SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50549; File No. SR-PCX-2004-87)

October 15, 2004

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Pacific Exchange, Inc. Relating to Trades Resulting from Obvious Error

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder,[2] notice is hereby given that on September 21, 2004, the Pacific Exchange, Inc. ("PCX" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. The proposed rule change has been filed by the PCX as a "non-controversial" rule change pursuant to Section 19(b)(3)(A) of the Act[3] and Rule 19b-4(f)(6) thereunder.[4] The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

PCX proposes to amend its rules pertaining to trade nullification and price adjustment procedures. Additions are italicized. Deletions are bracketed.

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Rule 6.87 (g) Trade Nullification and Price Adjustment Procedures

The Exchange shall either bust a transaction or adjust the execution price of a transaction that results from an Obvious Error as provided in this Rule.

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 15 U.S.C. 78s(b)(3)(A).

4 17 CFR 240.19b-4(f)(6).

(1) Definition of Obvious Error. For purposes of this Rule only, an Obvious Error will be deemed to have occurred when the execution price of a transaction is higher or lower than the Theoretical Price for the series by an amount equal to at least the amount shown below:

Theoretical Price	**Minimum Amount**
Below $2	.25
$2 to $5	.40
Above $5 to $10	.50
Above $10 to $20	.80
Above $20	1.00

(2) Definition of Theoretical Price. For purposes of this Rule only, the Theoretical Price of an option is:

(A) if the series is traded on at least one other options exchange, the last bid price with respect to an erroneous sell transaction and the last offer price with respect to an erroneous buy transaction, just prior to the trade, disseminated by the competing options exchange that has the most liquidity in that option; or

(B) if there are not quotes for comparison purposes, as determined by designated personnel of the Exchange.

(3) Obvious Error Procedure. The Exchange shall administer the application of this Rule as follows.

(A) Notification. If a Market Maker on the Exchange believes that it participated in a transaction that was the result of an Obvious Error, it must notify the Exchange within five (5) minutes of the execution. If an OTP Holder or OTP Firm not serving as a Market Maker on the Exchange believes that 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, the Exchange will not grant relief under this Rule unless notification is made within the prescribed time periods.

(B) Adjust or Bust. The Exchange will determine whether there was an Obvious Error as defined above. If it is determined that an Obvious Error has occurred, the Exchange shall take one of the following actions listed below. Upon taking final action, the Exchange shall promptly notify both parties to the trade.

(i) where each party to the transaction is a Market Maker on the Exchange, the execution price of the transaction will be adjusted by the Exchange to the prices provided in paragraphs (aa) and (bb) below unless both parties agree to adjust the transaction to a different price or agree to bust the trade within ten (10) minutes of being notified by the Exchange of the Obvious Error

(aa) Erroneous buy transactions will be adjusted to their Theoretical Price: plus $.15 if the Theoretical Price is under $3 and plus $.30 if the Theoretical Price is at or above $3.

(bb) Erroneous sell transactions will be adjusted to their Theoretical Price: minus $.15 if the Theoretical Price is under $3 and minus $.30 if the Theoretical Price is at or above $3.

(ii) Where at least one party to the Obvious Error is not a Market Maker on the Exchange, the trade will be busted by the Exchange unless both parties agree to an adjustment price for the transaction within thirty (30) minutes of being notified by the Exchange of the Obvious Error.[5]

[(1) Mutual Agreement: The determination as to whether an Auto-Ex trade was executed at an erroneous price may 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.

(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 OTP Holder is responsible

5 With the Exchange's consent, the Commission has made technical corrections to the text of the proposed rule change. Telephone conversation between Mai Shiver, Director and Senior Counsel, PCX, and Susie Cho, Special Counsel, and Frank Genco, Special Counsel, Division of Market Regulation ("Division"), Commission, on October 14, 2004.

where there is Exchange documentation providing that the OTP Holder 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). The bid/ask spread set forth in Rule 6.37(b)(1) will also apply to LEAPS and options subject to unusual market conditions. In the event the bid/ask spread in the underlying is greater than the bid/ask spread set forth in Rule 6.37(b)(1), the Exchange will apply the bid/ask spread differential set forth in Rule 6.37 (b)(3).

