



## Regulatory Circular RG04-130

**To:** Members

**From:** Legal Division

**Date:** December 22, 2004

**Re:** New Obvious Error Rule for Equities

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Effective immediately, CBOE is implementing a new obvious error rule applicable to equity options transactions only. Index options and options on ETFs will continue to be governed by the existing obvious error rule, which is being renumbered as Rule 24.16. This means the CBOE will have two obvious error rules: Rule 6.25 for equity options transactions and Rule 24.16 for transactions in index options and options on ETFs. The new obvious error rule is substantially different from the existing rule. This Regulatory Circular summarizes the new equity rule, which also is attached. In determining whether the obvious error rule has any application to their equity option transactions, members are advised to review and rely upon the full text of Rule 6.25 and not this summary.

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**Trades Subject to Review:** There are four types of transactions subject to review:

**1. Obvious Price Errors:** Occurs when the execution price of an electronic transaction is above or below the Theoretical Price for the series by an amount equal to at least the amount shown below:

Theoretical Price	Minimum Amount
Below \$2	\$0.25
\$2 to \$5	\$0.40
Above \$5 to \$10	\$0.50
Above \$10 to \$20	\$0.80
Above \$20	\$1.00

**Definition of Theoretical Price.** The Theoretical Price of an option series is, for multiply-listed options, the last bid (offer) price with respect to an erroneous sell (buy) transaction just prior to the trade, disseminated by the competing exchange with the most liquidity in that option class over the previous two calendar months. If there are no quotes for comparison, designated Trading Officials (TOs) will determine the Theoretical Price. For transactions occurring as part of the Rapid Opening System or Hybrid Opening System, Theoretical Price shall be the first quote after the transaction(s) in question that does not reflect the erroneous transaction(s).

**Price Adjustment or Nullification:** Obvious Pricing Errors will be adjusted as follows:

**Transactions Between CBOE Market Makers:** If both parties involved are CBOE Market-Makers, erroneous buy (sell) transactions will be adjusted to their Theoretical Price plus (minus) an adjustment penalty of either \$.15 if the Theoretical Price is under \$3 or \$.30 if the Theoretical Price is at or above \$3. For ROS or HOSS transactions, adjust to the first non-erroneous quote after the erroneous transaction on CBOE, less (plus) the adjustment penalty.

**Transactions Involving at least one non-CBOE Market Maker:** Where one party to the transaction is not a CBOE market maker, the transaction will be nullified unless both parties agree to an adjustment price within thirty (30) minutes of notification by Trading Officials of the Obvious Error.

**2. No Bid Series:** Electronic transactions in series quoted no bid at a nickel (i.e., \$0.05 offer) 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 a nickel at the time of execution.

**3. Verifiable Disruptions or Malfunctions of Exchange Systems:** Electronic or open outcry transactions arising out of a “verifiable disruption or malfunction” in the use or operation of any Exchange automated quotation, dissemination, execution, or communication system will either be nullified or adjusted by TOs. Transactions between CBOE MMs will be adjusted to Theoretical Price (no penalty). Other transactions will be nullified.

**4. Erroneous Print in Underlying:** Electronic or open outcry transactions will be nullified provided the erroneous print in the underlying market is higher or lower than the average trade in the underlying during a two-minute period before and after the bad print in question by at least five times the average quote width during the same period.

**Notification Requirement:** Absent unusual circumstances, members must notify a TO within 15 minutes after the execution. For “verifiable systems problems,” Trading Officials may initiate action within 60 minutes of the occurrence.

**Review and Determination:** Absent unusual circumstances, TOs must render a decision within 60 minutes of receiving notice and provide prompt verbal notification to the parties involved.

**Appeal to Obvious Error Panel:** A party may request the Obvious Error Panel review a TO decision by submitting a request in writing to any TO within (30) minutes after receiving verbal notification of a final ruling. The Panel may affirm, overturn, or modify a TO decision and must do so on trade date (unless appeal is after 2:30pm). The Panel consists of one TFL and four members (2 MMs and 2 FBs) chosen from EOPC, MPC, and Floor Officials.

**Expired Provisions:** The new obvious error rule no longer allows adjustment/nullification of trades executed below intrinsic value or trades executed as the result of an erroneous quote in the underlying.

