

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-54004; File No. SR-CBOE-2005-63)

June 16, 2006

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Granting Approval of a Proposed Rule Change and Amendments Nos. 1 and 2 Thereto Relating to the Nullification and Adjustment of Equity Options Transactions

I. Introduction

On August 12, 2005, the Chicago Board Options Exchange, Incorporated (“CBOE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change 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. On October 28, 2005, the CBOE submitted Amendment No. 1 to the proposed rule change.³ On April 7, 2006, the CBOE submitted Amendment No. 2 to the proposed rule change.⁴ The proposed rule change and Amendments No. 1 and 2 were published for comment in the Federal Register on April 26, 2006.⁵ The

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 1 replaced the original filing in its entirety.

⁴ Amendment No. 2 clarified and revised the example set forth in the purpose section of the filing.

⁵ Securities Exchange Act Release No. 53672 (April 18, 2006), 71 FR 24767 (April 26, 2006).

Commission received one comment letter on the proposal.⁶ This order approves the proposed rule change, as amended.

II. Description of the Proposed Rule Change

The CBOE proposes to revise CBOE Rule 6.25, the Exchange's obvious error rule. Under the proposal, non-broker-dealer customers would be permitted to request review for adjustment of an opening rotation transaction from Trading Officials until 3:30 p.m. Central Time ("CT") on the day that the transaction occurred.⁷ According to the Exchange, the purpose of the proposal 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 transaction. The proposed rule change, however, would not affect the procedure set forth in CBOE Rule 6.25(b)(1), which permits a non-broker-dealer customer to request within 15 minutes of an obvious error transaction to have the transaction nullified by Trading Officials, unless both parties agree to an adjustment price within 30 minutes of being notified by Trading Officials of the obvious error.

For transactions during opening rotation between a non-broker-dealer customer and a CBOE Market-Maker, after 15 minutes have elapsed since the trade involving the obvious error occurred, but before 3:30 p.m. CT on the same trading day, the non-broker-dealer customer would be able to request an obvious error review. In determining the extent of any adjustment of

⁶ See letter to Jonathan G. Katz, Secretary, Commission, from Matthew B. Hinerfeld, Managing Director and Deputy General Counsel, Citadel Investment Group, L.L.C. on behalf of Citadel Derivatives Group LLC (collectively "Citadel") dated May 17, 2006 ("Citadel Letter").

⁷ The term "Trading Officials" means two Exchange members designated as Floor Officials and one member of the Exchange's trading floor liaison staff. See Interpretations and Policies .02 of CBOE Rule 6.25.

the transaction, the Trading Officials would look to the competing exchange with the most liquidity in the option class for 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 displaying 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 p.m. CT on the same trading day, the non-broker-dealer customer would be able to request an obvious error review. In determining the extent of any adjustment to the transaction, the Trading Officials would look to the competing exchange with the most liquidity in the options class for the two preceding calendar months. The transaction would be adjusted to the competing exchange's disseminated price at the time the trade occurred, but it would not be adjusted beyond the non-CBOE Market-Maker's limit price, and not for a size greater than the disseminated size of the competing exchange.

III. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange⁸ and, in particular, the requirements of Section 6(b) of the Act⁹ and the rules and regulations

⁸ 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).

⁹ 15 U.S.C. 78f(b).

thereunder. Specifically, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,¹⁰ in that the proposal promotes just and equitable principles of trade, removes impediments to and perfects the mechanism of a free and open market and a national market system, and protects investors and the public interest.

The Commission considers that in most circumstances trades that are executed between parties should be honored. On rare occasions, the price of the executed trade indicates an "obvious error" may exist, suggesting that it is unrealistic to expect that the parties to the trade had come to a meeting of the minds regarding the terms of the transaction. In the Commission's view, the determination of whether an "obvious error" has occurred should be based on specific and objective criteria and subject to specific and objective procedures. CBOE's proposal would permit a non-broker-dealer customer, whose order was executed during CBOE's opening rotation but who did not discover that its transaction may have involved an obvious error within 15 minutes of its execution, to request an obvious error review for adjustment of the transaction from Trading Officials until 3:30 p.m. CT on the date of the transaction. The Commission believes that permitting non-broker-dealer customers to request an obvious error review until 3:30 p.m. CT on the day of the transaction would give those customers a reasonable amount of time to discover an obvious error transaction that occurred during an opening rotation and to request an obvious error review.

The Commission also believes that CBOE's proposal with respect to the price to which a transaction will be adjusted is consistent with the Act. Under the Exchange's proposal, an obvious error transaction during an opening rotation involving a non-broker-dealer customer

¹⁰ 15 U.S.C. 78f(b)(5).

would be adjusted to the Theoretical Price (provided that it does not violate the customer's limit price). The Theoretical Price of an option series is, for securities 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. The Commission believes that this basis for determining Theoretical Price is consistent with the Linkage Plan, which requires the options exchanges to avoid trading through better prices available on all exchanges, not just the exchange that has the most liquidity, because the Linkage Plan does not apply to transactions effected during opening rotations.

The Commission has carefully considered the comments raised in the Citadel Letter.¹¹ The Citadel Letter stated that the proposed rule change effectively would require CBOE Market Makers retroactively to trade during the opening rotation at prices at which they were not quoting and at which they did not want to trade. Citadel indicated that the price protections offered by the Linkage Plan do not apply to transactions during opening rotation. Citadel noted that, as a result, there is a risk that orders executed on one exchange as part of the opening rotation could receive a different price if executed as part of the opening rotation on another exchange. Citadel asserted that no "obvious error" is involved and that the proposal is an inappropriate punitive measure because the market maker has not done anything wrong. Citadel also stated that the proposal creates an irrational distinction between those customer orders that get the benefit of the adjustment and those that do not.

¹¹ See Citadel Letter, supra note 6.

The Exchange countered that its obvious error rule currently applies to transactions occurring as part of the opening rotation and provides for the adjustment of market maker to market maker transactions to prices that the market maker may not have been quoting at the opening.¹² The Exchange also noted that its obvious error rule currently provides for differing treatment with respect to obvious errors depending on the nature of the order and the parties involved. According to the Exchange, the proposed rule change is consonant with its obvious error rule, which currently addresses an error at the opening, adjustment of an opening transaction, and differing treatment of customers and market makers.

The Commission believes that the Citadel Letter does not raise any issues that would preclude approval of the proposed rule change. In the Commission's view, the proposed rule change strikes a reasonable balance by affording non-broker-dealer customers the opportunity to seek review of an opening rotation transaction until 3:30 CT on the day of the transaction, if the transaction occurred at a price that satisfies the threshold set forth in the Exchange's obvious error rule, while at the same time limiting the size and amount of any such adjustment.

¹² Telephone conference among Andrew Spiwak, Director, Legal Division, and Chief Enforcement Attorney, Jennifer Lamie, Managing Senior Attorney, and Nancy Sanow, Assistant Director, Division of Market Regulation, Commission on June 13, 2006.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹³ that the proposed rule change (SR-CBOE-2005-63), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁴

Nancy M. Morris

Secretary

¹³ 15 U.S.C. 78f(b)(2).

¹⁴ 17 CFR 200.30-3(a)(12).