

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-57355; File No. SR-CBOE-2007-03)

February 20, 2008

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Granting Approval of a Proposed Rule Change as Modified by Amendment No. 1 Thereto Amending its Obvious Error Rule for Options on Indices, ETFs, and HOLDRS

I. Introduction

On February 21, 2007, 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 Rule 24.16, 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”), to: (i) modify the nullification and adjustment provisions for erroneous prints and erroneous quotes in the underlying; (ii) eliminate the nullification and adjustment provision for trades below intrinsic value; and (iii) modify the nullification provision for “no bid series.” On December 20, 2007, the CBOE submitted Amendment No. 1 to the proposed rule change. The proposed rule change, as amended, was published for comment in the Federal Register on December 28, 2007.³ The Commission received no comment letters on the proposal. This order approves the proposed rule change, as amended.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 57012 (December 20, 2007), 72 FR 73921.

II. Description of the Proposed Rule Change

The Exchange proposes to modify CBOE Rule 24.16 with respect to erroneous prints and erroneous quotes in the underlying. Under the revised rule, the appropriate Exchange committee would identify particular underlying or related instrument(s) that would be used to determine an erroneous print or quote and also would 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) may include the underlying or related ETF(s), HOLDRS(s), and/or index value(s),⁴ and/or related futures product(s).⁵ The relevant underlying market(s) may include one or more markets. The underlying or related instrument(s) and relevant market(s) would be designated by the appropriate Exchange committee and announced to the membership 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.

In addition, the proposal would eliminate the nullification and adjustment provision for trades below intrinsic value. CBOE Rule 24.16(a)(5) currently states that an obvious pricing error will be deemed to have occurred when the transaction price of an option series is more than

⁴ An “index value” is the value of an index as calculated and reported by the index’s reporting authority. Use of an index value would be applicable only for purposes of identifying an erroneous print in the underlying (and not an erroneous quote). See proposed changes to CBOE Rule 24.16(a)(3).

⁵ This proposed rule change does not seek to designate any of the individual underlying stocks (or related options or futures on any of the individual underlying stocks) that comprise a particular ETF, HOLDR, or index.

\$0.10 below the intrinsic value of the same option. The purpose of deleting this provision is to account for circumstances under which options are correctly priced \$0.10 or more below the intrinsic value. For example, this situation might occur in options with underlying securities that are hard-to-borrow, extremely volatile issues where one market participant seeks to transfer the risk of selling or buying a security to other market participants by trading options, and options having European-style exercise, thus preventing exercise prior to expiration. According to the Exchange, the elimination of this provision is consistent with the Exchange's current rule for equity options, which does not have an obvious error review for trades below intrinsic value.⁶

Finally, the proposal would modify the nullification provision for no bid series. Currently, the rule provides that electronic transactions in series that are quoted no bid on the Exchange are subject to nullification, provided that at least one strike price below (for calls) or above (for puts) in the same options class was quoted no bid at the time of execution. Under the revised rule, additional criteria and clarifying language would be added. Specifically, an electronic transaction in a series quoted no bid on the Exchange would be subject to nullification provided that: (i) the bid in that series immediately preceding the execution was, and for five seconds prior to the execution remained, zero; and (ii) at least one strike price below (for calls) or above (for puts) in the same options class was quoted no bid and offered at the same price or lower as that series at the time of execution. The revised no bid provision would provide that, when determining the Exchange's quotes in the relevant series, bids and offers of the parties to the subject trade that are in any of the series in the same options class shall not be considered. The revised rule also would provide that when an option series in a class has a non-standard deliverable (e.g., 150 contract delivery requirement), it will be considered separately for

⁶ See CBOE Rule 6.25.

purposes of the no bid provision from series in such class that do not have a non-standard deliverable. The revised rule would clarify that the no bid provision is intended to apply to series quoted no bid on the Exchange (as opposed to series for which the national best bid is quoted no bid).

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 exchange⁷ and, in particular, the requirements of Section 6(b) of the Act⁸ and the rules and regulations thereunder. Specifically, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,⁹ in that the proposal promotes just and equitable principles of trade, prevents fraudulent and manipulative acts, removes impediments to and perfects the mechanism of a free and open market and a national market system, and, in general, 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.

⁷ 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).

⁸ 15 U.S.C. 78f(b).

⁹ 15 U.S.C. 78f(b)(5).

The provisions of Rule 24.16 that relate to an erroneous print or quote in the underlying market would be revised to permit the Exchange to designate the underlying or related instruments that can be used as a basis for determining whether there is an erroneous print or quote in such instrument that indicates an obvious error has occurred. This revision recognizes that market participants trading in the index, ETF, or HOLDRS options may base their options pricing on trading in various markets and instruments. By requiring the underlying related instrument to be derived from or track the same underlying index, the Exchange has set forth objective criteria that must be met before it can designate such underlying or related instrument for use in the obvious error analysis. The elimination of the provision for trades below intrinsic value would align Rule 24.16 with the Exchange's obvious error rule for equity options, which does not contain a similar provision. The revisions to the "no bid series" provision incorporate additional objective factors to be used by CBOE in determining whether an obvious error exists.

In the Commission's view, the proposed changes to Rule 24.16 are appropriate and are consistent with the Act. These revisions provide reasonable and objective measures to assist the Exchange in ascertaining whether an obvious error has occurred in the aforementioned circumstances.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁰ that the proposed rule change (SR-CBOE-2007-03), as amended, is hereby approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹¹

Florence E. Harmon

Deputy Secretary

¹⁰ 15 U.S.C. 78s(b)(2).

¹¹ 17 CFR 200.30-3(a)(12).