

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-54926; File No. SR-CBOE-2006-62)

December 13, 2006

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of a Proposed Rule Change and Amendment No. 1 Thereto Amending its Index Obvious Error Rule

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 July 7, 2006, 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 substantially prepared by the Exchange. On October 30, 2006, the CBOE submitted Amendment No. 1 to the proposed rule change.³ The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

The Exchange proposes to amend CBOE Rule 24.16 (“Rule”), which is the Exchange’s rule applicable to the nullification and adjustment of transactions in index options, options on exchange-traded funds (“ETFs”), and options on HOLDing Company Depository Receipts (“HOLDRS”). The Exchange is proposing to amend the Rule in order to: (i) re-define what constitutes an “obvious price error;” (ii) provide for a Market-Maker to Market-Maker adjustment of obvious price errors (currently such erroneous transactions are subject to

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 1 (“Amendment No. 1”) supersedes and replaces the original filing in its entirety. The substance of Amendment No. 1 is incorporated into this notice.

nullification); (iii) eliminate the nullification and adjustments provisions for erroneous quantity errors; and (iv) make various non-substantive changes to the text of the Rule.

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

Chicago Board Options Exchange, Incorporated

Rules

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Rule 24.16. Nullification and Adjustment of [Index Option] Transactions in Index Options,

Options on ETFs and Options on HOLDRS

RULE 24.16. This Rule only governs the nullification and adjustment of transactions involving index options and options on ETFs or HOLDRS[s]. Rule 6.25 governs the nullification and adjustment of transactions involving equity options. Paragraphs (a)(1), [(2),] ([6]5) and ([7]6) 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, as provided herein, 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 price[ing] error will be deemed to have occurred when the execution price of a transaction is above or below the fair market value of the option by at least a prescribed minimum error amount. For series trading with normal bid-ask differentials as established in Rule 8.7(b)(iv), the prescribed minimum error amount shall be: [(a) the greater of \$0.10 or 10% for options trading under \$2.50; (b) 10% for options trading at or above \$2.50 and under \$5; or (c) \$0.50 for options trading at \$5 or higher.]

<u>Fair Market Value</u>	<u>Minimum Error Amount</u>
<u>Below \$2</u>	<u>\$0.125</u>
<u>\$2 to \$5</u>	<u>\$0.20</u>
<u>Above \$5 to \$10</u>	<u>\$0.25</u>
<u>Above \$10 to \$20</u>	<u>\$0.40</u>
<u>Above \$20</u>	<u>\$0.50</u>

For series trading with bid-ask differentials that are [greater than]a multiple of the widths established in Rule 8.7(b)(iv), the prescribed minimum error amount shall have the same multiple applied to the minimum error amount prescribed above[be: (a) the greater of \$0.20 or 20% for options trading under \$2.50; (b) 20% for options trading at or above \$2.50 and under \$5; or (c) \$1.00 for options trading at \$5 or higher].

(i) Definition of Fair Market Value: For purposes of this Rule only, the fair market value of an option is the midpoint of the national best bid and national best offer for the series (across all exchanges trading the option). In multiply listed issues, if there are no quotes for comparison purposes, fair market value shall be determined by Trading Officials. For singly-listed issues, fair market value shall be the midpoint of the first quote after the transaction(s) in question that does not reflect the erroneous transaction(s). For transactions occurring as part of the Rapid Opening System ("ROS trades") or Hybrid Opening System ("HOSS"), fair market value shall be the midpoint of the first quote after the transaction(s) in question that does not reflect the erroneous transaction(s). The determination of fair market value shall be made by Trading Officials in accordance with the provisions of this paragraph.

(ii) Price Adjustment or Nullification: Obvious price errors will be adjusted or nullified in accordance with the following:

(A) 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 upon notification pursuant to paragraph (b) and in accordance with the adjustment and nullification provisions of paragraph (c)(1) below.

(B) Transactions involving at least one non-CBOE Market-Maker: Where one of the parties to the transaction is not a CBOE Market-Maker, the transaction will be adjusted or nullified by Trading Officials upon notification pursuant to paragraph (b) and in accordance with the adjustment and nullification provisions of paragraph (c)(3) below.

