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MEMORANDUM

TO: Members and Member Organizations

FROM: Richard S. Rudolph
Vice President and Counsel

DATE: April 29, 2008

RE: SEC Approves Amendments to Rule 1092, Obvious Errors

The Securities and Exchange Commission ("SEC" or "Commission") has **approved** a proposed rule change by the Philadelphia Stock Exchange, Inc. ("Phlx" or "Exchange") to amend Exchange Rule 1092, Obvious Errors, to: (i) change the definition of Theoretical Price to mean either the last National Best Bid price with respect to an erroneous sell transaction or the last National Best Offer price with respect to an erroneous buy transaction, just prior to the trade; (ii) allow an Options Exchange Official to establish the Theoretical Price when there are no quotes for comparison purposes, or when the National Best Bid/Offer ("NBBO") for the affected series, just prior to the erroneous transaction, was at least two times the permitted bid/ask differential under Exchange Rule 1014(c)(1)(A)(i)(a); (iii) establish the Theoretical Price for transactions occurring as part of the Exchange's automated opening system as the first quote after the transaction(s) in question that does not reflect the erroneous transaction(s); (iv) determine the average quote width by adding the quote widths of sample quotations at regular 15-second intervals during the two minutes preceding and following an erroneous transaction; (v) permit nullification of transactions that occur during trading halts on the Exchange or in the underlying security in certain situations; and (vi) increase the time period within which a party to an erroneous transaction must notify Market Surveillance that they believe they are a party to a transaction resulting from an obvious error and establish a specific notification time period for the opening.

<u>Definition of Theoretical Price</u>

Rule 1092 previously defined the Theoretical Price of an option (for purposes of Rule 1092 only) as: (i) if the series is traded on at least one other options exchange, the mid-point of the NBBO just prior to the transaction; and (ii) if there are no quotes for comparison purposes, as determined by an Options Exchange Official and designated personnel in the Exchange's Market Surveillance Department.

The new rule re-defines "Theoretical Price" to mean either the last National Best Bid price with respect to an erroneous sell transaction or the last National Best Offer price with respect to an erroneous buy transaction, just prior to the trade. The new rule also permits an Options Exchange Official to establish the Theoretical Price when there are no quotes available for comparison purposes, or when the bid/ask differential of the NBBO for the affected series, just prior to the erroneous transaction, was at least two times the permitted bid/ask differential under Exchange Rules. In each such circumstance, the Theoretical Price would be determined by an Options Exchange Official. In order to expedite the process, the current requirement for Market Surveillance input is deleted.

The new rule also states that for transactions occurring as part of the Exchange's automated opening system, the Theoretical Price would be the first quote after the transaction(s) in question that does not reflect the erroneous transaction(s).

Erroneous Quote in Primary Underlying Market

Previously, in order for an options trade to be nullified or adjusted due to an erroneous quote in the primary market for the underlying security, Market Surveillance was required to conduct complex and cumbersome research involving the average quote width in the underlying quote during the two minutes preceding and following the transaction.

In order to streamline and expedite the process, the new rule amends this provision such that Market Surveillance will not review *each* quote during this time period; instead, the average quote width will be determined by adding the quote widths of sample quotations at regular 15-second intervals during the four minute time period referenced above, and dividing by the number of quotation samples used.

Transactions During Trading Halts

The new rule permits nullification of transactions that occur during trading halts on the Exchange or in the primary market for the underlying security. Specifically, the Exchange is adopting new Rule 1092(c)(iv), which provides that trades will be nullified when (i) the trade occurred during a trading halt in the affected option on the Exchange; (ii) respecting equity options (including options overlying ETFs), the trade occurred during a trading halt on the primary market for the underlying security; or (iii) respecting index options, the trade occurred during a trading halt on the primary market in underlying securities representing more than 10% of the current index value.

Notification Period

The new rule increases the current time period within which a party to an erroneous transaction must notify Market Surveillance that they believe they are a party to a transaction resulting from an obvious error, and establish a specific time period applicable to openings.

