



RULE
ADOPTION
NOTICE

RAN-05-39
May 31, 2005

TO: All PCX OTP Holders and OTP Firms

FROM: Department of Regulatory Policy

**SUBJECT: Market Maker Risk Limitation Mechanism
(File No. SR-PCX-2005-64)**

On May 2, 2005, the Exchange filed with the Securities and Exchange Commission a proposal to adopt Rule 6.40, which governs the use of the Market Maker Risk Limitation Mechanism. The Exchange filed Amendment Nos. 1 and 2 on May 19, 2005 and May 23, 2005 respectively and Amendments Nos. 3 and 4 on May 24, 2005. In addition to the adoption of the new rule in this filing, the Exchange proposed to amend PCX Rule 6.37(g)(1) which deals with a Lead Market Makers quoting obligations. The rule change was approved on May 27, 2005.

The following is the text of Rule 6.40. and 6.37(g)(1). Questions regarding this bulletin may be directed to Glenn H.Gsell at (415)-835-4805.

EXHIBIT 5
Text of the Proposed Rule Change:¹

**Rules of the
Pacific Exchange, Inc.**

Rule 6
Market Maker Risk Limitation Mechanism

Rule 6.40 [Reserved.] (a) Trade Counter. The trading engine will maintain a "trade counter" for each Market Maker on each class to which the Market Maker is appointed. This trade counter will be incremented by one every time the Market Maker executes a trade on any series in the appointed class. The trade counter will automatically reset itself every "n" seconds.

¹ New text is underlined, deleted text is in brackets for changes made pursuant to Amendment 2 filing; new text is in bold and deleted text is in strike through for changes made pursuant to partial Amendment No. 3

(b) Market Maker Risk Limitation Mechanism. The trading engine will activate the Market Maker Risk Limitation Mechanism on an appointed class whenever the following conditions are met: The trade counter has reached "n" executions against the quotes of the Market Maker in the Market Maker's appointed class during a period of "n" seconds. When the above conditions are met, the trading engine will automatically cancel all quotes posted by the Market Maker on that class by generating a "bulk cancel" message.

(c) The bulk cancel message will be processed in time priority with any other quote or order message received by the trading engine. Any orders or quotes that matched with the Market Maker's quote and were received in the trading engine prior to the receipt of the bulk cancel message will be automatically executed. Orders or quotes received in the trading engine after receipt of the bulk cancel message will not be executed against the Market Maker.

(d) Once the Market Maker Risk Limitation Mechanism has been activated for an options class, any bulk quote messages sent by the Market Maker on that class would continue to be rejected until the Market Maker submits a message to the trading engine to enable new quotes.

(e) In the event that a Lead Market Maker's ("LMM") quotes are cancelled and there are no other Market Makers quoting in the issue, the trading engine will automatically provide two-sided legal quotes on behalf of the LMM until such time the LMM submits a message to the trading engine to enable new quotes. All quotes generated by the Exchange on behalf of an LMM will be considered "firm quotes" and shall be the obligation of the LMM.

(f) Each Market Maker that is quoting in an issue shall determine the appropriate trade counter threshold of "n" executions and the time period of "n" seconds as described in paragraph (b) above to activate the Market Maker Risk Limitation Mechanism. The trade counter threshold must be at least five executions. The time period must be at least 1/2 second. At no time may the trade counter be set for a trade rate of less than five executions in a one second period.

(g) For purposes of this Rule 6.40, a "bulk quote" message is a single message from a Market Maker that simultaneously updates all of the Market Maker's quotes in multiple series in a class at the same time.

Commentary:

.01 A trade rate of five executions in a one second period will allow for Market Makers to provide different risk settings. Based on a minimum rate of five executions per second, permissible settings could be five executions in a one second period, ten executions in a two second period fifteen executions in three a second period and so forth, using the same minimum executions per second ratio.

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Obligations of Market Makers

Rule 6.37 (a)- (f) - No change

(g) Quoting Obligations of Market Makers.

(1) Lead Market Makers. Lead Market Makers must provide continuous two-sided quotations throughout the trading day in each of their appointed issues for 99% of the time the Exchange is open for trading in each issue. Such quotations must meet the legal quote width requirements of Rule 6.37(b). LMMs must also specify a size for each of their quotations applicable to:

(A) – (B) - No change.

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