RULE
ADOPTION
NOTICE

RAN-06-01
January 4, 2006

TO: **All OTP Holders and OTP Firms**
All ETP Holders and Sponsored Participants

FROM: **Equity Securities Qualification**

SUBJECT: **Generic Listing Standards for Options on Narrow-Based and Micro Narrow-Based Indexes (File No. SR-PCX-2005-79)**

On June 27, 2005, the Pacific Exchange, Inc. ("PCX" or "Exchange") filed a proposed rule change with the Securities and Exchange Commission ("Commission") to amend PCX Rule 5 to:

(1) provide for the listing and trading of narrow-based index options,
(2) amend the position and exercise limits with respect to narrow-based index options,
(3) update the Exchange's narrow-based index options rules to ensure conformity with those of other Self-Regulatory Organizations, and
(4) adopt new generic listing standards for options on micro narrow-based indexes.

On November 3 and December 6, 2005, the Exchange amended the proposed rule changes.

On December 15, 2005, the Commission's Order granting accelerated approval of the proposed rule change, as amended, was published in the Federal Register.

The following is the text of the revised Rule 5. Please direct any questions regarding this bulletin to David Strandberg at (312) 442-7085.

EXHIBIT 5

Text of the Proposed Rule Change:[1]

Rules of the Pacific Exchange, Inc.

Rule 5

[1] New text is underscored; deleted text is in brackets.

Options Contracts Traded on the Exchange

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Definitions

Rule 5.10(b)(1) – (24) – No Change.

> (25) The term "Micro Narrow-Based Index" means an industry or narrow-based index that meets the specific criteria provided under Rule 5.13(d).

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Designation of the Index Narrow-Based Index Options

Rule 5.13(a) The component securities of an index underlying an index option contract need not meet the requirements of Rule 5.3. Except as set forth in subsection (b) below, the listing of a class of index options on a narrow-based index requires the filing of a proposed rule change to be approved by the SEC under Section 19(b) of the Securities Exchange Act of 1934 (“1934 Act”). [The listing of a class of index options on a new narrow-based index will be treated by the Exchange as a proposed rule change subject to filing with and approval by the Securities and Exchange Commission (“Commission”) under Section 19(b) of the Exchange Act. A rule change proposing the listing of a class of index options on a new underlying index may be designated by the Exchange as constituting a stated policy, practice or interpretation with respect to the administration of this Rule 5.13(a) within the meaning of subparagraph (3)(A) of subsection 19(b) of the Exchange Act, thereby qualifying the rule change for effectiveness upon filing with the Commission if the Exchange prefiles with the Commission a draft copy of the rule change not less than one week before it is filed, and if the Exchange proposes to commence trading in the subject class of index options not earlier than 30 days after the date of filing, and if each of the following conditions is satisfied:]

(b) *Narrow-Based Index*. The Exchange may trade options on a narrow-based index pursuant to Rule 19b-4(e) of the 1934 Act, if each of the following conditions is satisfied:

> (1) – No Change.
> (2) The index is capitalization-weighted, price weighted, [or] or equal dollar-weighted, or modified capitalization-weighted, and consists of ten or more component securities;
>
> (3) – (4) – No Change.
>
> (5) In a capitalization-weighted index or a modified capitalization-weighted index, the lesser of the five highest weighted component securities in the index or the highest weighted component securities in the index that in the

aggregate represent at least 30% of the total number of component securities in the index each have had an average monthly trading volume of at least 2,000,000 shares over the past six months;

(6) No single component security represents more than [25]30% of the weight of the index, and the five highest weighted component securities in the index do not in the aggregate account for more than 50% ([60]65% for an index consisting of fewer than 25 component securities) of the weight of the index.

(7) – No change.

(8) – [All Component securities are "reported securities" as defined in Rule 11Aa3-1 under the Exchange Act.] Each component security must be an "NMS stock" as defined in Rule 600 of Regulation NMS of the Securities Exchange Act of 1934.

(9) – (12) – No change.

[Maintenance Requirements
Narrow-Based Index Options]

[5.13(b)](c) *Maintenance Criteria.* The following maintenance listing standards shall apply to each class of index options originally listed pursuant to subsection [paragraph] [(a)] (b) above:

(1) The requirements [conditions] stated in subsections [subparagraphs] [(a)](b)(1), (3), (6), (7), (8), (9), (10), (11) and (12) must continue to be satisfied, provided that the requirements [conditions] stated in subparagraph [(a)](b)(6) must be satisfied only as of the first day of January and July in each year;

(2) – (3) – No change.

