

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-50880; File No. SR-CBOE-2004-83]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change and Amendment Nos. 1 and 2 Thereto by the Chicago Board Options Exchange, Inc. To Amend Its Obvious Error Rule

December 17, 2004.

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 December 9, 2004, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. The proposed rule change has been filed by CBOE as a "non-controversial" rule change pursuant to Section 19(b)(3)(A) of the Act³ and Rule 19b-4(f)(6) thereunder.⁴ On December 13, 2004, CBOE submitted Amendment No. 1 to the proposed rule change.⁵ On December 16, 2004, CBOE submitted Amendment No. 2 to the proposed rule change.⁶ 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

CBOE proposes to amend its obvious error rule. Additions are italicized. Deletions are bracketed.

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Rule 6.25 Nullification and Adjustment of [Electronic] Equity Options Transactions

This Rule governs the nullification and adjustment of [options trades] 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), (6), and (7)] 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 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 amount. For series trading with normal bid-ask differentials as established in Rule 8.7(b)(iv), the prescribed 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. For series trading with bid-ask differentials that are greater than the widths established in Rule 8.7(b)(iv), the prescribed error amount shall 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 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 first quote after the transaction(s) in question that does not reflect the erroneous transaction(s).]

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:

Theoretical price	Minimum amount
Below \$2	\$0.25
\$2 to \$5	0.40

Theoretical price	Minimum amount
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 the following:

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.

Transactions Involving at least one non-CBOE Market Maker: Where one of the parties to the transaction is not a CBOE market maker, 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) [Obvious Quantity Error: An obvious error in the quantity term will

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 15 U.S.C. 78s(b)(3)(A).

⁴ 17 CFR 240.19b-4(f)(6).

⁵ In Amendment No. 1, CBOE proposes to adopt new Interpretations and Policies .03 to Rule 6.25. The purpose of adopting this provision is to provide a definition of "erroneous buy" and "erroneous sell" transaction. Additionally, the Exchange proposes to capitalize the term "Theoretical Price" in the last sentence of proposed paragraph (a)(1) of CBOE Rule 6.25.

⁶ In Amendment No. 2, CBOE proposes to replace paragraph (c) of proposed CBOE Rule 24.16 and to make a technical correction to proposed paragraph (a)(1) of CBOE Rule 6.25 by replacing the word "with" with the word "within."

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).]

No Bid Series: Electronic transactions in series quoted no bid at a nickel (i.e., \$0.05 offer) will be nullified provided at least one strike price below (for calls) or above (for puts) in the same options class was quoted no bid at a nickel at the time of execution.

(3) Verifiable Disruptions or Malfunctions of Exchange Systems: *Electronic or open outcry transactions [Trades] arising out of a "verifiable disruption or malfunction" in the use or operation of any Exchange automated quotation, dissemination, execution, or communication system [may] will either be nullified or adjusted by Trading Officials. Transactions that qualify for price adjustment will be adjusted to Theoretical Price, as defined in paragraph (a)(1) above.*

(4) *Erroneous Print in Underlying:* A trade resulting from an erroneous print disseminated by the underlying market which is later cancelled or corrected by that underlying market may be [adjusted or] nullified. In order to be [adjusted or] nullified, however, the trade must be the result of an erroneous print that is higher or lower than the average trade in the underlying security during a two-minute period before and after the erroneous print by an amount at least five times greater than the average quote width for such underlying security during the same period.

For purposes of this Rule, the average trade in the underlying security shall be determined by adding the prices of each trade during the four minute time period referenced above (excluding the trade in question) and dividing by the number of trades during such time period (excluding the trade in question). For purposes of this Rule, the average quote width shall be determined by adding the quote widths of each separate quote during the four minute time period referenced above (excluding the quote in question) and dividing by the number of quotes during such time period (excluding the quote in question).

[(5) *Erroneous Quote in Underlying:* A trade resulting from an erroneous quote in the underlying security may be adjusted or nullified. An erroneous quote occurs when the underlying security has a width of at least \$1.00

and has a width at least five times greater than the average quote width for such underlying security on the primary market during the time period encompassing two minutes before and after the dissemination of such quote.