Specifically, a specialist or Registered Options Trader ("ROT") must notify Market Surveillance within **fifteen minutes** of the transaction **(increased from the previous five-minute window)**. A member or member organization that initiated the order from off the floor of the Exchange must notify Market Surveillance within **twenty minutes** of the execution **(increased from the current fifteen minute window).**

Additionally, Rule 1092(e)(i) has been amended to afford a longer time period during which non-broker-dealer customers may notify Market Surveillance that they believe they participated in a transaction that was the result of an Obvious Error. Respecting transactions that occur as part of the Exchange's automated opening process, after the proposed twenty minute notification period and until 4:30 p.m. Eastern Time ("ET") on the subject trade date, where parties to the transaction are a non-broker-dealer customer and an Exchange specialist, Streaming Quote Trader, ("SQT"), Remote Streaming Quote Trader ("RSQT"), or non-SQT ROT the non-broker-dealer customer may request review of the subject transaction, and the execution price of the transaction will be adjusted to the first quote after the transaction(s) in question that does not reflect the erroneous transaction(s) (provided the adjustment does not violate the customer's limit price) by an Options Exchange Official, if there was an Obvious Error.
The Exchange believes that this provision should address the situation on the opening where a large opening order might cause the Exchange's opening transaction to result from an Obvious Error, because the Exchange's opening price is defined as the price at which the greatest number of contracts will trade.

The text of the proposed rule change is set forth below. Questions on the proposed rule change may be addressed to Rick Rudolph, Vice President in the Phlx Legal Department at (215) 496-5074, or to Ed Deitzel, Vice President, Phlx On-Floor Surveillance, at (215) 496-5298.

New Rule Text

Brackets indicate deletions; underlining indicates new text

Obvious Errors

Rule 1092. The Exchange shall either nullify a transaction or adjust the execution price of a transaction that results in an Obvious Error as provided in this Rule.

(a) No change.

(b) Definition of Theoretical Price. For purposes of this Rule only, the Theoretical Price of an option is:

(i) If the series is traded on at least one other options exchange [, the mid-point of the National Best Bid and Offer ("NBBO"), just prior to the transaction;] <u>the last National Best Bid price with respect to an erroneous sell transaction and the last National Best Offer price with respect to an erroneous buy transaction, just prior to the trade;</u>[.]

(ii) if there are no quotes for comparison purposes, <u>or if the bid/ask differential of the National Best Bid and Offer ("NBBO") for the affected series, just prior to the erroneous transaction, was at least two times the</u>

permitted bid/ask differential under Rule 1014(c)(1)(A)(i)(a), as determined by an Options Exchange Official [and designated personnel in the Exchange's Market Surveillance Department.]; or

(iii) for transactions occurring as part of the Exchange's automated opening system, the Theoretical Price shall be the first quote after the transaction(s) in question that does not reflect the erroneous transaction(s).

(c) Absent Mutual Agreement as provided in Rule 1092(c)(iii) below, parties to a trade may have a trade nullified or its price adjusted if:

(i) No change.

(ii) one of the conditions below is met:

(A) – (C) No change.

(D) The trade resulted from an erroneous quote in the Primary Market for the underlying security that has a width of at least $1.00 and that width is at least five times greater than the average quote width for such underlying security during the time period encompassing two minutes before and after the dissemination of such quote. For the purposes of this rule, the average quote width shall be determined by adding the quote widths of [each separate quote] sample quotations at regular 15-second intervals 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); or

(E) No change.

(F) [The trade is automatically executed at a price where the specialist or ROT sells $0.10 or more below parity. Parity describes an option contract's total premium when that premium is equal to its intrinsic value. Parity for calls is measured by reference to the offer price of the underlying security in the primary market at the time of the transaction minus the strike price for the call. Parity for puts is measured by the strike price of an underlying security minus its bid price in the primary market at the time of the transaction; or

(G)] The trade occurred at a price that is deemed to be an Obvious Error as defined in Paragraph (a) of this Rule 1092.