(4) In a capitalization-weighted index or a modified capitalization-weighted index, the lesser of the five highest weighted component securities in the index or the highest weighted component securities in the index that in the aggregate represent at least 30% of the total number of stocks in the index each have had an average monthly trading volume of at least 1,000,000 shares over the past six months.

In the event of a class of index options listed on the Exchange fails to satisfy the maintenance listing standards set forth herein, the Exchange shall not open for trading any additional series of options of that class unless such failure is determined by the Exchange not to be significant and the Commission concurs in that determination, or unless the continued listing of that class of index options has been approved by the Commission under Section 19(b)(2) of the Exchange Act.

(d) Notwithstanding paragraph (a) above, the Exchange may trade options on a Micro Narrow-Based security index pursuant to Rule 19b-4(e) of the 1934 Act, if each of the following condition is satisfied:

(1) The Index is a security index:

(i) that has 9 or fewer component securities; or

(ii) in which a component security comprises more than 30 percent of the index's weighting; or

(iii) in which the 5 highest weighted component securities in the aggregate comprise more than 60 percent of the index's weighting; or

(iv) in which the lowest weighted component securities comprising, in the aggregate, 25 percent of the index's weighting have an aggregate dollar value of average daily trading volume of less than $50,000,000 (or in the case of an index with 15 or more component securities, $30,000,000) except that if there are two or more securities with equal weighting that could be included in the calculation of the lowest weighted component securities comprising, in the aggregate, 25 percent of the index's weighting, such securities shall be ranked from lowest to highest dollar value of average daily trading volume and shall be included in the calculation based on their ranking starting with the lowest ranked security;

(2) The index is capitalization-weighted, modified capitalization-weighted, price-weighted, share weighted, equal dollar-weighted, approximate equal-dollar weighted, or modified equal-dollar weighted;

(i) For the purposes of this Rule 5.13(d), an approximate equal-dollar weighted index is composed of one or more securities in which each component security will be weighted equally based on its market price on the index's selection date and the index must be reconstituted and rebalanced if the notional value of the largest component is at least twice the notional volume of the smallest component for fifty percent or more of the trading days in the three months prior to December 31 of each year. For purposes of this provision the "notional value" is the market price of the component times the number of shares of the underlying component in the index. Reconstitution and rebalancing are also mandatory if the number of components in the index is greater than five at the time of rebalancing. The Exchange reserves the right to rebalance quarterly at its discretion.

(ii) For the purposes of this Rule 5.13(d), a modified equal-dollar weighted index is an index in which each underlying component represents a pre-determined weighting percentage of the entire index. Each component is assigned a weight that takes into account the relative market capitalization of the securities comprising the index. A modified equal-dollar weighted index will be balanced quarterly.

(iii) For the purposes of this Rule 5.13(d), a share-weighted index is calculated by multiplying the price of the component security by an adjustment factor. Adjustment factors are chosen to reflect the investment objective deemed appropriate by the designer of the index and will be published by the Exchange as part of the contract specifications. The value of the index is calculated by adding the weight of each component security and dividing the total by an index divisor, calculated to yield a benchmark index level as of a particular date. A share-weighted index is not adjusted to reflect changes in the number of outstanding shares of its components. A share-weighted Micro Narrow-Based index will not be re-balanced. If a share-weighted Micro Narrow-Based Index fails to meet the maintenance listing standards under Rule 5.13(e), the Exchange will restrict trading in existing option series to closing transactions and will not issue additional series for that index.

(iv) The Exchange may rebalance any Micro Narrow-Based index on an interim basis if warranted as a result of extraordinary changes in the relative values of the component securities. To the extent investors with open positions must rely upon the continuity of the options contract on the index, outstanding contracts are unaffected by rebalancings.

