Rule 6.24(a) through Rule 6.24(e) are not applicable to expiring series on the business day prior to expiration.]

(H) Exercises of American-style, cash-settled index options (and the submission of corresponding “exercise advice” and “advice cancel” forms) shall be prohibited during any time when trading in such options is delayed, halted, or suspended, subject to the following exceptions:

(i) The exercises of an American-style, cash-settled index option may be processed and given effect in accordance with and subject to the rules



of the Options Clearing Corporation while trading in the option is delayed, halted, or suspended if it can be documented, in a form prescribed by the Exchange, that the decision to exercise the option was made during allowable time frames prior to the delay, halt, or suspension.

(ii) Exercises of expiring American-styled, cash-settled index options shall not be prohibited on the last business day prior to their expiration.

(iii) Exercises of American-style, cash-settled index options shall not be prohibited during a trading halt that occurs at or after 1:00 p.m. Pacific Time. In the event of such a trading halt, exercises may occur through 1:20 p.m. Pacific Time. In addition, if trading resumes following such a trading halt (such as by closing rotation), exercises may occur during the resumption of trading and for five (5) minutes after the close of the resumption of trading. The provisions of this subparagraph (iii) are subject to the authority of the Board of Governors to impose restrictions on transactions and exercises pursuant to Rule 6.10.

(iv) An Exchange official designated by the Board of Governors may determine to permit the exercise of American-style, cash-settled index options while trading in such options is delayed, halted, or suspended.

(2) (No changes).

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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 PCX 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 III below. The PCX 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

a. Position and Exercise Limits

The PCX is proposing to amend PCX Rules 7.5 and 7.6 in order to increase the position and exercise limits for broad-based index options to the levels currently in place at the CBOE. Specifically, the Exchange proposes to amend the current broad-based position and exercise limits to 25,000.<sup>18</sup> In certain circumstances, however, there may be no position limits for certain specified broad-based option contracts.<sup>19</sup>

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<sup>18</sup> The 25,000 contract position and exercise limit for broad-based index options is derived from CBOE Rule 24.4. In CBOE Rule 24.4, 25,000 contracts serves as the base position limit for broad-based index options.

<sup>19</sup> For example, CBOE Rule 24.4 states that there are no position limits on DJX, OEX and SPX classes. See supra note 4.

b. Other Index Options Related Rules

The Exchange is proposing to amend the following rules related to index options in order to bring the PCX rules up to date and consistent with other SROs. These changes also include several re-numbering and cosmetic changes.

- (a) Amendment to PCX Rules 7 and 7.1: This proposed amendment is intended to clarify that the Exchange will file additional proposed rule changes with the Commission with respect to particular indices that are product specific. The proposed amendment also contains several updates to definitions with respect to index options.
- (b) Amendment to PCX Rule 7.7: This proposed amendment outlines the exemptions for position limits for broad-based index options and the procedures for requesting such exemptions.
- (c) Amendment to PCX Rules 7.9 and 7.12: The proposed amendment to PCX Rule 7.9 (currently PCX Rule 7.8(a)) outlines the terms of index options contracts, while proposed PCX Rule 7.12 applies to debit put spreads.
- (d) Amendment to PCX Rule 7.10: The proposed amendments to PCX Rule 7.10 apply to trading sessions, trading rotations, and trading halts or suspensions for index options.
- (e) Amendment to PCX Rule 7.13: This proposed amendment updates the provisions for liability for index reporting authorities.
- (f) Amendment to PCX Rules 6.11, 7.14 and 7.15: These proposed amendments apply to the exercise of index options, exercise of American-style index

options, and the procedure for underwriter requests for restrictions on uncovered opening writing transactions during public distributions.<sup>20</sup>

- (g) Amendment to PCX Rule 6.37: This proposed amendment provides the Exchange with greater flexibility on applying market making obligations when the primary underlying securities market is not open for trading. The proposed amendment also addresses calculation of bid/ask differentials on options on indices.
- (h) Amendment to PCX Rule 6.8: This proposed amendment adds broad-based index options to the market maker exemption from position limits.
- (i) Amendment to PCX Rule 6.64(e): This proposed amendment includes index options to the closing rotation provision.

## 2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Act,<sup>21</sup> in general, and furthers the objectives of Section 6(b)(5),<sup>22</sup> in particular, in that it is designed to facilitate transactions in securities, to promote just and equitable principles of trade, to enhance competition, and 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.

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<sup>20</sup> See supra note 4.

<sup>21</sup> 15 U.S.C. 78f(b).

<sup>22</sup> 15 U.S.C. 78f(b)(5).

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

Written comments on the proposed rule change were neither solicited nor received.

III. 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. Comments may also be submitted electronically at the following e-mail address: [rule-comments@sec.gov](mailto:rule-comments@sec.gov). All comment letters should refer to File No. SR-PCX-2003-60. The file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. 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 in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the PCX. All submissions should refer to the File No. SR-PCX-2003-60 and should be submitted by [insert date 21 days from date of publication].

