

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-57127; File No. SR-ISE-2007-112)

January 10, 2008

Self-Regulatory Organizations; International Securities Exchange, LLC; Notice of Filing of a Proposed Rule Change, as Modified by Amendment No. 1 Thereto, Relating to Obvious Errors

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 November 29, 2007, the International Securities Exchange, LLC (“ISE” 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 January 4, 2008, the ISE 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 its Obvious Error rule to address “Catastrophic Errors.” The text of the proposed rule change is available at the Exchange, the Commission’s Public Reference Room, and [www.ise.com](http://www.ise.com).

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

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

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

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 states that the purpose of the proposed rule change is to amend ISE Rule 720 (the "Obvious Error Rule") to address certain extreme circumstances. In particular, the Exchange proposes 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.

The Exchange notes that, currently under the Obvious Error Rule, trades that result from an Obvious Error may be adjusted or busted according to objective standards. Under the rule, whether an Obvious Error has occurred is determined by comparing the execution price to the theoretical price of the option. The rule requires that members notify ISE Market Control within a short time period following the execution of a trade (five minutes for market makers and 20 minutes for Electronic Access Members ("EAMs")) if they believe the trade qualifies as an Obvious Error. Trades that qualify for adjustment are adjusted under the rule to a price that matches the theoretical price plus or minus an adjustment value, which is \$.15 if the theoretical value is under \$3 and \$.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 what the party making the error would have received had it not made the error.

In formulating the Obvious Error Rule, the Exchange has weighed carefully the need to assure that one market participant is not permitted to receive a wind-fall at the expense of

another market participant that made an Obvious Error, against the need to assure that market participants are not simply being given an opportunity to reconsider poor trading decisions. The Exchange states that, while it believes that the Obvious Error Rule strikes the correct balance in most situations, 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, ISE believes members should be given more time to seek relief so that there is a greater opportunity to mitigate very large losses and reduce the corresponding large wind-falls. However, to maintain the appropriate balance, the Exchange believes members should only be given more time when the execution price is much further away from the theoretical price than is required for Obvious Errors, and that the adjustment “penalty” should be much greater, so that relief is only provided in extreme circumstances.<sup>3</sup>

Accordingly, the Exchange proposes to amend the Obvious Error Rule to address “Catastrophic Errors.” Under the proposed rule, Members will have until 8:30 a.m. Eastern Time on the day following the trade to notify Market Control of a potential Catastrophic Error. For trades that take place in an expiring series on expiration Friday, Members must notify Market Control of a potential Catastrophic Error by 5:00 p.m. Eastern Time that same day. Once a member has notified Market Control of a Catastrophic Error within the required time period, a

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<sup>3</sup> The Exchange does not believe the type of extreme situation that is covered by the proposed rule would occur in the normal course of trading. Rather, this type of situation could potentially occur as a result of, for example, an error in a member’s quotation system that causes a market maker to severely misprice an option.

tribunal comprised of two representatives from market makers and two representatives from EAMs that are unrelated to the transaction in question (the “Tribunal”) will review the Catastrophic Error claim. In the event the Tribunal determines that a Catastrophic Error did not occur, the member that initiated the review will be charged \$5,000 to reimburse the Exchange for the costs associated with reviewing the claim.

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 amount shown in the second column of the chart below (the “Minimum Amount”), and the adjustment would be made plus or minus the amount shown in column three of the chart below (the “Adjustment Value”). At all price levels, the Minimum Amount and the Adjustment Value for Catastrophic Errors would be significantly higher than for Obvious errors, which the Exchange believes, would limit the application of the proposed rule to situations where the losses are very large.