(6) *Trades Below Intrinsic Value:* An obvious pricing error will be deemed to occur when the transaction price of an equity option is more than \$0.10 below the intrinsic value of the same option (an option that trades at its intrinsic value is sometimes said to trade at "parity"). Paragraph (6) shall not apply to transactions occurring during the last two minutes of the trading day (which is typically 3:00:01 p.m. (CT) to 3:02 p.m. (CT)) on days with regular trading hours).

(i) *Definition of Intrinsic Value:* For purposes of this Rule, the intrinsic value of an equity call option equals the value of the underlying stock (measured from the bid or offer as described below) minus the strike price, and the intrinsic value of an equity put option equals the strike price minus the value of the underlying stock (measured from the bid or offer as described below), provided that in no case is the intrinsic value of an option less than zero. In the case of purchasing call options and selling put options, intrinsic value is measured by reference to the bid in the underlying security, and in the case of purchasing put options and selling call options, intrinsic value is measured by reference to the offer in the underlying security.

(7) *No Bid Series:* Electronic transactions in series quoted no bid at a nickel (i.e., \$0.05 offer) will be nullified provided at least one strike price below (for calls) or above (for puts) in the same options class was quoted no bid at a nickel at the time of execution.]

(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. [For transactions occurring after 2:45 p.m. (CST), notification must be provided promptly but not later than fifteen (15) minutes after the close of trading of that security on CBOE.] 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) *Review and Determination:* Once a party to a transaction has applied to a Trading Official for review, the transaction shall be reviewed and a determination rendered, unless both parties to the transaction agree to withdraw the application for review prior to the time a decision is rendered. Absent unusual circumstances (e.g., a large number of disputed transactions arising out of the same incident), Trading Officials must render a determination within sixty (60) minutes of receiving notification pursuant to paragraph (b)(1) above. [If the transaction(s) in question occurred after 2:30 p.m., Trading Officials shall have until 9:30 a.m. the following morning to render a determination.] Trading Officials shall promptly provide verbal notification of a determination to the members involved in the disputed transaction and to the control room.

[(c) Adjustments

Unless otherwise specified in Rule 6.25(a)(1)-(6), transactions will be adjusted provided the adjusted price does not violate the customer's limit price. Otherwise, the transaction will be nullified. With respect to 6.25(a)(1)-(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 6.25(a)(6), the transaction shall be adjusted to a price that is \$0.10 under parity.]

(c) Obvious Error Panel

(i) *Composition. An Obvious Error Panel will be comprised of at least one (1) Trading Floor Liaison (TFL) and four (4) Exchange members. Fifty percent of the number of Exchange members on the Obvious Error Panel must be directly engaged in market making activity and fifty percent of the number of Exchange members on the Obvious Error Panel must act in the capacity of a non-DPM floor broker. The Exchange members shall be representatives from any of the following Committees: Equity Options Procedure Committee, Equity Market Performance Committee, and Floor Officials Committee.*

(ii) *Scope of Review.* If a party affected by a determination made under this Rule so requests within the time permitted in paragraph (b), an Obvious Error Panel will review decisions made by the Trading Officials under this Rule, including whether an obvious error occurred, whether the correct Theoretical Price was used, and whether the correct adjustment was made at the correct price. A party may also request that the Obvious Error Panel provide relief as required in this Rule in cases where the party failed to provide the notification required in paragraph (b) and the Trading Officials declined to grant an extension, but unusual circumstances must merit special consideration.

(iii) *Procedure for Requesting Review.* A request for review must be made in writing within (30) minutes after a party receives verbal notification of a final determination by the Trading Officials under this Rule, except that if notification is made after 2:30 p.m. Central Time ("CT"), either party has until 8:30 a.m. CT the next trading day to request review. The Obvious Error Panel shall review the facts and render a decision on the day of the transaction, or the next trade day in the case where a request is properly made the next trade day.

(iv) *Panel Decision.* The Obvious Error Panel may overturn or modify an action taken by the Trading Officials under this Rule upon agreement by a majority of the Panel representatives. All determinations by the Obvious Error Panel may be appealed in accordance with paragraph (d) of this rule.