(3) Each component security in the index has a minimum market capitalization of at least $75 million, except that each of the lowest weighted securities in the index that in the aggregate account for no more than 10% of the weight of the index may have a minimum market capitalization of only $50 million;

(4) The average daily trading volume in each of the preceding six months for each component security in the index is at least 45,500 shares, except that each of the lowest weighted component securities in the index that in the aggregate account for no more than 10% of the weight of the index may have an average daily trading volume of only 22,750 shares for each of the last six months;

(5) In a capitalization-weighted index, the lesser of: (1) the five highest weighted component securities in the index each have had an average daily trading volume of at least 90,000 shares over the past six months; or (2) the highest weighted component securities in the index that in the aggregate represent at least 30% of the total number of component securities in the index each have had an average daily trading volume of at least 90,000 shares over the past six months;

(6) Subject to subparagraphs (4) and (5) above, the component securities that account for at least 90% of the total index weight and at least 80% of the total number of component securities in the index must meet the requirements of Rule 5.3 applicable to individual underlying securities;

(7)(i) Each component security in the index is a "reported security" as defined in Rule 11Aa3-1 under the Exchange Act; and

(ii) Foreign securities or ADRs that are not subject to comprehensive surveillance sharing agreements do not represent more than 20% of the weight of the index;

(8) The current underlying index value will be reported at least once every fifteen seconds during the time the index options are traded on the Exchange;

(9) An equal dollar-weighted index will be rebalanced at least once every quarter;

(10) If the underlying index is maintained by a broker-dealer, the index is calculated by a third party who is not a broker-dealer, and the broker-dealer has in place an information barrier around its personnel who have access to information concerning changes in and adjustments to the index;

(11) Each component security in the index is registered pursuant to Section 12 of the Exchange Act; and

(12) Cash settled index options are designated as A.M.-settled options.

(e) The following maintenance listing standards shall apply to each class of index options originally listed pursuant to paragraph (d) above:

(1) The index meets the criteria of paragraph (d)(1) of this Rule;

(2) Subject to subparagraphs (9) and (10) below, the component securities that account for at least 90% of the total index weight and at least 80% of the total number of component securities in the index must meet the requirements of Rule 5.3;

(3) Each component security in the index has a market capitalization of at least $75 million, except that each of the lowest weighted component securities that in the aggregate account for no more than 10% of the weight of the index may have a market capitalization of only $50 million;

(4) Each component security must be an “NMS stock" as defined in Rule 11Aa3-1 under the Exchange Act; and

(5) Foreign securities or ADRs thereon that are not subject to comprehensive surveillance sharing agreements do not represent more than 20% of the weight of the index;

(6) The current underlying index value will be reported at least once every fifteen seconds during the time the index options are traded on the Exchange;

(7) If the underlying index is maintained by a broker-dealer, the index is calculated by a third party who is not a broker-dealer, and the broker-dealer has in place an information barrier around its personnel who have access to information concerning changes in and adjustments to the index;

(8) The total number of component securities in the index may not increase or decrease by more than 33 1/3% from the number of component securities in the index at the time of its initial listing;

(9) Trading volume of each component security in the index must be at least 500,000 shares for each of the last six months, except that for each of the lowest weighted component securities in the index that in the aggregate account for no more than 10% of the weight of the index, trading volume must be at least 400,000 shares for each of the last six months;

(10) In a capitalization-weighted index and a modified capitalization-weighted index, the lesser of the five highest weighted component securities in the index or the highest weighted component securities in the index that in the aggregate represent at least 30% of the total number of stocks in the index each have had an average monthly trading volume of at least 1,000,000 shares over the past six months;

(11) Each component security in the index is registered pursuant to Section 12 of the Exchange Act;

(12) In an approximate equal-dollar weighted index, the index must be reconstituted and rebalanced if the notional value of the largest component is at least twice the notional volume of the smallest component for fifty percent or more of the trading days in the three months prior to December 31 of each year. For purposes of this provision the "notional value" is the market price of the component times the number of shares of the underlying component in the index. Reconstitution and rebalancing are also mandatory if the number of components in the index is greater than five at the time of rebalancing. The Exchange reserves the right to rebalance quarterly at its discretion;

(13) In a modified equal-dollar weighted index the Exchange will rebalance the index quarterly;

(14) In a share-weighted index, if a share-weighted Micro Narrow-Based Index fails to meet the maintenance listing standards under Rule 5.13(e), the Exchange will not re-balance the index, will restrict trading in existing option series to closing transactions, and will not issue additional series for that index; and

(15) In the event a class of index options listed on the Exchange fails to satisfy the maintenance listing standards set forth herein, the Exchange shall not open for trading any additional series of options of that class unless such failure is determined by the Exchange not to be significant and the Commission concurs in that determination, or unless the continued listing of that class of index options has been approved by the Commission under Section 19(b)(2) of the 1934 Act.

