

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-57005; File No. SR-CBOE-2007-122)

December 20, 2007

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

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on October 31, 2007, 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 December 14, 2007, the CBOE submitted Amendment No. 1 to the proposed rule change. 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, 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 to change the manner in which it applies the obvious price error provision to transactions occurring as part of the Hybrid Opening System (“HOSS”) process. The text of the proposed rule change is available at the Exchange, the Commission’s Public Reference Room, and [www.cboe.com](http://www.cboe.com).

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

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 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 amend CBOE Rule 24.16, which is its obvious error rule pertaining to index options, options on ETFs, and options on HOLDRS. The proposal would revise the obvious price error provision that pertains to transactions occurring as part of the HOSS opening rotation process. Currently, Rule 24.16 provides that an obvious price error would be deemed to have occurred when the execution price of a buy (sell) transaction is above (below) the fair market value of the option by at least a prescribed minimum error amount.<sup>3</sup> For purposes of transactions occurring on HOSS, "fair market value" is currently defined as the midpoint of the first quote after the transaction(s) in question that does not reflect the erroneous transaction(s). The Exchange is proposing to revise the fair market value calculation to provide additional conditions that would apply during regular HOSS rotations and during HOSS

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<sup>3</sup> For example, for series trading with normal bid-ask differentials as established in CBOE Rule 8.7(b)(iv), the prescribed minimum error amount is as follows: \$0.125 if the fair market value is below \$2, \$0.20 if the fair market value is \$2 to \$5, \$0.25 if the fair market value is above \$5 to 10, \$0.40 if the fair market value is above \$10 to 20, and \$0.50 if the fair market value is above \$20. See CBOE Rule 24.16(a)(1).

rotations in index options series that are being used to calculate the final settlement price of volatility indexes. The additional conditions are intended to reasonably factor the amount of available liquidity into the fair market value calculation during these rotations.

With respect to regular 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).<sup>4</sup> For example, assume that the opening transactions in series XYZ totaled 200 contracts at a price \$0.75. Also assume that a member representing non-CBOE Market-Maker A sold 200 contracts, trading 100 contracts with CBOE Market-Maker B and 100 contracts with non-CBOE Market-Maker C. Finally, assume that the first quote after the transaction in question that does not reflect the erroneous transaction is bid 100 contracts for \$0.95 and offered 150 contracts at \$1.15. In this scenario, an erroneous sell transaction would be deemed to have occurred in accordance with the obvious price error provision because the \$0.75 price received by non-CBOE Market-Maker A is at least \$0.125 lower than the fair market value of \$1.05.<sup>5</sup> In addition, because the size of the bid in the first quote after that does not reflect the erroneous transaction is for 100 contracts, up to 100 contracts executed on the opening on behalf of non-CBOE Market-Maker A would be subject to nullification or adjustment under the obvious price error provision.<sup>6</sup> Any nullifications or adjustments would occur on a pro rata basis considering

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<sup>4</sup> For erroneous sell transactions, the size of the bid would be used. For erroneous buy transactions, the size of the offer would be used.

<sup>5</sup> \$1.05 is the midpoint of \$0.95 and \$1.15.

<sup>6</sup> A HOSS transaction involving a non-CBOE Market-Maker is adjusted based on the first non-erroneous quote after the erroneous transaction on CBOE, provided the price does not violate the non-CBOE Market-Maker's limit price. Otherwise, the transaction is nullified. See Rule 24.16(a)(1)(ii)(B) and (c)(3).

the overall size of the HOSS opening trade. Thus, 50 contracts executed against CBOE Market-Maker B would have a price adjustment to \$1.05 (provided the adjusted price does not violate A's limit price) and 50 contracts executed against non-CBOE Market-Maker C would have a price adjustment to \$1.05 (provided the adjusted price does not violate A's or C's limit price).

With respect to HOSS rotations in index options series being used to calculate the final settlement price of a volatility index,<sup>7</sup> the Exchange is proposing to add a condition that the first quote after the transaction(s) in question that does not reflect the erroneous transaction(s) must be for at least the overall size of the HOSS opening transaction(s).<sup>8</sup> If the size of the quote is

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<sup>7</sup> The Exchange states that CBOE's and the CBOE Futures Exchange, LLC's (a designated contract market approved by the Commodity Futures Trading Commission and a wholly-owned subsidiary of CBOE) rules provide for the listing and trading of options and futures, as applicable, on various volatility indexes. This proposed obvious price error provision would be utilized only for those index options series used to calculate the final settlement price of a volatility index and only on the final settlement date of the options and futures contracts on the applicable volatility index in each expiration month. Thus, for example, the proposed obvious price error provision would be used for the relevant Standard & Poor's 500 Stock Index ("SPX") options series on settlement days for CBOE Volatility Index ("VIX") options and futures contracts. The Exchange notes that, during the final settlement date, traders holding hedged volatility futures positions to settlement can be expected to trade out of their SPX options on that date. Traders who hold short, hedged VIX futures would liquidate that hedge by selling their SPX options, while traders holding long, hedged VIX positions would liquidate their hedge by buying SPX options. In order to seek convergence with the VIX final settlement value, these traders would be expected to liquidate their hedges by submitting orders in the appropriate SPX option series during the SPX opening on the final settlement date of the VIX futures contract. To the extent: (i) traders who are liquidating hedges predominately are on one side of the market (e.g., seek to buy the particular SPX options); and (ii) those traders' orders predominate over other orders during the SPX opening on the final settlement date for the VIX futures contract, trades to liquidate hedges may contribute to an order imbalance during the SPX opening on that date. The same is equally applicable with respect to the final settlement dates of other volatility index options and futures. In light of this potential for a large order imbalance in the applicable series on these dates, the Exchange believes that the application of a modified obvious price error provision is reasonable and appropriate and will contribute to a fair and orderly opening.

<sup>8</sup> See supra note 4.

less than the overall size of the opening transaction(s), then the obvious price error provision shall not apply. For example, if the opening trade in Series XYZ is for a total of 200 contracts and the bid or offer, as applicable, of the first quote after the transaction(s) in question that does not reflect the erroneous transaction(s) is for 500 contracts, then the quote would be used to determine the fair market value and whether an obvious price error occurred. If the bid or offer, as applicable, of the quote is for only 100 contracts, then the trade would not be subject to nullification or adjustment under the obvious price error provision.

## 2. Statutory Basis

The Exchange believes the proposed rule change is consistent with Section 6(b) of the Act,<sup>9</sup> in general, and furthers the objectives of Section 6(b)(5) of the Act,<sup>10</sup> in particular, in that it is designed to promote just and equitable principles of trade, serve to remove impediments to and perfect the mechanism of a free and open market and a national market system, and 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 will impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

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<sup>9</sup> 15 U.S.C. 78f(b).

<sup>10</sup> 15 U.S.C. 78f(b)(5).

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.

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, 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 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](mailto:rule-comments@sec.gov). Please include File Number SR-CBOE-2007-122 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-2007-122. 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, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. Copies of such 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-2007-122 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

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

Florence E. Harmon  
Deputy Secretary

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<sup>11</sup> 17 CFR 200.30-3(a)(12).