

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-59981; File No. SR-CBOE-2009-024)

May 27, 2009

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Granting Approval of a Proposed Rule Change Related to its Obvious Error Rules

I. Introduction

On April 8, 2009, 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 amend CBOE Rules 6.25 and 24.16 (collectively, the “Obvious Error Rules”) pertaining to the nullification and adjustment of options transactions. The proposed rule change was published for comment in the Federal Register on April 24, 2009.³ The Commission received no comment letters on the proposal. This order approves the proposed rule change.

II. Discussion

A. Merging Rules

The Exchange proposes to merge Rule 24.16 (which currently relates to only index, ETF and HOLDRS options) into Rule 6.25 (which currently relates to only equity options) to form a single obvious error rule.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 59793 (April 20, 2009), 74 FR 18762.

B. Obvious Pricing Errors

1. Definition of Theoretical Price

The Exchange proposes to amend Rule 6.25's definition of "Theoretical Price" to base it on the national best bid or offer ("NBBO") instead of the market with the most liquidity. Using the NBBO to define Theoretical Price is similar to how "fair market value" is currently defined for obvious pricing errors under Rule 24.16. The Exchange also proposes to permit Trading Officials to establish the Theoretical Price when the NBBO for the affected series, just prior to the erroneous transaction, is at least two times the permitted bid/ask differential under subparagraph (b)(iv)(A) of Rule 8.7.

2. Non-CBOE Market Makers

The Exchange proposes to provide for the adjustment of Obvious Pricing Error transactions involving non-CBOE Market-Makers, provided the adjusted price does not violate the non-CBOE Market-Maker's limit price.

3. ROS and HOSS Rotations

The Exchange proposes to revise the Obvious Pricing Error provision as it pertains to transactions occurring as part of the Rule 6.2A, Rapid Opening System ("ROS"), or Rule 6.2B, Hybrid Opening System ("HOSS"), rotations. With respect to regular ROS and HOSS rotations, the Exchange is proposing to add a condition that the option contract quantity subject to nullification or adjustment would not exceed the size of the first quote after the transaction(s) in question that does not reflect the erroneous transaction(s). Any nullifications or adjustments would occur on a pro rata basis considering the overall size of the ROS or HOSS opening trade. With respect to HOSS rotations in index options series being used to calculate the final settlement price of a volatility index, the Exchange proposes to carryover a condition from Rule

24.16 that the first quote after the transaction(s) in question that does not reflect the erroneous transaction(s) must be for at least the size of the HOSS opening transaction(s). If the size of the quote is less than the size of the opening transaction(s), then the Obvious Pricing Error provision shall not apply.

4. Non-Broker-Dealer Customer Orders Entered Before the Opening Rotation.

The Exchange proposes to extend the expanded notification period applicable to transactions during opening rotations involving non-broker-dealer Customers to include certain orders entered before the opening that are executed immediately following the opening rotation. Specifically, Rule 6.25 currently requires that members notify CBOE Trading Officials or designated personnel in the control room within a short time period following the execution of a trade (generally 15 minutes) if they believe the trade qualifies as an Obvious Pricing Error. However, an expanded notification period is available for transactions during option rotation occurring as part of ROS or HOSS where at least one party to the transaction is a non-broker-dealer Customer. The Exchange proposes to make the expanded notification period applicable to transactions involving non-broker-dealer Customers' marketable orders that are entered before the opening rotation and that are executed as part of the Hybrid Agency Liaison ("HAL") on the opening process and certain transactions involving non-broker-dealer Customers' complex orders that are entered before the opening rotation and that are executed immediately following the opening rotation through the Exchange's electronic Complex Order Book.

5. Binary Options

The Exchange proposes to provide that any price adjustment for a binary option series (including any adjustment penalty that may be applicable to transactions between CBOE Market-Makers) shall not exceed the applicable exercise settlement amount for the binary option.