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Position Limits for Industry (Narrow-Based) Index Options
[Narrow-Based Index Options]

Rule 5.16(a). Rule 6.8 generally shall govern position limits for industry index options, as modified by this Rule 5.16. Option contracts on an industry index shall, subject to the procedures specified in subsection (c) of this rule, be subject to the following position limits: [In determining compliance with Rule 6.8, narrow based (industry) index option contracts shall be subject to position limits determined as follows:]

(1) 18,000 [— 9,000] contracts if the Exchange determines, at the time of a review conducted pursuant to subsection [paragraph] (b) below, that any single underlying stock [in the group] accounted, on average, for 30% or more of the index value during the 30-day period immediately preceding the review; or

(2) 24,000 [— 12,000] contracts if the Exchange determines, at the time of a review conducted pursuant to subsection [paragraph] (b) below, that any single underlying stock [in the group] accounted, on average, for 20% or more of the index value or that any five underlying stocks [in the group] together accounted, on average, for more than 50% of the index value, but that no single stock in the group accounted, on average, for 30% or more of the index value, during the 30-day period immediately preceding the review; or

(3) 31,500 [— 15,000] contracts if the Exchange determines that the conditions specified above, which would require the establishment of a lower limit, have not occurred.

(b) The Exchange shall make the determinations required by subsection (a) above with respect to options on each industry index at the commencement of trading of such options on the Exchange and thereafter review the determination semi-annually on January 1 and July 1. [determine the appropriate position limit at the time options on an index are initially opened for trading and shall review its determination semi-annually, at the same time it reviews position and exercise limits for stock options, pursuant to Rule 6.8 and Rule 6.9. If the Exchange determines after conducting its review that a higher position limit is appropriate for an index the Exchange shall increase the limit as soon as practicable. If the Exchange determines that a lower limit is appropriate for an index, the lower limit shall take effect after the expiration of the farthest term series open for trading at the time of the Exchange's review.]

(c) If the Exchange determines, at the time of a semi-annual review, that the position limit in effect with respect to options on a particular industry index is lower than the maximum position limit permitted by the criteria set forth in subsection (a), the Exchange may effect an appropriate position limit increase immediately. If the Exchange determines, at the time of a semi-annual review, that the position limit in effect with respect to options on a particular industry index exceeds the maximum position limit permitted by the criteria set forth in subsection (a), the Exchange shall reduce the position limit applicable to such options to a level consistent with such criteria; provided, however, that such a reduction shall not become effective until after the expiration date of the most distantly expiring options series relating to the industry index that is open for trading on the date of the review; and provided further that such a reduction shall not become effective if the Exchange determines, at the next semi-annual review, that the existing position limit applicable to such options is consistent with the criteria set forth in subsection (a).

(d) – No change.

[(c)] (e) Index [O]option contracts [on an index] shall not be aggregated with option contracts on any stocks whose prices are the basis for the calculation of the index.

(f) Positions in reduced-value index options shall be aggregated with positions in full-value index options. For such purposes, ten (10) reduced-reduced value options shall equal one (1) full-value contract.

Position Limits for Options on Cash Settled Micro Narrow-Based Indexes

Rule 5.16(f) Methodology for Establishing Position Limits on Cash-Settled Options on Micro Narrow-Based Indexes as defined under Rule 5.10(b)(25). The position limit for a cash-settled option on a Micro Narrow-Based Index that meets the criteria under Rule 5.13(d) shall be calculated in accordance with the following methodology:

(1) Determine the Market Capitalization of the S&P 500 Index.

(2) Calculate the Notional Value of a position at the limit in the Chicago Mercantile Exchange's ("CME") S&P 500 futures contract. The position limit for that contract is 20,000 (in all months combined) and the Index Multiplier is $250.

Notional Value for the purposes of this rule = Index Level * Index Multiplier. Therefore, Notional Value of 20,000 S&P 500 futures contracts = 20,000 * S&P 500 Index Level * 250.

(3) Calculate the Market Capitalization Ratio of the S&P 500 Index Market Capitalization to the Notional Value of a position limit at the limit.