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 OTP Holder 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 reference to the strike price for the put minus the bid price of the underlying security in the Primary Market at the time of the transaction.

(3) Obvious Error Procedure. Two Trading Officials will administer the application of this Rule as follows:

A. Notification. If an OTP Holder believes that it participated in a transaction that was the result of an Obvious Error, it must notify two Trading 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 Trading Officials will not grant relief under this Rule unless notification is made within the prescribed time periods.

B. Adjust or Nullify**.** Two Trading Officials will determine whether the execution is subject to a trade nullification or price adjustment. If two Trading 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 Trading 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 Trading 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 Trading Officials making such determination.

(3) Upon taking final action, the two Trading Officials will promptly notify both parties to the trade.]

Commentary:

[.01 In no case will the two Trading Officials involved in an obvious error determination include a person related to a party to the trade in question.]

.01 [02] All determinations made by the [two Trading Officials] Exchange under subsection [(g)(2)] (g)(3) will be rendered without prejudice as to the rights of the parties to the transaction to submit a dispute to arbitration.

.02 [.03] Nothing in this rule prevents a potentially aggrieved party from appealing the decision of [two Trading Officials] the Exchange pursuant to Rule [11] 10.14 of the Exchange rules.

.03 When the Exchange determines that an Obvious Error has occurred and action is warranted under Rule 6.87(g)(3)(B) above, the identity of the parties to the trade will be disclosed to each other in order to encourage conflict resolution.[6]

.04 Buyers of options with a zero bid and $.05 offer (i.e., a Theoretical Price of $.05) may request that their execution be busted if at least the two strikes below (for calls) or above (for puts) in the same options class were quoted with a zero bid and $.05 offer at the time of the execution. Such buyers must follow the procedures of Rule 6.87(g)(3) above.

[6] With the Exchange's consent, the Commission has made technical corrections to the text of the proposed rule change. Telephone conversation between Mai Sharif Shiver, Director/Senior Counsel, PCX, and Susie Cho, Special Counsel, Division, Commission, on October 12, 2004.

.05 For purposes of Rule 6.87 (g)(2)(A), the competing options exchange with the most liquidity will be the options exchange that had the highest total contract volume in the options class for the previous two months (e.g., if an obvious error occurs on March 9, the total contract volume from January 8 to March 9 will be used).

.06 For purposes of Rule 6.87(g)(3)(B), an "erroneous sell transaction" is one in which the price received by the person selling the option is erroneously low, and an "erroneous buy transaction" is one in which the price paid by the person purchasing the option is erroneously high.

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Rule 10.14(a). General Provisions. This Rule provides the procedure for persons aggrieved by any of the following actions taken by the Exchange to apply for an opportunity to be heard and to have the action reviewed. These actions are:

(1) – (4) – No change.

(5) actions taken pursuant to Rules 6.37, 6.82(f), [and] 6.82(g), and 6.87; or

(6) – No change.

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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 parts of such statements.

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

1. Purpose

In 2003, the Commission approved a proposal by the Exchange to adopt PCX Rule 6.87(g), which delineated (1) the circumstances under which an error would be subject to a trade adjustment or nullification, and (2) the procedures that the Exchange would follow in order to effect such adjustments and nullifications.[7] Because OTP Holders and OTP Firms operating on the Exchange also serve as members of other national options exchanges, and because other options exchanges have moved towards rule simplification in order to eliminate uncertainty in the event of an error, the Exchange believes it would be advantageous to adopt a simplified procedure whereby OTP Holders and OTP Firms would have the ability to rely on a uniform standard for evaluating their response to a transaction that qualifies as an obvious error. The Exchange has consulted with its OTP Holders and OTP Firms and determined that the structure adopted by the International Stock Exchange, Inc. ("ISE") pursuant to ISE Rule 720 for obvious error resolution provides a sound, simplified procedure. As a result, the Exchange seeks to amend its Rule 6.87(g) to make it substantially identical to ISE's provisions.

