

[.05] .02 To qualify as a representative of an Electronic Access Member on an Obvious Error Panel, a person must (i) be employed by a Member whose revenues from options market making activity do not exceed ten percent (10%) of its total revenues; or (ii) have as his or her primary responsibility the handling of Public Customer orders or supervisory responsibility over persons with such responsibility, and not have any responsibilities with respect to market making activities.

[.06] .03 The Exchange shall designate at least ten (10) market maker representatives and at least ten (10) Electronic Access representatives to be called upon to serve on Obvious Error Panels as needed. In no case shall an Obvious Error Panel include a person related to a party to the trade in question. To the extent reasonably possible, the Exchange shall call upon the designated representatives to participate on an Obvious Error Panel on an equally frequent basis.

[.07] .04 All determinations made by the Exchange, Market Control or an Obvious Error Panel under this Rule shall be rendered without prejudice as to the rights of the parties to the transaction to submit a dispute to arbitration.

.05 *Buyers of options with a zero bid and \$.05 offer (i.e., a Theoretical Price of \$.05) may request that their execution be busted if at least the three strikes below (for calls) or above (for puts) in the same options class were quoted with a zero bid and \$.05 offer at the time of the execution. Such buyers must follow the procedures of paragraph (c)(1) above.*

.06 *For purposes of paragraph (b)(1) of Rule 720, the competing options exchange with the most liquidity will be the options exchange that had the highest total contract volume in the options class for the previous two months (e.g., if an obvious error occurs on March 9, the total contract volume from January 8 to March 8 will be used).*

.07 *For purposes of Rule 720, 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 received by the person purchasing the option is erroneously high.*

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## 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 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 proposes to amend ISE Rule 720 to simplify its application. When the Exchange first adopted the Obvious Error Rule,<sup>4</sup> it was the first such rule of its kind on any options exchange. During the nearly two-year period since the Rule was approved by the Commission, the Exchange made minor adjustments to the Rule to address specific issues that arose.<sup>5</sup>

The current proposed rule change represents the result of a comprehensive analysis of the effectiveness of the Rule in addressing obvious error situations. After consultation with Members, the Exchange believes that the structure and standards of the Rule have worked very well. However, the Rule itself is unnecessarily complex, which can create confusion and uncertainty regarding when trades qualify as obvious errors and the prices to which qualifying trades may be adjusted. Accordingly, the Exchange proposes the changes described herein.

#### Determining Whether or Not an Obvious Error Has Occurred

Currently, under paragraph (b) of the Rule and Supplementary Material .02, the Theoretical Price for an option is determined by the bid price on the options exchange other than ISE that has the most volume in the option for erroneous buy orders or bid quotes. Similarly, the Theoretical Price for an option is determined by the offer price on the other options exchange for erroneous sell orders or offer quotes. Determining the Theoretical Price in this manner is counter-intuitive to market participants, which generally look to the offer as the price at which one can buy and the bid as the price at which one can sell. Moreover, under paragraph (a) of the Rule, the required deviation from the Theoretical Price necessary to qualify the trade as an

obvious error is a multiple of the option's maximum allowable bid/ask spread, with a greater multiple applied in fast market conditions.

The Exchange proposes to amend the Rule to provide that the Theoretical Price for trades caused by erroneous buy orders or bid quotes will be determined by the offer from the other options exchange, and that the Theoretical Price of trades caused by erroneous sell orders or offer quotes will be determined by the bid from the other options exchange. Because the side to which the Rule will look to determine the Theoretical Price is switched, the Exchange proposes to reduce the required deviation necessary for a trade to qualify as an obvious error to the amount equivalent to the maximum bid/ask spread for the series, rather than a multiple of the allowable spread. The result of these two changes taken together is not material for options priced \$3 and higher, as the price at which a trade must occur to qualify as an obvious error does not change.<sup>6</sup> For options priced under \$3, the proposed rule change will increase the deviation required for a trade to qualify as an obvious error.

As described below, the Exchange is also proposing a manner in which to address obvious errors in the purchase of certain very low-priced options. Finally, the Exchange proposes to eliminate entirely the current rule's distinction between regular market condition and fast market condition, as the higher standard for fast market conditions is unnecessary in the Exchange's electronic environment.

#### Adjusting Prices

Paragraph (c) in Supplementary Material .03 of the current Rule governs the price to which a trade is adjusted when there is an obvious error. Currently, the price used is dependent on whether the erroneous price existed in the market first, or whether the erroneous price executed against an existing order or quote in the book. The Exchange proposes to apply a single adjustment standard to all executions that qualify as an obvious error: erroneous buy executions will be adjusted to the Theoretical Price (the offer) plus \$.15 for options under \$3, and plus \$.30 for options as or above \$3.

<sup>4</sup> See Securities Exchange Act Release No. 44376 (June 1, 2001), 66 FR 30772 (June 7, 2001).

<sup>5</sup> See Securities Exchange Act Release No. 46110 (June 25, 2002), 67 FR 44487 (July 2, 2002).

<sup>6</sup> For example, assume the quote on the options exchange other than ISE for an option is \$6 to \$6.50. Under the current Rule, the execution price of a buy order must be \$7 higher, i.e., the Theoretical Price (the bid from the other options exchange) plus an amount equal to twice the allowable spread (\$.50). Under the amended Rule, the execution price of the buy order must still be \$7 or higher, i.e., the Theoretical Price (the offer from the other options exchanges) plus an amount equal to the allowable spread (\$.50).