

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-53672; File No. SR-CBOE-2005-63)

April 18, 2006

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of Proposed Rule Change and Amendments No. 1 and 2 Thereto Relating to the Nullification and Adjustment of Equity Options Transactions

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 August 12, 2005, the Chicago Board Options Exchange, Incorporated (“CBOE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. On October 28, 2005, the CBOE submitted Amendment No. 1 to the proposed rule change.<sup>3</sup> On April 7, 2006, the CBOE submitted Amendment No. 2 to the proposed rule change.<sup>4</sup> The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The CBOE proposes to amend Exchange Rule 6.25 to provide for an adjustment provision for transactions during opening rotation resulting from obvious errors between a non-broker-dealer customer and CBOE Market-Maker(s), as well as transactions during opening rotation between a non-broker-dealer customer and at least one non-CBOE Market-Maker(s).

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

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

<sup>3</sup> Amendment No. 1 replaced the original filing in its entirety.

<sup>4</sup> Amendment No. 2 clarifies and revises the example set forth in the purpose section of the filing.

Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in [brackets].

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## **Rules of the Chicago Board Options Exchange**

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### **Chapter VI**

#### **Doing Business on the Exchange Floor (Rules 6.1-6.85)**

##### **Section B: Member Activities on the Floor**

###### **Rule 6.25. Nullification and Adjustment of Equity Options Transactions**

This Rule governs the nullification and adjustment of transactions involving equity options. Rule 24.16 governs the nullification and adjustment of transactions involving index options and options on ETFs and HOLDRs. Paragraphs (a)(1), and (2) of this Rule have no applicability to trades executed in open outcry.

###### **(a) Trades Subject to Review**

A member or person associated with a member may have a trade adjusted or nullified if, in addition to satisfying the procedural requirements of paragraph (b) below, one of the following conditions is satisfied:

**(1) Obvious Price Error:** An obvious pricing error occurs when the execution price of an electronic transaction is above or below the Theoretical Price for the series by an amount equal to at least the amount shown below:

<b>Theoretical Price</b>	<b>Minimum Amount</b>
Below \$2	\$0.25
\$2 to \$5	\$0.40
Above \$5 to \$10	\$0.50
Above \$10 to \$20	\$0.80
Above \$20	\$1.00

**Definition of Theoretical Price.** For purposes of this Rule only, the Theoretical Price of an option series is, for series 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 class in the previous two calendar months. If there are no quotes for comparison, designated Trading Officials will determine the Theoretical Price. For transactions occurring as part of the Rapid Opening System ("ROS trades") or Hybrid Opening System ("HOSS"), Theoretical Price shall be the first quote after the transaction(s) in question that does not reflect the erroneous transaction(s).

**Price Adjustment or Nullification:** Obvious Pricing Errors will be adjusted or nullified in accordance with (i), (ii), (iii) or (iv) below or any combination thereof [the following]:

**(i) Transactions Between CBOE Market-Makers:** Where both parties to the transaction are CBOE Market-Makers, the execution price of the transaction will be adjusted by Trading Officials to the prices provided in Paragraphs (A) and (B) below, minus (plus) an adjustment penalty ("adjustment penalty"), unless both parties agree to adjust the transaction to a different

price or agree to bust the trade within fifteen (15) minutes of being notified by Trading Officials of the Obvious Error.

- A. Erroneous buy transactions will be adjusted to their Theoretical Price plus an adjustment penalty of either \$.15 if the Theoretical Price is under \$3 or \$.30 if the Theoretical Price is at or above \$3.
- B. Erroneous sell transactions will be adjusted to their Theoretical Price minus an adjustment penalty of either \$.15 if the Theoretical Price is under \$3 or \$.30 if the Theoretical Price is at or above \$3.