Market Capitalization Ratio = Market Capitalization of the S&P 500 / Notional Value of 20,000 S&P 500 futures contract positions.

(4) Determine the Market Capitalization of the Micro Narrow-Based Index by adding together the market capitalization of each underlying security component.

(5) Determine the Notional Value of the Micro Narrow-Based Index Option (Index Level * Contract Multiplier).

(6) Calculate the Position Limit of the Micro Narrow-Based Index using the following formula:

Contract Position Limit on the Micro Narrow-Based Index = Market Capitalization of Micro Narrow-Based Index / (Notional Value of Micro Narrow-Based Index Option * Market Capitalization Ratio).

(7) Establishing the Position Limit. After the applicable position limit has been determined pursuant to Rule 5.16(f)(1)-(6), round the calculated position limit to the nearest 1,000 contracts using standard rounding procedures. For position limits that are 400 or greater, but less than 1000 contracts, round up to 1,000 contracts.

Rule 5.13(d) shall not apply to any Micro Narrow-Based Index in which the applicable position limit, as calculated using Rule 5.16(f)(1)-(6), for that Micro Narrow-Based Index is less than 400 contracts.

Exemptions from Position Limits

Rule 5.17(a). *Broad-based Index Hedge Exemptions* – No Change.

(b) *Industry (Narrow-Based) Index Hedge Exemptions*. The industry (narrow-based) index hedge exemption is in addition to the other exemptions available under Exchange Rules, interpretations and policies, and may not exceed twice the standard limit established under Rule 5.16. Industry [Narrow-based (industry)] index option positions may be exempt from established position limits for each option contract "hedged" by an equivalent dollar amount of the underlying component securities or securities convertible into such components; provided that, in applying such hedge, each option position to be exempted is hedged by a position in at least 75% of the number of component securities underlying the index. In addition, the underlying value of the option position may not exceed the value of the underlying portfolio. The value of the underlying portfolio is:

(1)[(a)] the total market value of the net stock position; and [, less]

(2)[(b)] for positions in excess of the standard limit, subtract the underlying market value of:

(A)[(1)] any offsetting calls and puts in the respective index option; and

(B)[(2)] any offsetting positions in related stock index futures or options; and

(C)[(3)] any economically equivalent positions (assuming no other hedges for these contracts exist).

The following procedures and criteria must be satisfied to qualify for an industry index hedge exemption:

[Prior Exchange approval on the appropriate form designated by the Exchange is required. This exemption requires that both the option and stock positions be initiated and liquidated in an orderly manner. Specifically, a reduction of the option position must occur at or before the corresponding reduction in the stock portfolio position. The position in a narrow-based index option may not exceed the total of: (a) the limit established under Rule 5.16, plus (b) two times that limit (for hedged positions). The Exchange may determine, in its discretion, to grant a hedge exemption for a number of contracts that is less than the maximum number permitted under this Commentary. The Exchange may also grant other position limit exemptions under Exchange rules, and such exemptions shall be applied in addition to any exemption provided under this Commentary.]

(1) The hedge exemption account must have received prior Exchange approval for the hedge exemption specifying the maximum number of contracts that may be exempt under this Rule. The hedge exemption account must have provided all information required on Exchange-approved forms and must have kept such information current. Exchange approval may be granted on the basis of verbal representations, in which event the hedge exemption account shall within two business days, or such other time period designated by the Exchange, furnish the Exchange with appropriate forms and documentation substantiating the basis for the exemption. The hedge exemption account may apply from time to time for an increase in the maximum number of contracts exempt from the position limits.

(2) A hedge exemption account that is not carried by an OTP Holder or OTP Firm must be carried by a member of a self-regulatory organization participating in the Intermarket Surveillance Group.

(3) The hedge exemption account shall:

(A) liquidate and establish options, stock positions or economically equivalent positions 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 portfolio which options would thereby be rendered excessive.

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

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

(5) The hedge exemption account shall promptly provide to the Exchange any information requested concerning the portfolio.

(6) Positions included in a 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.

(7) Any OTP Holder or OTP Firm that maintains an industry index option position in such OTP Holder or OTP Firm'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 Rule 6.8, and this Rule 5.16 by the OTP Holder or OTP Firm.

(8) Violation of any of the provisions of this Rule, 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.

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