Currently, Exchange Rule 6.87(g) provides that, absent mutual agreement, parties to a trade may have a trade nullified or its price adjusted if: (1) the trade resulted from a verifiable disruption or malfunction of an Exchange system that caused trades in excess of the disseminated size; (2) the trade resulted from a verifiable disruption or malfunction of an Exchange system that prevented an OTP Holder or OTP Firm from updating or canceling a quote/order for which the OTP Holder or OTP Firm is responsible; (3) the trade resulted from an erroneous print

[7] See Securities Exchange Act Release No. 48538 (September 25, 2003), 68 FR 56858 (October 2, 2003) (approving File No. PCX-2002-01).

disseminated by the underlying market which is later cancelled or corrected by the underlying market; (4) the trade resulted from an erroneous quote in the Primary Market for the underlying security (under specified conditions); (5) the execution price of the trade is higher or lower than the mid-point of the best bid and offer by an amount equal to at least the bid/ask spread; (6) 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 (7) the trade is automatically executed at a price where the market maker sells $0.10 or more below parity.

As proposed, the amended PCX Rule 6.87(g) would provide that the Exchange[8] shall either bust a transaction or adjust the execution price of a transaction only when the execution price of a transaction is higher or lower than a theoretical price for the series by an amount equal to at least the amount shown below:

Theoretical Price	**Minimum Amount**
Below $2	.25
$2 to $5	.40
Above $5 to $10	.50
Above $10 to $20	.80
Above $20	1.00

8 The Exchange represents that, for purposes of PCX Rule 6.87(g) and its associated Commentaries, references to the Exchange and Exchange personnel shall mean senior operations personnel in the Exchange's Department of Options Operations. Telephone conversation between Mai Sharif Shiver, Director/Senior Counsel, PCX, and Susie Cho, Special Counsel, and Frank Genco, Special Counsel, Division, Commission, on October 12, 2004.

For purposes of PCX Rule 6.87(g), the theoretical price of an option would be the last bid price with respect to an erroneous sell transaction and the last offer price with respect to an erroneous buy transaction, just prior to the trade, disseminated by the competing options exchange that has the most liquidity in that option ("Theoretical Price"). If there are no quotes for comparison purposes, the Theoretical Price would be determined by designated personnel of the Exchange.

The Exchange also proposes to modify the procedure it uses to adjust or nullify an execution that occurred as a result of an obvious error. The Exchange proposes that the administration and application of the obvious error procedure be handled by the Exchange itself, rather than by two trading officials. The Exchange also seeks to modify its adjust or nullify rules to eliminate most of the nuances between PCX Rule 6.87(g) and ISE Rule 720. Specifically, the Exchange's current rules provide that the execution price of a trade would be adjusted if the transaction is between market makers or if it involves a limit order that may be adjusted to its limit. In such case, the trade would be adjusted to the last bid or offer from the exchange providing the highest total contract volume in the option for the previous 60 days with respect to the erroneous bid or offer entered on the Exchange. The Exchange's current rules also provide that where a party to a transaction is not a market maker on the Exchange or where the trade involves a limit order that may be adjusted to its limit, the Exchange would nullify the transaction.

The Exchange proposes to adopt the following procedure instead:

<u>Notification:</u> If a market maker on the Exchange believes that it participated in a transaction that was the result of an obvious error, it must notify the Exchange within five (5) minutes of the execution. If an OTP Holder or OTP Firm not serving as a market maker on the Exchange believes that 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, the Exchange would not grant relief under this rule unless notification is made within the prescribed time periods.