**(ii) Transactions during Opening Rotation Between a non-broker-dealer Customer and**

**CBOE Market-Maker(s):** After the fifteen minute notification period as described in (b)(1)

below and until 3:30 pm central time (“CT”) on the subject trade date, where parties to the

transaction are a non-broker dealer customer and CBOE Market-Maker(s), the non-broker-dealer

customer may request review of the subject transaction, and the execution price of the

transaction will be adjusted (provided the adjustment does not violate the customer’s limit price)

by Trading Officials to the prices provided in Paragraphs (A) and (B) above, without the

adjustment penalty, unless both parties agree to adjust the transaction to a different price or agree

to bust the trade within fifteen (15) minutes of being notified by Trading Officials of the Obvious

Error. The option contract quantity of any adjustment shall not exceed the disseminated size by

the competing options exchange that has the most liquidity in that option class in the previous

two calendar months. In the event a non-CBOE Market-Maker is also party to the transaction,

the adjustment procedures described below shall also apply.

**(iii) Transactions during Opening Rotation Between a non-broker-dealer Customer and at**

**least one non-CBOE Market-Maker(s):** After the fifteen minute notification period as

described in (b)(1) below and until 3:30 pm CT on the subject trade date, where parties to the transaction are a non-broker Dealer customer and a non-CBOE Market-Maker(s), the non-broker-dealer customer may request review of the subject transaction and, the execution price of the transaction will be adjusted (provided the adjustment does not violate non-CBOE Market-Maker's limit price) by Trading Officials to the prices provided in Paragraphs (A) and (B) above, without the adjustment penalty, unless both parties agree to adjust the transaction to a different price or agree to bust the trade within fifteen (15) minutes of being notified by Trading Officials of the Obvious Error. The option contract quantity of any adjustment shall not exceed the disseminated size by the competing options exchange that has the most liquidity in that option class in the previous two calendar months.

**(iv) Transactions Involving at least one non-CBOE Market-Maker:** Where one of the parties to the transaction is not a CBOE Market-Maker, and Paragraphs (a)(1)(i), (ii), or (iii) above do not apply the transactions will be nullified by Trading Officials unless both parties agree to an adjustment price for the transaction within thirty (30) minutes of being notified by Trading Officials of the Obvious Error.

(2)-(5) No change

**(b) Procedures for Reviewing Transactions**

**(1) Notification:** Any member or person associated with a member that believes it participated in a transaction that may be adjusted or nullified in accordance with paragraph (a) must notify any Trading Official promptly but not later than fifteen (15) minutes after the execution in question, except for the time frame set forth in Paragraphs (a)(1)(ii) or (a) (1)(iii). Absent unusual circumstances, Trading Officials shall not grant relief under this Rule unless notification is made within the prescribed time periods.

In the absence of unusual circumstances, Trading Officials (either on their own motion or upon request of a member) must initiate action pursuant to paragraph (a)(3) above within sixty (60) minutes of the occurrence of the verifiable disruption or malfunction. When Trading Officials take action pursuant to paragraph (a)(3), the members involved in the transaction(s) shall receive verbal notification as soon as is practicable.

(2) No change

(c)-(e) No change.

### **Interpretations and Policies....**

**.01-.03** 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 aspects of such statements.

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

##### 1. Purpose

The Exchange proposes to revise its obvious error rule (CBOE Rule 6.25). The CBOE states that the purpose of this filing is to protect non-broker-dealer customers from obvious

errors during the opening rotation when they do not discover the error within 15 minutes of the execution of the erroneous transaction. The current 15-minute notification period for nullification of the transaction would not be modified. Under the proposed rule, non-broker-dealer customers would be permitted to request an obvious error review for adjustment of the transaction from Trading Officials until 3:30 pm Central Time (“CT”) on the day that the transaction occurs. The term “Trading Officials” means two Exchange members designated as Floor Officials and one member of the Exchange’s trading floor liaison staff. The extent of the adjustment would depend on whether or not the party trading with the non-broker-dealer is a CBOE Market-Maker. The CBOE states that the intention of this filing is to protect the non-broker-dealer customer who fails to discover an obvious error within 15 minutes of execution from being forced to accept an execution price that results from an obvious error during the opening rotation.

For transactions during opening rotation between a non-broker-dealer customer and a CBOE Market-Maker, after 15 minutes have elapsed since the trade containing the obvious error occurred but before 3:30 pm CT on the same trading day, the non-broker-dealer customer would be able to request an obvious error review. In determining how to adjust the transaction, the Trading Official would look to the away competing exchange with the most liquidity in the option class over the two preceding months. The transaction would be adjusted to the competing exchange’s disseminated price at the time the trade occurred (provided the adjustment does not violate the non-broker-dealer customer’s limit price), but only up to the number of contracts that the competing exchange was listing as its disseminated size at the time the trade occurred.