For more information, please contact Trading Floor Liaisons, Floor Officials, Andrew Spiwak at (312) 784-7483, or Steve Youhn at (312) 786-7416

## Rule 6.25 Nullification and Adjustment of Equity Options Transactions

This Rule governs the nullification and adjustment of transactions involving equity options. Rule 24.16 governs the nullification and adjustment of transactions involving index options and options on ETFs and HOLDRS. Paragraphs (a)(1) and (2) 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 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 pricing error occurs when the execution price of an electronic transaction is above or below the Theoretical Price for the series by an amount equal to at least the amount shown below:

Theoretical Price	Minimum Amount
Below \$2	\$0.25
\$2 to \$5	\$0.40
Above \$5 to \$10	\$0.50
Above \$10 to \$20	\$0.80
Above \$20	\$1.00

**Definition of Theoretical Price.** For purposes of this Rule only, the Theoretical Price of an option series is, for series traded on at least one other options exchange, the last bid price with respect to an erroneous sell transaction and the last offer price with respect to an erroneous buy transaction, just prior to the trade, disseminated by the competing options exchange that has the most liquidity in that option class in the previous two calendar months. If there are no quotes for comparison, designated Trading Officials will determine the Theoretical Price. For transactions occurring as part of the Rapid Opening System (“ROS trades”) or Hybrid Opening System (“HOSS”), Theoretical Price shall be the first quote after the transaction(s) in question that does not reflect the erroneous transaction(s).

**Price Adjustment or Nullification:** Obvious Pricing Errors will be adjusted or nullified in accordance with the following:

**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 to the prices provided in Paragraphs (A) and (B) below, minus (plus) an adjustment penalty (“adjustment penalty”), unless both parties agree to adjust the transaction to a different price or agree to bust the trade within fifteen (15) minutes of being notified by Trading Officials of the Obvious Error.

A. Erroneous buy transactions will be adjusted to their Theoretical Price plus an adjustment penalty of either \$.15 if the Theoretical Price is under \$3 or \$.30 if the Theoretical Price is at or above \$3.

B. Erroneous sell transactions will be adjusted to their Theoretical Price minus an adjustment penalty of either \$.15 if the Theoretical Price is under \$3 or \$.30 if the Theoretical Price is at or above \$3.

**Transactions Involving at least one non-CBOE Market Maker:** Where one of the parties to the transaction is not a CBOE market maker, the transactions will be nullified by Trading Officials unless both parties agree to an adjustment price for the transaction within thirty (30) minutes of being notified by Trading Officials of the Obvious Error.

**(2) No Bid Series:** Electronic transactions in series quoted no bid at a nickel (i.e., \$0.05 offer) 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 a nickel at the time of execution.

**(3) Verifiable Disruptions or Malfunctions of Exchange Systems:** Electronic or open outcry transactions arising out of a “verifiable disruption or malfunction” in the use or operation of any Exchange automated quotation, dissemination, execution, or communication system will either be nullified or adjusted by Trading Officials. Transactions that qualify for price adjustment will be adjusted to Theoretical Price, as defined in paragraph (a)(1) above.

**(4) 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 nullified. In order to be 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).

#### **(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. 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. Trading Officials shall promptly provide verbal notification of a determination to the members involved in the disputed transaction and to the control room.

### **(c) Obvious Error Panel**

**(i) Composition.** An Obvious Error Panel will be comprised of at least one (1) Trading Floor Liaison (TFL) and four (4) Exchange members. Fifty percent of the number of Exchange members on the Obvious Error Panel must be directly engaged in market making activity and fifty percent of the number of Exchange members on the Obvious Error Panel must act in the capacity of a non-DPM floor broker. The Exchange members shall be representatives from any of the following Committees: Equity Options Procedure Committee, Equity Market Performance Committee, and Floor Officials Committee.

**(ii) Scope of Review.** If a party affected by a determination made under this Rule so requests within the time permitted in paragraph (b), an Obvious Error Panel will review decisions made by the Trading Officials under this Rule, including whether an obvious error occurred, whether the correct Theoretical Price was used, and whether the correct adjustment was made at the correct price. A party may also request that the Obvious Error Panel provide relief as required in this Rule in cases where the party failed to provide the notification required in paragraph (b) and the Trading Officials declined to grant an extension, but unusual circumstances must merit special consideration.

**(iii) Procedure for Requesting Review.** A request for review must be made in writing within (30) minutes after a party receives verbal notification of a final determination by the Trading Officials under this Rule, except that if notification is made after 2:30 p.m. Central Time ("CT"), either party has until 8:30 a.m. CT the next trading day to request review. The Obvious Error Panel shall review the facts and render a decision on the day of the transaction, or the next trade day in the case where a request is properly made the next trade day.

**(iv) Panel Decision.** The Obvious Error Panel may overturn or modify an action taken by the Trading Officials under this Rule upon agreement by a majority of the Panel representatives. All determinations by the Obvious Error Panel may be appealed in accordance with paragraph (d) of this rule.

### **(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.

**.03 Definitions:** For purposes of this Rule, an “erroneous sell transaction” is one in which the price received by the person selling the option is erroneously low, and an “erroneous buy transaction” is one in which the price paid by the person purchasing the option is erroneously high.