SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-49462, File No. SR-CBOE-2004-02)

March 23, 2004

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

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),[1] and Rule 19b-4 thereunder,[2] notice is hereby given that on January 8, 2004, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. On February 2, 2004, CBOE submitted Amendment No. 1 to the proposed rule change.[3] The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

CBOE proposes to amend its obvious error rule, CBOE Rule 6.25, relating to "no-bid" options. Proposed new language is italicized.

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Rule 6.25 Nullification and Adjustment of Electronic Transactions

(a) Trades Subject to Review

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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 Amendment No. 1 replaced and superseded the original filing in its entirety.

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) - (6) No change

(7) No Bid Series: Buyers of options series quoted no bid may request that their execution be nullified provided: (a) the bid in that series immediately preceding the execution was zero; (b) at least one strike price below (for calls) or above (for puts) in the same options class was quoted no bid immediately before the execution; and (c) the bid following the execution in that series was zero.

(b) – (e) No change

Interpretations and Policies……

.01 - .02 No change

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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 III 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

Recently, the Commission approved CBOE's obvious error rule, CBOE Rule 6.25,[4] 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 "no-bid"[5] options, which may be used as a basis for nullifying trades. Under this guideline, buyers of options that were quoted no-bid may request that their execution be nullified provided:

(a) the bid in that series immediately preceding the execution(s) in question was zero;

(b) at least one strike price below (for calls) or above (for puts) in the same options class was quoted no-bid immediately before the execution(s) in question; and

(c) the bid following the execution(s) in question in that series was zero.

A "zero-bid" or "no-bid" option refers to an option where the bid price is $0.00.[6] According to CBOE, series of options quoted zero-bid are usually deep out-of-the-money series that are perceived as having little if any chance of expiring in-the-money. For this reason, relatively few transactions occur in these series and those that do are usually the result of a momentary pricing error. In some cases, the pricing error is substantial enough such that CBOE Rule 6.25(a)(1) becomes applicable. In many cases, though, the pricing error is not substantial

4 Securities Exchange Act Release No. 48827 (November 24, 2003), 68 FR 67498 (December 2, 2003).

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

6 The offer price is typically $0.05. In this instance, the option typically is referred to as "no bid at a nickel."

enough to warrant adjustment under CBOE Rule 6.25(a)(1). The proposed rule would apply to these transactions.

For example, if the underlying stock trades at $21 during December expiration week, related options with the strike price of 30, 35, and 40 likely would trade no-bid at a nickel. Assume a momentary pricing anomaly occurs, resulting in a quoted price of $0.10 - 0.20 in the 40s and, as a result, an electronic order to sell immediately executes against the $0.10 bid. The displayed quote immediately returns to no-bid at a nickel. In this case, the market maker has just purchased a worthless option for $0.10.[7] Because the displayed quote prior to the trade was zero-bid, the 35s were zero-bid, and the quote after the erroneous transaction in question was zero-bid, this transaction would qualify for relief under the rule.

According to CBOE, the proposed rule is similar to Pacific Exchange, Inc. ("PCX") Rule 6.87(g)(2)(F)[8] with a few notable differences, as described below. First, CBOE believes its proposed rule is more restrictive in that it requires the bid following the execution in question to return to zero. CBOE believes that this serves as an added measure of protection designed to ensure that the transaction really was erroneous.

Second, the PCX rule requires at least one strike below (calls) or above (puts) be quoted no-bid "at the time of execution" while CBOE uses "immediately prior to the execution" as the reference point. CBOE believes that this is an important distinction only if more than one series

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7 This trade does not qualify as an obvious pricing error because it is less than $0.10 from fair market value.

8 Under PCX Rule 6.87(g)(2)(F), parties to a trade may have a trade nullified or its price adjusted if any such party makes a timely documented request and the trade resulted in an execution price in a series quoted no bid and at least one strike price below (for calls) or above (for puts) in the same class were quoted no bid at the time of the erroneous execution.

of the same class is affected. With respect to the example above, assume that at the same time the 30s, 35s, and 40s all go from no-bid to \$0.10 – 0.20, and a few seconds later an execution occurs in each series, and then the price in each series returns to zero-bid. In this scenario, using the PCX reference point of "at the time of execution," none of the trades could be adjusted because the second criteria (i.e., at least one strike below is quoted zero-bid) is not satisfied.[9] Using the CBOE reference point of "immediately prior to execution" allows the trades in all three series, which CBOE believes clearly are erroneous, to be nullified.[10] Finally, CBOE's proposed rule only allows for the nullification of trades, whereas the PCX rule would allow for the nullification or adjustment of trades. Practically, CBOE believes that these trades cannot be adjusted because the adjusted price would be zero.

2. Statutory Basis

CBOE represents that the filing provides for the nullification of no-bid trades executed at clearly erroneous prices due to the occurrence of an inaccurate pricing anomaly. In addition, CBOE notes that a substantially similar provision has already been approved on PCX. Therefore, the Exchange believes that the proposed rule change is consistent with Section 6(b) of the Act[11] in general, and furthers the objectives of Section 6(b)(5)[12] in particular, in that it is 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 for a free and open market and a national market

9 For example, the trade in the 40s could not be nullified, because at the time of execution the strike below (i.e., the 35s) were not quoted no bid. Rather, they were quoted \$0.10 – 0.20. The same goes with the trade in the 35s: at the time of execution, the 30s were not quoted zero bid.

10 This assumes, however, that the strike below the 30s is quoted zero bid.

11 15 U.S.C. 78f(b).

12 15 U.S.C. 78f(b)(5).

system, and, in general, to protect investors and the public interest.

B. Self-Regulatory Organization's Statement on Burden on Competition

CBOE does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

CBOE did not solicit or receive written comments on the proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding, or (ii) as to which the Exchange consents, the Commission will:

(A) by order approve such proposed rule change; or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the proposed rule change, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Comments may also be submitted electronically at the following e-mail address: rule-comments@sec.gov.

All comment letters should refer to File No. 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, comments should be sent in hardcopy or by e-mail but not by both methods. 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 at the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange. All submissions should be submitted by [insert date 21 days from date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[13]

Margaret H. McFarland
Deputy Secretary

[13] 17 CFR 200.30-3(a)(12).