For transactions during opening rotation between a non-broker-dealer and at least one non-CBOE Market-Maker, which could include (but is not limited to) an away specialist, an

upstairs firm, or another non-broker-dealer customer, after the 15-minute notification period has passed but before 3:30 pm CT on the same trading day, the non-broker-dealer customer would be able to request an obvious error review. In determining how to adjust the transaction, the Trading Official would look to the away competing exchange with the most liquidity in the options class over the two preceding calendar months, but would not adjust the price beyond the non-CBOE Market-Maker's limit price, and not for a size greater than the disseminated size of the aforementioned away competing exchange.

### Example

In a hypothetical situation, a non-broker-dealer customer ("Customer XYZ") enters a limit order to buy 100 contracts in an options class at \$3.80 prior to the opening. Assume that prior to the opening, a Market-Maker ("Market-Maker A") was offered at \$3.80 for 50 contracts and prior to the opening, a non-CBOE Market-Maker ("BD Firm ABC") entered an order to sell 50 contracts at a price of \$3.80. Now assume that the Hybrid Opening System ("HOSS") established an opening price of \$3.80 and the opening rotation is complete and Customer XYZ purchased 100 contracts at \$3.80 during opening rotation.<sup>5</sup>

For purposes of this example, the away competing exchange with the most liquidity in the option class in the previous two calendar months is the International Securities Exchange ("ISE"). However, Customer XYZ did not check the execution status of his order until 12:30 pm CT (more than the 15 minute notification period for a nullification under Exchange Rule

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<sup>5</sup> See Amendment No. 2, note 4, supra.

6.25(b)(1)). Disseminated quote and size for the option class at ISE at the time the 100 contracts printed from the opening HOSS rotation on CBOE at a price of \$3.80 was:

Exchange	Bid	Offer	Size
ISE	\$3.30	\$3.40	100 x 100

Because the \$3.80 price is at least \$.40 higher than the best offer<sup>6</sup> on the ISE, these trades would be obvious price errors under Exchange Rule 6.25. Pursuant to the proposed rule, 50 option contracts Customer XYZ executed against Market-Maker A would have a price adjustment to \$3.40 (obvious error trades with a CBOE Market-Maker would be adjusted to the disseminated price for the disseminated size listed on the competing exchange with the most liquidity in the options class for the preceding two months (here, ISE)). The 50 option contracts executed with BD Firm ABC would execute at \$3.80, because the adjustment would not exceed the non-CBOE Market-Makers limit price (here BD Firm ABC had a limit price of \$3.80). The adjustment involving the transaction against the Market-Maker could occur as long as the non-broker-dealer customer reported the obvious error more than 15 minutes after the erroneous transaction occurred, but before 3:30 pm CT on the same trading day.

## 2. Statutory Basis

The Exchange believes the proposed rule change, as amended, is consistent with Section 6(b) of the Act<sup>7</sup>, in general, and furthers the objectives of Section 6(b)(5) of the Act,<sup>8</sup> in particular, in that it should promote just and equitable principles of trade, serve to remove

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<sup>6</sup> Id.

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

<sup>8</sup> 15 U.S.C. 78f(b)(5).

impediments to and perfect the mechanism of a free and open market and a national market system, and to protect investors and the public interest.

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

The Exchange believes the proposed rule change, as amended, will impose no burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

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

No written comments were solicited or received by the Exchange on this proposal.

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

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding, or (ii) as to which the Exchange consents, the Commission will:

- (A) by order approve the proposed rule change, as amended, or
- (B) institute proceedings to determine whether the proposed rule change, as amended, should be disapproved.

IV. Solicitation of Comments

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

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](mailto:rule-comments@sec.gov). Please include File Number SR-CBOE-2005-63 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-CBOE-2005-63. 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 Room. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-CBOE-2005-63 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.<sup>9</sup>

Nancy M. Morris  
Secretary

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<sup>9</sup> 17 CFR 200.30-3(a)(12).