SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50169; File No. SR-CBOE-2004-02)

August 9, 2004

Self-Regulatory Organizations; Chicago Board Options Exchange, Inc.; Order Granting Approval to Proposed Rule Change and Amendment No. 1 Thereto, and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 Thereto to Amend the Obvious Error Rule Relating to Options Quoted "No-Bid"

On January 8, 2004, the Chicago Board Options Exchange, Inc. ("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 its obvious error rule, CBOE Rule 6.25. On February 2, 2004, CBOE submitted Amendment No. 1 to the proposed rule change.[3] The proposed rule change, as amended, was published for comment in the Federal Register on March 31, 2004.[4] The Commission received no comments on the proposal. On June 10, 2004, CBOE filed Amendment No. 2 to the proposed rule change.[5] This order approves CBOE's proposed rule change, as amended, publishes

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1. 15 U.S.C. 78s(b)(1).
2. 17 CFR 240.19b-4.
3. See Letter from Steve Youhn, Legal Division, CBOE, to Nancy J. Sanow, Assistant Director, Division of Market Regulation ("Division"), Commission, dated January 30, 2004 ("Amendment No. 1"). Amendment No. 1 replaced and superseded the original filing in its entirety.
4. See Securities Exchange Act Release No. 49462 (March 23, 2004), 69 FR 16998.
5. See Letter from Steve Youhn, Legal Division, CBOE, to Nancy J. Sanow, Assistant Director, Division, Commission, dated June 9, 2004 ("Amendment No. 2"). Amendment No. 2 replaced and superceded the original proposal, as amended, in its entirety. In Amendment No. 2, the Exchange amended the proposed rule text to provide that buyers of options series quoted "no-bid" at a nickel (i.e., $0.05 offer) may request that their execution be nullified provided that at least one strike price below (for calls) or above (for puts) in the same options class was quoted no bid at a nickel at the time of execution.

notice of Amendment No. 2 to the proposed rule change, and grants accelerated approval to Amendment No. 2.

I. Description of the Proposal

The Exchange proposes to amend CBOE Rule 6.25 (Nullification and Adjustment of Electronic Transactions), which establishes six specific objective guidelines that may be used as the basis for adjusting or nullifying a transaction. The Exchange proposes to adopt one additional guideline, relating to options quoted "no-bid,"[6] which may be used as a basis for nullifying trades. Under this guideline, buyers of options series quoted no-bid at a nickel (i.e., $0.05 offer) may request that their execution 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 a nickel at the time of execution.

According to CBOE, series of options quoted no-bid at a nickel are usually deep out-of-the-money series that have little, if any, chance of expiring in-the-money. CBOE asserts that for this reason, relatively few transactions occur in these series, and those that do are usually the result of error. As an example, CBOE notes that during expiration week with the underlying stock trading at $21, the DEC 40 calls likely will be quoted no-bid at a nickel. If the DEC 30s, 35s, and 40s are trading no-bid at a nickel, and a buyer inadvertently purchases the DEC 40 series calls at a nickel, then this transaction would qualify for nullification under the proposed rule, as there is at least one series below the 40s (i.e., the 35s) also quoted no-bid at a nickel.

The Exchange believes that this type of transaction should qualify as an obvious error by virtue of the fact that strikes below (for calls) or above (for puts) are quoted no-

6 "No-bid" is synonymous with "zero-bid."

bid at a nickel. According to CBOE, there is no legitimate reason why a buyer of calls would pay a nickel for the DEC 40s when the DEC 35s, which are not as far out-of-the-money, trade at the same price.

The Exchange also proposes to restrict applicability of the "no-bid at a nickel rule" to electronic transactions only by amending the introductory text to CBOE Rule 6.25. Trades occurring in open outcry would not qualify for nullification under this proposal.

CBOE represents that this proposed rule is substantially similar to PCX Rule 6.87(g)(2)(F) and ISE Rule 720.05, with minor differences. The CBOE proposal differs slightly from the PCX rule in that CBOE requires the series in question to be offered at \$0.05, while the PCX does not.[7] The CBOE proposal differs slightly from the ISE proposal in that the ISE rule requires at least three strikes below (calls) or above (puts) in the same class be zero bid at a nickel. CBOE, like the PCX, proposes to only require one series above or below be quoted no-bid at a nickel.

II. Discussion

The Commission has reviewed carefully the proposed rule change and 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 exchange.[8] In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the

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7 For example, on PCX a series may be "no-bid," offered at \$0.20. The ISE also requires an \$0.05 offer.

8 In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78f(b)(5).

Act,[9] which requires that the rules of an exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to 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.

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, and the nullification of a transaction because an obvious error is considered to exist, should be based on specific and objective criteria and subject to specific and objective procedures. The Commission believes that CBOE's proposed amendment to its obvious error rule establishes specific and objective criteria for determining when a trade is an obvious error for options quoted no-bid at a nickel in electronic transactions. Moreover, the proposal clearly specifies that such trades may be nullified pursuant to the Exchange's existing procedures governing the review of obvious error transactions. Finally, the Commission notes that the Exchange's proposed amendment to its obvious error rule for options quoted no-bid at a nickel is similar to the rules of other exchanges that the Commission has previously approved.[10]

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9 15 U.S.C. 78f(b)(5).

10 See Securities Exchange Act Release Nos. 48097 (June 26, 2003), 68 FR 39604 (July 2, 2003) (approving File No. SR-ISE-2003-10); and 48538 (September 25, 2003), 68 FR 56858 (October 2, 2003) (approving File No. SR-PCX-2002-01).

Pursuant to Section 19(b)(2) of the Act,[11] the Commission may not approve any proposed rule change, or amendment thereto, prior to the 30th day after the date of publication of notice of the filing thereof, unless the Commission finds good cause for so doing and publishes its reasons for so finding. The Commission hereby finds good cause for approving Amendment No. 2 to the proposal prior to the 30th day after publishing notice of Amendment No. 2 in the Federal Register. The revisions made to the proposal in CBOE's Amendment No. 2, which sets forth specific and objective criteria for determining whether an electronic transaction in an option quoted no-bid at a nickel is an obvious error, are based on rules of other exchanges that the Commission previously has approved.[12] Thus, the Commission believes that no new issues are raised by the proposal. Accordingly, pursuant to Section 19(b)(2) of the Act,[13] the Commission finds good cause to approve Amendment No. 2 prior to the thirtieth day after notice of the Amendment is published in the Federal Register.

III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 2, including whether the proposed amendment 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.

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11 15 U.S.C. 78s(b)(2).

12 See supra note 10.

13 15 U.S.C. 78s(b)(2).

<u>Paper comments:</u>

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-CBOE-2004-02. 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 Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of CBOE. 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-2004-02 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[14] that the proposed rule change (File No. SR-CBOE-2004-02), as amended, be, and hereby is, approved, and that Amendment No. 2 to the proposed rule change be, and hereby is, approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[15]

Margaret H. McFarland
Deputy Secretary

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[14] 15 U.S.C. 78s(b)(2).

[15] 17 CFR 200.30-3(a)(12).