



To: Members  
From: Legal Division  
Date: February 8, 2007  
Subject: Obvious Error Rule Changes for Index, ETF and HOLDRS Options

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A rule change that amended Rule 24.16, *Nullification and Adjustment of Transactions in Index Options, Options on ETFs and Options on HOLDRS*, was approved (see Release 34-55246, SR-CBOE-2006-62). The rule change amended the rule in the following respects:

- (i) **Revised the pricing parameters used to determine what constitutes an “obvious price error.”** Under the rule, an obvious price 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 minimum error amount. Under the revised parameters, for series trading with normal bid-ask differentials as established in Rule 8.7(b)(iv), the prescribed minimum error amount shall be:

Fair Market Value	Minimum Error Amount
Below \$2	\$0.125
\$2 to \$5	\$0.20
Above \$5 to \$10	\$0.25
Above \$10 to \$20	\$0.40
Above \$20	\$0.50

For series trading with bid-ask differentials that are a multiple of the widths established in Rule 8.7(b)(iv), the prescribed minimum error amount shall have the same multiple applied to the minimum error amount prescribed above. For purposes of the Rule, the “fair market value” of an option is the midpoint of the NBBO. Please refer to the Rule for additional information regarding the manner in which fair market value is determined.

- (ii) **Provided for a Market-Maker to CBOE Market-Maker adjustment of obvious price errors (previously such erroneous transactions are subject to nullification).** Under the revised rule, where both parties to the transaction are CBOE Market-Makers, the execution price of the transaction will be adjusted by Trading Officials upon notification in accordance with the Rule to the fair market value minus (plus) the prescribed minimum error amount with respect to an erroneous sell (buy) transaction. If the adjusted price is not in a multiple of the applicable minimum trading increment, the adjusted price will be rounded down (up) to the next price that is a multiple of the applicable minimum trading increment with respect to an erroneous sell (buy) transaction. Where one of the parties to the transaction is not a CBOE Market-Maker, the transaction will be adjusted or nullified by Trading Officials upon notification in accordance with the adjustment and nullification provisions described in the Rule. The Rule also provides that a trade may be nullified if the parties to the trade agree to the nullification.
- (iii) **Eliminated the nullification and adjustments provisions pertaining to erroneous quantity errors.**

The text of the revised rule is attached. Members seeking further information as to the revised rule should refer to the rule change, which is available on CBOE’s website at [www.cboe.org/Legal](http://www.cboe.org/Legal). For any other questions, please contact Jennifer Lamie, Legal Division, at (312) 786-7576.

**Rule 24.16. Nullification and Adjustment of Transactions  
in Index Options, Options on ETFs and Options on HOLDRS**

**RULE 24.16.** This Rule only governs the nullification and adjustment of transactions involving index options and options on ETFs or HOLDRS. Rule 6.25 governs the nullification and adjustment of transactions involving equity options. Paragraphs (a)(1), (5) and (6) 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, as provided herein, 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 price 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 minimum error amount. For series trading with normal bid-ask differentials as established in Rule 8.7(b)(iv), the prescribed minimum error amount shall be:

<b>Fair Market Value</b>	<b>Minimum Error Amount</b>
Below \$2	\$0.125
\$2 to \$5	\$0.20
Above \$5 to \$10	\$0.25
Above \$10 to \$20	\$0.40
Above \$20	\$0.50

For series trading with bid-ask differentials that are a multiple of the widths established in Rule 8.7(b)(iv), the prescribed minimum error amount shall have the same multiple applied to the minimum error amount prescribed above.

**(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 midpoint of 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 midpoint of the first quote after the transaction(s) in question that does not reflect the erroneous transaction(s). The determination of fair market value shall be made by Trading Officials in accordance with the provisions of this paragraph.

**(ii) Price Adjustment or Nullification:** Obvious price errors will be adjusted or nullified in accordance with the following:

**(A) 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 upon notification pursuant to paragraph (b) and in accordance with the adjustment and nullification provisions of paragraph (c)(1) below.

**(B) Transactions involving at least one non-CBOE Market-Maker:** Where one of the parties to the transaction is not a CBOE Market-Maker, the transaction will be adjusted or nullified by Trading Officials upon notification pursuant to paragraph (b) and in accordance with the adjustment and nullification provisions of paragraph (c)(3) below.

**(2) 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.

**(3) 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).

**(4) 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.

**(5) 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.

**(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.

**(6) No Bid Series:** Electronic transactions in series quoted no bid 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 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. (CT), 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 and Nullifications**

(1) Transactions between CBOE Market-Makers pursuant to paragraph (a)(1) shall be adjusted to the fair market value minus (plus) the prescribed minimum error amount with respect to an erroneous sell (buy) transaction. If the adjusted price is not in a multiple of the applicable minimum trading increment, the adjusted price will be rounded down (up) to the next price that is a multiple of the applicable minimum trading increment with respect to an erroneous sell (buy) transaction.

(2) Transactions between CBOE Market-Makers pursuant to paragraphs (a)(2) – (a)(5) shall be nullified.

(3) Transactions involving at least one non-CBOE Market-Maker pursuant to paragraphs (a)(1) through (a)(5) will be adjusted provided the adjusted price does not violate the non-CBOE Market-Maker's limit price. Otherwise, the transaction will be nullified. With respect to Rule 24.16(a)(1)(ii)(B) – (a)(4), 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 Rule 24.16(a)(5), 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.