[(2) Obvious Quantity Error: An obvious error in the quantity term will be deemed to occur when the transaction size exceeds the responsible broker or dealer's average disseminated size over the previous four hours by a factor of five (5) times. The quantity to which a transaction shall be adjusted from an obvious quantity error shall be the responsible broker or dealer's average disseminated size over the previous four trading hours (which may include the previous trading day).]

(3) – (7) Renumbered to (2) – (6)

(b) No change.

(c) Adjustments and Nullifications

(1) Transactions between CBOE Market-Makers pursuant to paragraph (a)(1) shall be adjusted to the fair market value minus (plus) the prescribed minimum error amount with respect

to an erroneous sell (buy) transaction. If the adjusted price is not in a multiple of the applicable minimum trading increment, the adjusted price will be rounded down (up) to the next price that is a multiple of the applicable minimum trading increment with respect to an erroneous sell (buy) transaction.

(2) Transactions between CBOE Market-Makers pursuant to paragraphs (a)(2) – (a)(5) shall be nullified.

(3) [Unless otherwise specified in Rule 24.16(a)(1)-(6), t]Transactions involving at least one non-CBOE Market-Maker pursuant to paragraphs (a)(1) through (a)(5) will be adjusted provided the adjusted price does not violate the [customer's]non-CBOE Market-Maker's limit price. Otherwise, the transaction will be nullified. With respect to Rule 24.16(a)(1)(ii)(B) – (a)(4)[(5)], the price to which a transaction shall be adjusted shall be the National Best Bid (Offer) immediately following the erroneous transaction with respect to a sell (buy) order entered on the Exchange. For ROS or HOSS transactions, the price to which a transaction shall be adjusted shall be based on the first non-erroneous quote after the erroneous transaction on CBOE. With respect to Rule 24.16(a)([6]5), the transaction shall be adjusted to a price that is \$0.10 under parity.

(d) – (e) No change.

. . . Interpretations and Policies:

.01 - .02 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, as amended, and discussed any comments it received on the proposed rule change, as amended. 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 is proposing to make various amendments to CBOE Rule 24.16, which is its obvious error rule pertaining to index options, options on ETFs, and options on HOLDRS. First, the Exchange states that the proposal would revise the scale used to identify the minimum error amount necessary to constitute an obvious price error. Specifically, an "obvious price error" would be deemed to have occurred for series trading with normal bid-ask differentials as established in CBOE Rule 8.7(b)(iv) when the execution price of a transaction is above or below the fair market value of the option by at least: \$0.125 for options trading under \$2; \$0.20 for options trading at or above \$2 and up to \$5; \$0.25 for options trading above \$5 and up to \$10; \$0.40 for options trading above \$10 and up to \$20; and \$0.50 for options trading above \$20. For series trading with bid-ask differentials that are a multiple of the widths established in CBOE Rule 8.7(b)(iv), the prescribed error amount would have the same multiple applied to the amounts prescribed above. For example, if double-wide bid-ask relief has been granted in an

option that currently trades at a price of \$6, the minimum error amount would be \$0.50 above or below the fair market value.⁴

Second, the Exchange states that the proposal would revise the obvious price error provision as it relates to the handling of transactions involving only CBOE Market-Makers. Under the current rule, such erroneous price transactions are nullified. Under the proposal, these CBOE-Market-Maker-to-CBOE-Market-Maker transactions would be subject to adjustment.⁵ The Exchange states that this change is intended to address feedback from Exchange members that an adjustment is preferential to having a transaction nullified because in many instances the