(d) Review by the Appeals Committee

A member affected by a determination made under this rule may appeal such determination to the Appeals Committee, in accordance with Chapter XIX of the Exchange's rules. For purposes of this Rule, a member must be aggrieved as described in Rule 19.1. Notwithstanding any provision in Rule 19.2 to the contrary, a request for review must be made in writing (in a form and manner prescribed by the Exchange) no later than the close of trading on the next trade date after the member receives verbal notification of such determination by Trading Officials.

(e) Negotiated Trade Nullification

A trade may be nullified if the parties to the trade agree to the nullification. When all parties to a trade have agreed to a trade nullification one party must promptly disseminate cancellation information in OPRA format.

Interpretations and Policies * * *

.01 *Applicability:* Trading Officials may also allow for the execution of ROS trades (and assign those trades to participating ROS market-makers) that were not executed on the opening but that should have been executed had ROS opened the series at the non-erroneous quote. The Exchange will endeavor to notify its members as soon as practicable after the correction of an erroneous print and will indicate that this may result in the adjustment of trades executed pursuant to ROS. The only trades that will be adjusted are those that were executed on the opening or those that should have executed on the opening. All adjustments will be made during the day when the correction of the erroneous print occurred.

.02 *Trading Officials:* The term "Trading Officials" means two Exchange members designated as Floor Officials and one member of the Exchange's trading floor liaison (TFL) staff.

.03 *Definitions:* For purposes of this Rule, an "erroneous sell transaction" is one in which the price received by the person selling the option is erroneously low, and an "erroneous buy transaction" is one in which the price paid by the person purchasing the option is erroneously high.

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Rule 24.16 Nullification and Adjustment of Index Option Transactions

This Rule only governs the nullification and adjustment of transactions involving index options and options on ETFs or HLDs. Rule 6.25 governs the nullification and adjustment of transactions involving equity options. Paragraphs (a)(1), (2), (6) and (7) 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 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 amount. For series trading with normal bid-ask differentials as established in Rule 8.7(b)(iv), the prescribed 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. For series trading with bid-ask differentials that are greater than the widths established in Rule 8.7(b)(iv), the prescribed error amount shall 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 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 first quote after the transaction(s) in question that does not reflect the erroneous transaction(s).

(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) *Verifiable Disruptions or Malfunctions of Exchange Systems:* Trades arising out of a "verifiable disruption or malfunction" in the use or operation of any Exchange automated quotation, dissemination, execution, or communication system may either be nullified or adjusted by Trading Officials.

(4) *Erroneous Print in Underlying:* A trade resulting from an erroneous print disseminated by the underlying market which is later cancelled or corrected by that underlying market may be adjusted or nullified. In order to be adjusted or nullified, however, the trade must be the result of an erroneous print that is higher or lower than the average trade in the underlying security during a two-minute period before and after the erroneous print by an amount at least five times greater than the average quote width for such underlying security during the same period.

For purposes of this Rule, the average trade in the underlying security shall be determined by adding the prices of each trade during the four minute time period referenced above (excluding the trade in question) and dividing by the number of trades during such time period (excluding the trade in question). For purposes of this Rule, the average quote width shall be determined by adding the quote widths of each separate quote during the four minute time period referenced above (excluding the quote in question) and dividing by the number of quotes during such time period (excluding the quote in question).

(5) **Erroneous Quote in Underlying:** A trade resulting from an erroneous quote in the underlying security may be adjusted or nullified. An erroneous quote occurs when the underlying security has a width of at least \$1.00 and has a width at least five times greater than the average quote width for such underlying security on the primary market during the time period encompassing two minutes before and after the dissemination of such quote.

(6) **Trades Below Intrinsic Value:** An obvious pricing error will be deemed to occur when the transaction price of an equity option is more than \$0.10 below the intrinsic value of the same option (an option that trades at its intrinsic value is sometimes said to trade at "parity"). Paragraph (6) shall not apply to transactions occurring during the last two minutes of the trading day (which is typically 3:00:01 p.m. (CT) to 3:02 p.m. (CT)) on days with regular trading hours).