C. Catastrophic Pricing Errors

The Exchange proposes to amend Rule 6.25 to add criteria for identifying “Catastrophic Errors” and making adjustments when Catastrophic Errors occur, as well as a streamlined procedure for reviewing actions taken in these extreme circumstances. Under Rule 6.25, trades that result from an Obvious Pricing Error may be adjusted or busted according to objective standards. Under the Rule, whether an Obvious Pricing error has occurred is determined by comparing the execution price to the Theoretical Price of the option. The rule requires that members notify CBOE Trading Officials or designated personnel in the control room within a short time period following the execution of a trade (generally 15 minutes) if they believe the trade qualifies as an Obvious Pricing Error. Trades that qualify for adjustment or are nullified under the Rule are compared to a price that matches the theoretical price plus or minus an adjustment value for transactions between CBOE Market Makers, which is \$0.15 if the Theoretical Value is under \$3 and \$0.30 if the Theoretical Value is at or above \$3. By adjusting trades above or below the Theoretical Price, the rule assesses a “penalty” in that the adjustment price is not as favorable as the amount the party making the error would have received had it not made the error.

In some extreme situations, members may not be aware of errors that result in very large losses within the time periods required under the Rule. In this type of extreme situation, CBOE proposes to give members more time to seek relief so that there is a greater opportunity to mitigate very large losses and reduce the corresponding large windfalls. In such cases, the proposal sets forth the minimum amount by which the options execution price must differ from the Theoretical Price for a Catastrophic Error to occur. The proposal also sets forth the adjustment value to be used by CBOE when it makes a Catastrophic Error determination. A

Catastrophic Error would be deemed to have occurred when the execution price of a transaction is higher or lower than the Theoretical Price for the option by an amount equal to at least the “Minimum Amount,” and the adjustment would be made plus or minus the “Adjustment Value.” At all price levels, the Minimum Amount and the Adjustment Value for Catastrophic Errors would be significantly higher than for Obvious Pricing Errors, which the Exchange believes would limit the application of the proposed rule to situations where the losses are very large.

Under the new provision, generally, members will have until 7:30 a.m. Central Time on the day following the trade to notify Trading Officials or designated personnel in the control room of a potential Catastrophic Error. Once notification has been received within the required time period, a panel comprised of at least one member of the Exchange’s staff designated to perform Catastrophic Error Panel functions and four Exchange members (the “Panel”) will review the claim. Fifty percent of the number of Exchange members on the Panel must be directly engaged in market making activity and fifty percent of the number of Exchange members on the Panel must act in the capacity of a floor broker. In the event the Panel determines that a Catastrophic Error did not occur, the member that initiated the review will be charged \$5,000.

D. Erroneous Prints & Quotes in the Underlying

1. Adjustments

For consistency, the Exchange proposes to amend Rule 6.25 to allow for adjustments and nullifications of erroneous prints in the underlying (currently the provision calls for nullifications only).

2. Average Quote Width

The Exchange is also proposing to revise the provisions to determine the “average quote width” in the underlying by adding the quote widths of sample quotations at regular 15-second intervals during the two minutes preceding and following an erroneous transaction.

3. Designation of Underlying

The Exchange proposes to modify the erroneous trade and quote provisions to allow the Exchange to designate the applicable underlying security(ies) or related instruments for any option. Under the revised rule, the Exchange would identify particular underlying or, with respect to ETF(s), HOLDRS(s), and index options, related instrument(s) that would be used to determine an erroneous print or quote and would also identify the relevant market(s) trading the underlying or related instrument to which the Exchange would look for purposes of applying the obvious error analysis. The underlying or related instrument(s) and relevant market(s) will be designated by the Exchange and announced via Regulatory Circular. For a particular ETF, HOLDRS, index value and/or futures product to qualify for consideration as a “related instrument,” the revised rule requires that: (i) the option class and related instrument must be derived from or designed to track the same underlying index; or (ii) in the case of S&P 100-related options, the options class and related instrument must be derived from or designed to track the S&P 100 Index or the S&P 500 Index.

E. Trading Officials

The Exchange is proposing to change the definition of the term Trading Officials to mean three Exchange officials designated to perform Trading Official functions, at least one of which is an Exchange member designated as a Floor Official and at least one of which is a member of the Exchange’s staff designated to perform Trading Official functions. The term is currently

defined to mean two Exchange members designated as Floor Officials and one member of the Exchange's staff designated to perform Trading Official functions.