⁴ The Exchange states that under the current Rule, an “obvious pricing error” is deemed to have occurred when the execution price of a transaction is above or below the fair market value of the option by at least a prescribed amount. For series trading with normal bid-ask differentials as established in CBOE Rule 8.7(b)(iv), the prescribed amount is: (a) the greater of \$0.10 or 10% for options trading under \$2.50; (b) 10% for options trading at or above \$2.50 and under \$5; or (c) \$0.50 for options trading at \$5 or higher. For series trading with bid-ask differentials that are greater than the widths established in CBOE Rule 8.7(b)(iv), the prescribed error amount is: (a) the greater of \$0.20 or 20% for options trading under \$2.50; (b) 20% for options trading at or above \$2.50 and under \$5; or (c) \$1.00 for options trading at \$5 or higher. See CBOE Rule 24.16(a)(1). The Exchange states that the definition of fair market value will continue to apply as it currently does today. However, the Exchange is proposing to clarify in the text of the Rule that, with respect to singly-listed issues and transactions occurring as part of ROS or HOSS, the fair market value is the midpoint of the first quote after the transaction(s) in question that does not reflect the erroneous transactions(s). Additionally, the Exchange is proposing to clarify that the determination of fair market value is made by Trading Officials in accordance with the provisions of CBOE Rule 24.16(a)(1)(i). Telephone conference between Michou H.M. Nguyen, Special Counsel, Division of Market Regulation, Commission, and Jennifer Lamie, Managing Senior Attorney, Exchange, on October 31, 2006.

⁵ The Exchange states that the proposed revisions to the text of the Rule make clear that the manner in which obvious price errors involving at least one non-CBOE Market-Maker are handled will continue to apply unchanged. In addition, the proposed revisions to the text of the Rule make clear that the manner in which other obvious errors (*i.e.*, obvious errors related to verifiable disruptions or malfunctions of Exchange systems, erroneous prints or quotes in the underlying, trades below intrinsic value, and no bid

CBOE Market-Makers that are parties to the transaction may have already hedged the option position before being alerted to the erroneous price error. The CBOE notes that the change is also consistent with the Exchange's current procedures for adjusting erroneous price errors in equity options involving CBOE Market-Makers.⁶

The Exchange states that in applying the proposed CBOE Market-Maker adjustment provision to index options/ETF/HOLDERS, the adjustment price would be equal to the fair market value of the option minus the minimum error amount in the case of an erroneous sell transaction or the fair market value plus the minimum error amount in the case of an erroneous buy transaction. If the adjusted price is not in a multiple of the applicable minimum trading increment, the adjusted price would be rounded down (up) to the next price that is a multiple of the applicable minimum trading increment with respect to an erroneous sell (buy) transaction. For example, if an erroneous sale transaction involving two CBOE Market-Makers occurred in an option with a fair market value of \$6.075 and a minimum trading increment of \$0.10, the adjusted price would be \$5.80 ($\$6.075 - \$0.25 = \5.825, which is rounded down to the nearest \$0.10 increment of \$5.80).

Third, the Exchange states that the proposal would eliminate obvious quantity errors as a type of transaction that is subject to obvious error review. The Exchange represents that elimination of this provision is consistent with the Exchange's current rule for equity options, which does not have an obvious error review for quantity errors.⁷

series) will also continue to apply unchanged. See proposed revisions to CBOE Rule 24.16(c).

⁶ See CBOE Rule 6.25(a)(1).

⁷ See CBOE Rule 6.25(a).

Fourth, the Exchange states that the proposal would make various non-substantive changes to CBOE Rule 24.16, such as making cross-reference updates to correspond to the above-described revisions, changing the title of the rule to reflect its application to options on ETFs and HOLDRS (currently the title only references index options), clarifying that fair market value is as determined by Exchange Trading Officials who administer the obvious error rule, and making other non-substantive changes for ease of understanding the existing text.

2. Statutory Basis

The Exchange believes the proposed rule change, as amended, is consistent with Section 6(b) of the Act,⁸ in general, and furthers the objectives of Section 6(b)(5) of the Act,⁹ in particular, in that it is designed to promote just and equitable principles of trade, prevent fraudulent and manipulative acts, remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, 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, as amended, will impose any burden on competition 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 with respect to the proposed rule change, as amended.

⁸ 15 U.S.C. 78f(b).

⁹ 15 U.S.C. 78f(b)(5).

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 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. Please include File Number SR-CBOE-2006-62 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-2006-62. 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-2006-62 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.¹⁰

Florence E. Harmon
Deputy Secretary

¹⁰ 17 CFR 200.30-3(a)(12).