(i) **Definition of Intrinsic Value:** For purposes of this Rule, the intrinsic value of an equity call option equals the value of the underlying stock (measured from the bid or offer as described below) minus the strike price, and the intrinsic value of an equity put option equals the strike price minus the value of the underlying stock (measured from the bid or offer as described below), provided that in no case is the intrinsic value of an option less than zero. In the case of purchasing call options and selling put options, intrinsic value is measured by reference to the bid in the underlying security, and in the case of purchasing put options and selling call options, intrinsic value is measured by reference to the offer in the underlying security.

(7) **No Bid Series:** Electronic transactions in series quoted no bid at a nickel (i.e., \$0.05 offer) will be nullified provided at least one strike price below (for calls) or above (for puts) in the same options class was quoted no bid at a nickel at the time of execution.

(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. For transactions occurring after 2:45 p.m. (CST), notification must be provided promptly but not later than fifteen (15) minutes after the close of trading of that security on CBOE. 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) **Review and Determination:** Once a party to a transaction has applied to a Trading Official for review, the transaction shall be reviewed and a determination rendered, unless both parties to the transaction agree to withdraw the application for review prior to the time a decision is rendered. Absent unusual circumstances (e.g., a large number of disputed transactions arising out of the same incident), Trading Officials must render a determination within sixty (60) minutes of receiving notification pursuant to paragraph (b)(1) above. If the transaction(s) in question occurred after 2:30 p.m., Trading Officials shall have until 9:30 a.m. the following morning to render a determination. Trading Officials shall promptly provide verbal notification of a determination to the members involved in the disputed transaction and to the control room.

(c) Adjustments

Unless otherwise specified in Rule 24.16(a)(1)–(6), transactions will be adjusted provided the adjusted price does not violate the customer's limit price. Otherwise, the transaction will be nullified. With respect to 24.16(a)(1)–(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 24.16(a)(6), the transaction shall be adjusted to a price that is \$0.10 under parity.

(d) Review by the Appeals Committee

A member affected by a determination made under this rule may appeal such determination to the Appeals Committee, in accordance with Chapter XIX of the Exchange's rules. For purposes of this Rule, a member must be aggrieved as described in Rule 19.1. Notwithstanding any provision in Rule 19.2 to the contrary, a request for review must be made in writing (in a form and manner prescribed by the Exchange) no later than the close of trading on the next trade date after the member receives verbal notification of such determination by Trading Officials.

(e) Negotiated Trade Nullification

A trade may be nullified if the parties to the trade agree to the nullification. When all parties to a trade have agreed to a trade nullification one party must promptly disseminate cancellation information in OPRA format.

Interpretations and Policies* * *

.01 **Applicability:** Trading Officials may also allow for the execution of ROS trades (and assign those trades to participating ROS market-makers) that were not executed on the opening but that should have been executed had ROS opened the series at the non-erroneous quote. The Exchange will endeavor to notify its members as soon as practicable after the correction of an erroneous print and will indicate that this may result in the adjustment of trades executed pursuant to ROS. The only trades that will be adjusted are those that were executed on the opening or those that should have executed on the opening. All adjustments will be made during the day when the correction of the erroneous print occurred.

.02 **Trading Officials:** The term "Trading Officials" means two Exchange members designated as Floor Officials and one member of the Exchange's trading floor liaison (TFL) staff.

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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 parts 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's obvious error rule (CBOE Rule 6.25) establishes guidelines for the adjustment and nullification of transactions in both equity and index options. The Rule defines what constitutes an obvious error, provides an objective process members must follow to seek relief under the rule, and provides an appeals process for members seeking to challenge an initial determination. The Exchange's Rule operates completely independent of the other options exchanges' obvious error rules and is structured differently. In other words, transactions that might qualify as an obvious error on one options exchange might not qualify as such on CBOE, or vice versa. Because of this disparity and the potential for confusion, customers that routinely send orders to multiple exchanges have indicated that a more uniform obvious error pricing rule with respect to equity options would be beneficial to them. Accordingly, in response to the requests of its customers, CBOE proposes to adopt an obvious error pricing rule for equity options that is structured more like that of other options exchanges. The Exchange intends to keep its current obvious error for index options as well as options on ETFs and HOLDRS.⁷

a. Revised Rule CBOE 6.25, Nullification and Adjustment of Equity Options Transactions