(iii) Mutual Agreement. The determination as to whether a trade was automatically executed at an erroneous price may be made by mutual agreement of the affected parties to a particular transaction within the time periods specified in sub-paragraphs (d)(i)(A) or (B) below. A trade may be nullified or adjusted on the terms that all parties to a particular transaction agree. In the absence of mutual agreement by the parties, a particular trade may only be nullified or adjusted when the transaction results from an Obvious Error as provided in this Rule.

(iv) Trading Halts. Trades on the Exchange will be nullified when:

(A) The trade occurred during a trading halt in the affected option on the Exchange;

(B) Respecting equity options (including options overlying ETFs), the trade occurred during a trading halt on the primary market for the underlying security; or

(C) Respecting index options, the trade occurred during a trading halt on the primary market in underlying securities representing more than 10% of the current index value.

(d) No change.

(e) Obvious Error Procedure. Market Surveillance shall administer the application of this Rule as follows:

(i) Notification. If a specialist or Registered Options Trader (“ROT”) on the Exchange believes that he/she participated in a transaction that was the result of an Obvious Error, he/she must notify Market Surveillance within [five] fifteen minutes of the transaction. If a member or member organization that initiated the order from off the floor of the Exchange believes a transaction on the Exchange was the result of an Obvious Error, such member or member organization must notify Market Surveillance within [fifteen] twenty minutes of the execution. Absent unusual circumstances, Market Surveillance will not grant relief under this Rule unless notification is made within the prescribed time period. Notwithstanding the foregoing, respecting transactions that occur as part of the Exchange’s automated opening process, after the twenty minute notification period as described above and until 4:30 p.m. Eastern Time (“ET”) on the subject trade date, where parties to the transaction are a non-broker-dealer customer and an Exchange specialist, SQT, RSQT or non-SQT ROT, the non-broker-dealer customer may request review of the subject transaction, and the execution price of the transaction will be adjusted to the first quote after the transaction(s) in question that does not reflect the erroneous transaction(s) (provided the adjustment does not violate the customer’s limit price) by an Options Exchange Official.

(ii) Adjust or Bust. A Floor Official will determine whether there is an Obvious Error as defined in this Rule. If it is determined that an Obvious Error has occurred: (A) where each party to the transaction is either a specialist or ROT on the Exchange, the execution price of the transaction will be adjusted by one Floor Official, unless both parties agree to nullify the transaction within ten minutes of being notified by Market Surveillance of the Obvious Error; or (B) where at least one party to the transaction in which an Obvious Error occurred is not a specialist or ROT on the Exchange, an Options Exchange Official will nullify the transaction, unless both parties agree to adjust the price of the transaction within 30 minutes of being notified by Market Surveillance of the Obvious Error. Upon final [Floor] Options Exchange Official action, Market Surveillance, in conjunction with the AUTOM Help Desk, where appropriate, shall promptly notify both parties to the trade.

(f) No change.

Commentary:

.01 For purposes of paragraph (a) of this Rule, the maximum bid/ask spread shall be the maximum bid/ask spread allowed pursuant to Exchange Rule 1014(c)(i)(A), unless a wider spread has been allowed by the Exchange for the option because of unusual market conditions.

.02 The price to which a transaction is adjusted under paragraph (c)(ii) of this Rule will be determined as follows: (i) the bid price from the exchange disseminating the National Best Bid for the series at the time of the transaction that was the result of an obvious error will be used with respect to an erroneous offer price entered on the Exchange, and (ii) the offer price from the exchange disseminating the National Best Offer for the series at the time of the transaction that was the result of an obvious error will be used with respect to an erroneous bid price entered on the Exchange. If there are no quotes for comparison purposes, the adjustment price will be determined by two Floor Officials and Market Surveillance.

For purposes of Rule 1092, 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.