



To: Members
From: Legal Division
Date: February 15, 2008
Subject: Obvious Error Rule Change for Index, ETF and HOLDRS Options

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 34-57286, SR-CBOE-2007-122). The rule change amended the manner in which the obvious price error provision is applied to transactions occurring as part of the Hybrid Opening System (“HOSS”) rotation process.

Under Rule 24.16, 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. For transactions occurring on HOSS, “fair market value” is defined as the midpoint of the first quote after the transaction(s) in question that does not reflect the erroneous transaction(s). The rule change revised this fair market value calculation to provide additional conditions that apply during regular HOSS rotations and during HOSS rotations in index options series that are being used to calculate the final settlement price of volatility indexes. The additional conditions are as follows:

- **Regular HOSS Rotations:** With respect to regular HOSS rotations, the option contract quantity subject to nullification or adjustment cannot not exceed the size of the first quote after the transaction(s) in question that does not reflect the erroneous transaction(s). For erroneous sell transactions, the size of the bid would be used. For erroneous buy transactions, the size of the offer would be used. Any nullification or adjustment would occur on a pro rata basis and would take into account the overall size of the HOSS opening trade.¹
- **HOSS Rotations Related to Volatility Settlements:** With respect to HOSS rotations in index options series being used to calculate the final settlement price of a volatility index, the first quote after the transaction(s) in question that does not reflect the erroneous transaction(s) must be for at least the size of the HOSS opening transaction(s). If the size of the quote is less than the size of the opening transaction(s), then the obvious price error provision does not apply.²

Members seeking further information should refer to Rule 24.16 and the rule change, which is available on CBOE’s website at www.cboe.org/Legal. For any other questions, please contact Jennifer Lamie, Legal Division, at (312) 786-7576 or Trading Officials at (312) 786-7914.

¹For example, assume the opening transactions in series XYZ totaled 200 contracts at a price of \$0.75. Also assume 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 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 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 (which is the midpoint of \$0.95 and \$1.15). 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 would be subject to nullification or adjustment under the obvious price error provision (see Rule 24.16(a)(1)(ii)(B) and (c)(3)). Thus, 50 contracts executed between non-CBOE Market-maker A and CBOE Market-Maker B would have a price adjustment to \$0.95* (provided the adjusted price does not violate A’s limit price) and 50 contracts executed between non-CBOE Market-Maker A and non-CBOE Market-Maker C would have a price adjustment to \$0.95* (provided the adjusted price does not violate A’s or C’s limit price). (*Please note that the example in the Federal Register notice incorrectly identified the adjustment price as \$1.05.)

² 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.