<b>Theoretical Price</b>	<b>Minimum Amount</b>	<b>Adjustment Value</b>
Below \$2	\$1	\$1
\$2 to \$5	\$2	\$2
Above \$5 to \$10	\$5	\$3
Above \$10 to \$50	\$10	\$5
Above \$50 to \$100	\$20	\$7
Above \$100	\$30	\$10

The following example demonstrates how the proposed Catastrophic Error provisions would operate within the Obvious Error framework. Assume a member notifies ISE Market

Control within 2 minutes of a trade where 100 contracts of an option with a theoretical price of \$9 were purchased for \$17, resulting in an \$80,000 error.<sup>4</sup> The trade would qualify as an Obvious Error because the purchase price is more than \$.50 above the theoretical price and the member notified ISE Market Control within the required time period. Market Control would review the trade and either bust it or adjust it to a purchase price of \$9.30,<sup>5</sup> which reduces the cost of the error to \$3,000.<sup>6</sup> If, however, the member failed to identify the same error and notify Market Control until four hours after the trade, it could not be reviewed under the current Obvious Error Rule. Under the proposal, this trade would qualify as a Catastrophic Error because the purchase price is more than \$5 above the theoretical price. Under the proposal, the Tribunal would review the trade and adjust the purchase price to \$12, which reduces the cost of the error to \$30,000.<sup>7</sup>

The Exchange believes that the proposed longer time period is appropriate to allow members to discover, and seek relief from, trading errors that result in extreme losses. At the same time, the Exchange believes that the proposed Minimum Amounts required for a trade to qualify as a Catastrophic Error, in combination with the large Adjustment Values, assures that only those transactions where the price of the execution results in very high losses will be eligible

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<sup>4</sup> One hundred contracts equal 10,000 shares, and the purchase price is \$8 per share above the theoretical price. Therefore, the purchaser paid \$80,000 over the theoretical value.

<sup>5</sup> ISE Rule 720(c)(2).

<sup>6</sup> 10,000 shares at \$.30 per share over the theoretical value.

<sup>7</sup> 10,000 shares at \$3.00 per share over the theoretical value.

for adjustment under the new provisions. While the Exchange believes it is important to identify and resolve trading errors quickly, it also believes it is important to the integrity of the marketplace to have the authority to mitigate extreme losses resulting from errors. In this respect, the Exchange believes that the above example illustrates how market participants would continue to be encouraged to identify errors quickly, as losses will be significantly lower if the erroneous trades are busted or adjusted under the Obvious Error provisions of the rule.

In consideration of the extreme nature of situations that will be addressed under the proposed Catastrophic Error provisions, the Exchange proposes a streamlined procedure for making determinations and adjustments. Under the current rule for Obvious Errors, ISE Market Control makes determinations that can then be appealed to a panel of member representatives. For Catastrophic Errors, the Exchange proposes to have a one-step process where the Tribunal makes determinations and adjustments. Additionally, given the burden that reviews under the Catastrophic Error provisions of the rule will have on exchange staff and member representatives, the Exchange proposes to include a \$5000 fee in the event that the Tribunal determines that a Catastrophic Error did not occur. The Exchange believes that this is reasonable to encourage Members to request reviews only in appropriate situations, particularly given the objective criteria used to determine whether a Catastrophic Error occurred and the considerable amount of time members are given under the proposal to assess whether a trade falls within that criteria.

The Exchange also amended Supplementary Material .02, .03, and .04 to ISE Rule 720 to reflect the proposed creation of the Tribunal.

## 2. Statutory Basis

The Exchange believes the proposed rule change is consistent with Section 6(b) of the Act,<sup>8</sup> in general, and furthers the objectives of Section 6(b)(5) of the Act,<sup>9</sup> in particular, in that it is designed to 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. In particular, the proposal will allow members a longer opportunity to seek relief from errors that result in large losses.

### 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 that is 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.

## 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

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<sup>8</sup> 15 U.S.C. 78f(b).

<sup>9</sup> 15 U.S.C. 78f(b)(5).

- 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-ISE-2007-112 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-ISE-2007-112. 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-ISE-2007-112 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>10</sup>

Florence E. Harmon  
Deputy Secretary

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<sup>10</sup> 17 CFR 200.30-3(a)(12).