Under CBOE's current obvious error rule, there are seven types of transactions that qualify as obvious errors. The Exchange proposes to reduce this number to four, as described below.

i. Obvious Price Errors

The Exchange proposes to adopt an obvious price error rule that operates almost identically to that of the International Securities Exchange ("ISE") Rule 720, with minor differences. As such, an obvious pricing error will be deemed to have occurred when the execution price of an electronic transaction (not open outcry)

varies from the Theoretical Price⁸ by a requisite amount.⁹ When an obvious price error occurs, CBOE either will adjust or nullify the transaction in accordance with the following principles:

Transactions Between CBOE Market Makers ("MMs"): Transactions between CBOE MMs will be adjusted to the Theoretical Price plus/minus an "adjustment penalty" of either \$0.15 or \$0.30. Erroneous buy transactions will be adjusted to Theoretical Price plus an adjustment penalty of either \$0.15 if Theoretical Price is below \$3 or \$0.30 if the Theoretical Price is \$3 or higher. Conversely, erroneous sell transactions will be adjusted to Theoretical Price minus an adjustment penalty of either \$0.15 if Theoretical Price is below \$3 or \$0.30 if Theoretical Price is \$3 or higher. Both parties to the transaction may agree to adjust to a different price or nullify the transaction altogether provided they do so within fifteen minutes of being notified by trading officials that an obvious error occurred.

Transactions where One Party is not a CBOE MM: Where at least one party is not a CBOE MM, the transaction will be nullified by trading officials unless both parties agree to an adjustment price for the transaction within thirty minutes of being notified by trading officials of the obvious error. This is identical to the ISE Rule.

ii. No Bid Series

This provision, which is identical to current paragraph (a)(7) of CBOE Rule 6.25, is renumbered as paragraph (a)(2) of CBOE Rule 6.25.

iii. Verifiable Disruptions or Malfunctions of Exchange Systems

This provision, which is identical to current paragraph (a)(3) of CBOE Rule 6.25, will apply to transactions occurring electronically or in open outcry. For those transactions qualifying for adjustment, there will be no adjustment penalty. Accordingly, transactions between CBOE MMs will

⁸ The Exchange proposes to use a similar definition for Theoretical Price as does the ISE. For multiply traded options, Theoretical Price will be the last bid (offer) price with respect to an erroneous sell (buy) transaction just prior to the trade that is disseminated by the competing options exchange with the most liquidity in that class over the preceding two calendar months. If there are no quotes for comparison purposes, trading officials shall determine Theoretical Price. For transactions occurring as part of the Rapid Opening System or Hybrid Opening System, Theoretical Price shall be the first quote after the transaction(s) in question that does not reflect the erroneous transaction(s).

⁹ The requisite amount is: \$0.25 for options below \$2, \$0.40 for options priced from \$2 to \$5, \$0.50 for options priced above \$5 to \$10, \$0.80 for options priced above \$10 to \$20, and \$1.00 for options priced above \$20.

be adjusted to the Theoretical Price. Transactions involving at least one CBOE non-member will be nullified unless the parties otherwise agree.

iv. Erroneous Print in Underlying

The Exchange proposes to amend paragraph (a)(4) of CBOE Rule 6.25 to clarify that a trade resulting from an erroneous print disseminated by the underlying market that is later cancelled or corrected by that underlying market may only be nullified. The current Rule allows these transactions to be adjusted or nullified.

b. Current Provisions Proposed for Elimination

The Exchange proposes to eliminate current paragraphs (a)(2) (Obvious Quantity Error), (a)(5) (Erroneous Quote in Underlying), and (a)(6) (Trades Below Intrinsic Value) of CBOE Rule 6.25. Changes to the pricing error section, paragraph (a)(1) (Obvious Price Error), render these provisions unnecessary.

c. Procedures for Reviewing Transactions

The Exchange retains its current procedures for reviewing transactions, with two minor modifications. First, the Exchange proposes to require notification within 15 minutes of the transaction in question, regardless of the time it occurred. Currently, for transactions occurring after 2:45 p.m. (CST), notification must be provided no later than fifteen (15) minutes after the close of trading of that security on CBOE. Second, the current Rule gives trading officials until 9:30 a.m. the following day to render determinations for transactions occurring after 2:30 p.m. Because this creates significant overnight exposure risk for both parties, the Exchange proposes to require trading officials to render a determination within 60 minutes of notification, regardless of the time the transaction occurred.¹⁰