F. Obvious Error Panel

The Exchange is proposing to change a reference from "non-DPM floor brokers" to simply "floor brokers" in the composition requirements for Obvious Error Panels, which review certain determinations rendered by Trading Officials and the senior official in the Exchange's control room under Rule 6.25(b).

III. Commission Findings

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 exchange⁴ and, in particular, the requirements of Section 6(b) of the Act⁵ and the rules and regulations thereunder. Specifically, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,⁶ in that the proposal is designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts, to remove impediments and to perfect the mechanism for a free and open market and a national market system, and, in general, to protect 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

⁴ In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

⁵ 15 U.S.C. 78f(b).

⁶ 15 U.S.C. 78f(b)(5).

come to a meeting of the minds regarding the terms of the transaction. In approving proposals relating to adjustment or nullification of trades involving obvious errors, the Commission has stated that the determination of whether an obvious error has occurred and the process for reviewing such a determination should be based on specific and objective criteria and subject to specific and objective procedures.⁷ The Commission believes that the rule changes proposed by the CBOE are clear, specific, and objective.

Merging Rules

Merging CBOE Rules 6.25 and 24.16 improves clarity and efficiency by harmonizing the obvious error provision across all equity option transactions into one rule.

Obvious Pricing Errors

The modifications to CBOE's pricing error provision clarify the objective standards that are to be applied in determining whether an obvious error has occurred. Utilizing the NBBO as a reference point for theoretical price is in conformity with other obvious error provisions previously approved by the Commission.⁸ The amendments relating to non-CBOE market-makers and ROS and HOSS rotations also conform CBOE's rule to rules already approved by the Commission.⁹ The Commission believes that expanding the applicability of the extended customer obvious error notification provision for transactions involving certain non-broker-dealer customer orders that are entered before the opening rotation and that are executed as part

⁷ See, e.g., Securities Exchange Act Release Nos. 58778 (October 14, 2008), 73 FR 62577 (October 21, 2008) and 58460 (September 4, 2008), 73 FR 53060 (September 12, 2008) (approving revisions to CBOE's Obvious Error Rules).

⁸ See, e.g. Securities Exchange Act Release No. 57712 (April 24, 2008), 73 FR 24100 (May 1, 2008) (approving revisions to the Philadelphia Stock Exchange's Obvious Error Rule).

⁹ See, e.g. CBOE Rule 24.16.

of HAL on the opening process or that are executed immediately following the opening rotation through the Complex Order Book would give those customers a reasonable amount of time to discover an obvious error transaction and to request an obvious error review. The Commission believes that limiting the price adjustment for binary options is reasonable and objective in light of the payout structure of those options.

Catastrophic Error

The Commission believes that the proposed catastrophic error provision balances the need for certainty of trades and mitigating large losses due to errors in extreme circumstances through clear and objective procedures.¹⁰ Moreover, the Commission believes that the proposed Catastrophic Error Panel, the streamlined review process, and the proposed fee for unsuccessful claims are appropriate to accomplish this balance.

Erroneous Prints and Quotes in the Underlying

The Commission deems that the provision allowing CBOE to designate the applicable underlying securities (or related instruments) and relevant markets for any option is beneficial to members in determining whether an erroneous print or quote has occurred. The provision takes into account the fact that members often base their options prices on various products in various markets and that erroneous options transactions may be a result of erroneous prints or quotes in markets other than the primary market for an underlying security. The changes to the calculation of average quote width and allowing adjustments in addition to nullifications are appropriate and consistent with other rules previously approved by the Commission.¹¹

¹⁰ See Securities Exchange Act Release No. 57398 (February 28, 2008), 73 FR 12240 (March 6, 2008).

¹¹ See supra, note 8, and Rule 6.25(a)(5) (relating to an erroneous quote in the underlying).

Trading Officials and Obvious Error Panel

The Commission believes that the change to the definition of “Trading Officials” is appropriate and does not negatively impact the objectiveness or fairness of CBOE’s obvious error provisions. Lastly, the Commission notes that deleting “non-DPM” from the definition of floor brokers is a non-substantive technical change and is appropriate.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹² that the proposed rule change (SR-CBOE-2009-024) is hereby approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹³

Florence E. Harmon
Deputy Secretary

¹² 15 U.S.C. 78s(b)(2).

¹³ 17 CFR 200.30-3(a)(12).