Adjust or Bust: If it is determined that an obvious error has occurred, the Exchange would take one of the following actions listed below. Upon taking final action, the Exchange would promptly notify both parties to the trade. Where each party to the transaction is a market maker on the Exchange, the execution price of the transaction would be adjusted by the Exchange unless both parties agree to bust the trade within ten (10) minutes of being notified by the Exchange of the obvious error. Erroneous buy transactions would be adjusted to their Theoretical Price plus $.15 if the Theoretical price is under $3, or plus $.30 if the Theoretical Price is at or above $3. Erroneous sell transactions would be adjusted to their Theoretical Price minus $.15 if the Theoretical Price is under $3, or minus $.30 if the Theoretical Price is at or above $3. Where at least one party to the obvious error is not a market maker on the Exchange, the trade would be busted by the Exchange unless both parties agree to an adjustment price for the transaction within thirty (30) minutes of being notified by the Exchange of the obvious error.

The Exchange further seeks to renumber its Commentary provisions to PCX Rule 6.87 and add new ones that relate to: (1) disclosing the identity of parties to an obvious error transaction (Commentary .03 to PCX Rule 6.87); (2) inclusion of options with zero bid and offered at a nickel (Commentary .03 to PCX Rule 6.87 – modified from the Exchange's existing Rule 6.87(g)(2)(F) – relating to no bid erroneous executions); (3) defining the options exchange providing the most liquidity (Commentary .05 to PCX Rule 6.87); and (4) defining "erroneous sell transactions and erroneous buy transactions (Commentary .06 to PCX Rule 6.87). The Exchange also seeks to add a cross reference to its hearing and review rule, PCX Rule

10.14(a)(5), to include PCX Rule 6.87 as a rule from which a potentially aggrieved party may appeal a decision under PCX Rule 10.14.

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Act,[9] in general, and Section 6(b)(5) of the Act,[10] in particular, because it is designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts and practices, 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 significant burden on competition.

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

Written comments were neither solicited nor received with respect to the proposed rule change.

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

The foregoing proposed rule change (1) does not significantly affect the protection of investors or the public interest; (2) does not impose any significant burden on competition; and (3) by its terms, does not become operative until 30 days from the date on which it was filed, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest. Furthermore, the Exchange provided the Commission with written notice of its intent to file the proposed rule change, along with a brief description and text of the

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9 15 U.S.C. 78f(b).

10 15 U.S.C. 78f(b)(5).

proposed rule change, at least five business days prior to the date of filing of the proposed rule change. Consequently, the proposed rule change has become effective pursuant to Section 19(b)(3)(A) of the Act[11] and Rule 19b-4(f)(6) thereunder.[12]

The PCX has requested that the Commission waive the 30-day operative delay. The Commission believes that waiving the 30-day operative delay is consistent with the protection of investors and the public interest. The Commission believes that waiver of the 30-day operative delay would enable the Exchange to implement the proposal as quickly as possible. In addition, the Commission notes that the proposal to amend the PCX obvious error rule is substantially identical to ISE Rule 720. Thus, the Commission does not believe that the proposed rule change raises any new regulatory issues.[13] For these reasons, the Commission designates the proposal to be effective and operative upon filing with the Commission.[14]

At any time within 60 days of the filing of this proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

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11 15 U.S.C. 78s(b)(3)(A).

12 17 CFR 240.19b-4(f)(6).

13 See Securities Exchange Act Release No. 48097 (June 26, 2003), 68 FR 39604 (July 2, 2003) (amending ISE obvious error rule).

14 For purposes only of accelerating the operative date of this proposal, the Commission has considered the proposed rule's impact on efficiency, competition,

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-PCX-2004-87 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-PCX-2004-87. This 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, please use only one method. The Commission will post all comments on the Commission's Internet Web site (http://www.sec.gov/rules/sro.shtml). 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 Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of PCX. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information

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and capital formation. 15 U.S.C. 78c(f).

that you wish to make available publicly. All submissions should refer to File Number SR-PCX-2004-87 and should be submitted on or before [insert date 21 days from publication in the Federal Register]

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[15]

Jill M. Peterson
Assistant Secretary

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[15] 17 CFR 200.30-3(a)(12).