Currently, the process for appealing determinations regarding obvious errors is governed by paragraph (d) of CBOE Rule 6.25, which provides for an appeals process under Chapter XIX of the Exchange's rules. The Exchange proposes to amend this process and create an Obvious Error Panel that will review decisions rendered by trading officials. The rules creating and governing the Obvious Error Panel are substantially similar to ISE Rule 720. Regarding the composition of the panel,

¹⁰ ISE also requires same-day determinations regardless of the time the transaction occurred. CBOE represents that trading officials will remain on Exchange premises until a determination is rendered.

⁷ See proposed CBOE Rule 24.16, which is a identical in substance to current CBOE Rule 6.25, except that it is limited in application to index options and options on ETFs and HOLDRs.

CBOE, in addition to including one Exchange trading floor liaison, will require that the panel be comprised of an equal number of CBOE MMs and floor broker members. However, while determinations rendered by ISE's Obvious Error Panel constitute final exchange action, CBOE proposes to allow parties to appeal decisions of its Obvious Error Panel in accordance with the procedures set forth in Chapter XIX of CBOE's rules.

2. Statutory Basis

CBOE represents that the filing provides objective guidelines for the nullification or adjustment of transactions executed at clearly erroneous prices. Moreover, the proposed rule provides more uniformity regarding obvious pricing errors, which will serve to benefit customers. For these reasons, the Exchange believes the proposed rule change is consistent with the Act and the rules and regulations under the Act applicable to a national securities exchange and, in particular, the requirements of section 6(b) of the Act.¹¹ Specifically, the Exchange believes the proposed rule change is consistent with the requirements of Section 6(b)(5) of the Act¹² that the rules of an exchange be designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts and practices, and, in general, to protect investors and the public interest.

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

CBOE does not believe that the proposed rule change will impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange 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.

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

The foregoing proposed rule change (1) does not significantly affect the protection of investors or the public interest; (2) does not impose any significant burden on competition; and (3) by its terms, does not become operative until 30 days from the date on which it was filed, or such shorter time as the Commission may designate if

consistent with the protection of investors and the public interest. Furthermore, the Exchange provided the Commission with written notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing of the proposed rule change. Consequently, the proposed rule change has become effective pursuant to Section 19(b)(3)(A) of the Act¹³ and Rule 19b-4(f)(6) thereunder.¹⁴

The Exchange has requested that the Commission waive the 30-day operative delay. The Commission believes that waiving the 30-day operative delay is consistent with the protection of investors and the public interest. The Commission notes that the proposal to amend CBOE's obvious error rule provisions is substantially similar to provisions contained in ISE Rule 720,¹⁵ and incorporates certain aspects of current CBOE Rule 6.25, which the Commission previously approved. Thus, the Commission does not believe that the proposed rule change raises any new regulatory issues. In addition, the Commission believes that waiver of the 30-day operative delay would enable the Exchange to implement the proposal as quickly as possible, and thereby provide for greater uniformity with respect to obvious error determinations for options transactions. For these reasons, the Commission designates the proposal to be effective and operative upon filing with the Commission.¹⁶

At any time within 60 days of the filing of this proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

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:

¹³ 15 U.S.C. 78s(b)(3)(A).

¹⁴ 17 CFR 240.19b-4(f)(6).

¹⁵ See Securities Exchange Act Release No. 48097 (June 26, 2003), 68 FR 39604 (July 2, 2003) (approving ISE's obvious error rule).

¹⁶ For purposes only of accelerating the operative date of this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

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-2004-83 on the subject line.

Paper Comments

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609.

All submissions should refer to File Number SR-CBOE-2004-83. 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 Section, 450 Fifth Street, NW., Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of CBOE. 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-2004-83 and should be submitted on or before January 18, 2005.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁷

Margaret H. McFarland,
Deputy Secretary.

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¹¹ 15 U.S.C. 78(f)(b).

¹² 15 U.S.C. 78(f)(b)(5).

¹⁷ 17 CFR 200.30-3(a)(12).