IV. Commission’s Findings and Order Granting Accelerated Approval of Proposed Rule Change

After careful review, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of Section 6(b)(5) of the Act<sup>23</sup> and the rules and regulations thereunder applicable to a national securities exchange.<sup>24</sup> The Commission believes that the PCX’s proposal to update its trading rules and certain standards related to index options strikes a reasonable balance between the Commission’s mandates under Section 6(b)(5) of the Act<sup>25</sup> to remove impediments to and perfect the mechanisms of a free and open market and a national market system while protecting investors and the public interest.

The proposed rule, among other things, updates the rules that govern the trading sessions of index options, including the days and hours of business, the rules governing trading rotations at the opening, and the rules related to the trading halts or suspensions.<sup>26</sup> The proposed rule change provides updated definitions for terms related to index options.<sup>27</sup> The proposed rule further updates the procedures PCX members must follow with respect to the exercise of American-style, cash settled index options.<sup>28</sup> The proposed rule also updates position limits for broad-based index

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<sup>23</sup> 15 U.S.C. 78f(b)(5).

<sup>24</sup> In approving this proposal, the Commission has considered the proposed rule’s impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>25</sup> See note 21 supra.

<sup>26</sup> See Proposed PCX Rule 7.10 .

<sup>27</sup> See Proposed PCX Rule 7.1.

<sup>28</sup> See Proposed PCX Rule 6.11 and 7.15.

options<sup>29</sup> and exercise limits for broad-based and narrow-based index options.<sup>30</sup> In addition, the proposed rule updates the hedge exemption standards from position and exercise limits and procedures for requesting exemptions from the proposed rule.<sup>31</sup> The Commission notes that the PCX has not amended its Rule 7.3 to provide for generic listing standards for narrow-based index options that would be eligible for streamlined listing and trading pursuant to Rule 19b-4(e) under the Act.<sup>32</sup> Because the PCX has not established generic listing standards for narrow-based index options, the Exchange would be required to submit a proposed rule change pursuant to Section 19(b)(2) of the Act,<sup>33</sup> if it were to seek the listing and trading of a class of a new narrow-based index option,<sup>34</sup> notwithstanding the provision of PCX Rule 7.3(b), which suggests that the

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<sup>29</sup> See Proposed PCX Rule 7.5.

<sup>30</sup> See Proposed PCX Rule 7.8.

<sup>31</sup> See Proposed PCX Rule 7.7.

<sup>32</sup> 17 CFR 240.19b-4(e). Rule 19b-4(e) provides that the listing and trading of a new derivative securities product by an SRO shall not be deemed a proposed rule change, pursuant to paragraph (c)(1) of Rule 19b-4, if the Commission has approved, pursuant to Section 19(b) of the Act, the SRO's trading rules, procedures, and listing standards for the product class that include the new derivative securities product and the SRO has a surveillance program for the product class. When relying on Rule 19b-4(e), the SRO must submit Form 19b-4(e) to the Commission within five business days after the SRO begins trading the new derivative securities products. See Securities Exchange Act Release No. 40761 (December 8, 1998), 63 FR 70952 (December 22, 1998) (File No. S7-13-98) (“19b-4(e) Release”).

<sup>33</sup> 15 U.S.C. 78s(b)(2).

<sup>34</sup> See 19b-4(e) Release, supra note 32, at fn 135.

Exchange can list a class of certain narrow-based index options pursuant to Section 19(b)(3)(A) of the Act.<sup>35</sup>

The Commission believes that trading options on an index of securities permits investors to participate in the price movements of indexes' underlying securities and allows investors holding positions in some or all of such securities to hedge the risks associated with their portfolios. The Commission further believes that trading options on an index provides investors with an important trading and hedging mechanism that is designed to reflect accurately the overall movement of the component stocks.

The Commission finds good cause, pursuant to Section 19(b)(2) of the Act,<sup>36</sup> for approving the proposed rule change prior to the thirtieth day after the date of publication of the notice of the filing thereof in the Federal Register. The Commission believes that granting accelerated approval will provide PCX members with updated trading rules and standards that should serve to protect the interests of investors. In making this finding, the Commission notes that all of the proposed new Exchange Rules and changes to existing Exchange Rules are comparable to the existing rules of the other options exchanges.<sup>37</sup>

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<sup>35</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>36</sup> 15 U.S.C. 78s(b)(2).

<sup>37</sup> See, e.g. CBOE Rules 4.11, 4.16, 6.2, 6.7, 8.7, 11.1, and 24.1 through 24.14; ISE Rules 413, 418, 701, 705, 803, 1100, and 2000 through 2012.



V. Conclusion

IS IT THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>38</sup> that the proposed rule change (SR-PCX-2003-60) is hereby approved, as amended, on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>39</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>38</sup> 15 U.S.C. 78s(b)(2).

<sup>39</sup> 17 CFR 200.30-3(a)(12).