Regulatory Information Circular – 2001-11

To: ISE Members

Date: June 6, 2001

Re: Approval of Obvious Error Rule

The Securities and Exchange Commission ("SEC") approved the ISE’s Obvious Error Policy on June 1, 2001 (Release No. 34-44376). The text of the rule is attached. Some changes to the Policy regarding procedural matters and the composition of Obvious Error Panels were made prior to SEC approval. The amended Obvious Error Policy is now in effect.

Following is an overview of the amended Policy:

- A transaction that occurs at an execution price is higher or lower than the "theoretical price" by an amount equal to at least two times the maximum spread requirement (which must be at least $.50) is subject to being busted or adjusted as an Obvious Error. (During fast markets, the price has to be higher or lower by at least three times the maximum spread requirement, still subject to the $.50 minimum.) The "theoretical price" is determined by reference to the bid or offer on the exchange that has the most liquidity. If there are no quotes for comparison, ISE Market Control will determine the theoretical price.

- Market makers must notify Market Control of a possible obvious error within five minutes of an execution. EAMs have 20 minutes to notify Market Control of a possible obvious error. Absent unusual circumstances, Market Control will not bust or adjust any trades unless the notification is received within these time periods.

- If the ISE confirms that a transaction occurred at an obviously erroneous price, Market Control will ADJUST market maker to market maker trades and will BUST trades that involve customer orders -- unless the parties to the trade agree otherwise. Any agreement to bust market maker to market maker trades must be made within 10 minutes of notification by Market Control, and any agreement to adjust transactions where an Electronic Access Member is involved must be made within 30 minutes.
Market Control will notify the parties when it has made a final determination about a trade. The parties to the trade have 30 minutes from the time Market Control gives them this notice to request review by an Obvious Error Panel. If notification by Market Control is made after 3:30 p.m., the parties have until 9:30 a.m. the next day to make the request for review. The Obvious Error Panel will render a decision on the day the request is made unless the request is made after 3:30 p.m., in which case the decision will be rendered the next trade day.

The Obvious Error Panel will consist of four people, two market maker and two EAM representatives. Any change to a determination made by Market Control must be approved by three panel members. The Exchange will maintain a list of at least 10 market makers and at least 10 EAMs (people on the customer side of the firm's business) to serve on Obvious Error Panels.

Please contact Patrick Burke, Director Market Operations (877-473-9989) or Paul Bennett, Senior Vice President Market Operations (212-897-0270) if you have any questions regarding the Obvious Error Policy or if you would like to nominate a representative from your firm to be included in the pools from which the Obvious Error Panels will be formed.
Rule 720. Obvious Errors

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

(a) Definition of Obvious Error. For purposes of this Rule only, an Obvious Error will be deemed to have occurred when:

(1) during regular market conditions (including rotations), the execution price of a transaction is higher or lower than the Theoretical Price for the series by an amount equal to at least two (2) times the maximum bid/ask spread allowed for the option, so long as such amount is 50 cents or more; or

(2) during fast market conditions (i.e., the Exchange has declared a fast market status for the option in question), the execution price of a transaction is higher or lower than the Theoretical Price for the series by an amount equal to at least three (3) times the maximum bid/ask spread allowed for the option, so long as such amount is 50 cents or more.

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

(1) if the series is traded on at least one other options exchange, the last bid or offer, just prior to the trade, found on the exchange that has the most liquidity in that option as provided in Supplementary Material .02 below; or

(2) if there are no quotes for comparison purposes, as determined by designated personnel in the Exchange’s market control center (“Market Control”).

(c) Adjustments. Where the execution price of a transaction executed as the result of an Obvious Error is adjusted, the adjusted price will be:

(1) the Theoretical Price of the option in the case where the erroneous price is displayed in the market and subsequently executed by quotes or orders that did not exist in the System at the time the erroneous price was entered; or

(2) the last bid or offer, just prior to the trade, found on the exchange that has the most liquidity in that option as provided in Supplementary Material .03 below in the case where an erroneous price executes against quotes or orders already existing in the System at the time the erroneous price was entered.
(d) Obvious Error Procedure. Market Control shall administer the application of this Rule as follows.

(1) Notification. If a market maker on the Exchange believes that it participated in a transaction that was the result of an Obvious Error, it must notify Market Control within five (5) minutes of the execution. If an Electronic Access Member believes an order it executed on the Exchange was the result of an Obvious Error, it must notify Market Control within twenty (20) minutes of the execution. Absent unusual circumstances, Market Control will not grant relief under this Rule unless notification is made within the prescribed time periods.

(2) Adjust or Bust. Market Control will determine whether there was an Obvious Error as defined above. If it is determined that an Obvious Error has occurred, Market Control shall take one of the following actions: (i) where each party to the transaction is a market maker on the Exchange, the execution price of the transaction will be adjusted unless both parties agree to bust the trade within ten (10) minutes of being notified by Market Control of the Obvious Error; or (ii) where at least one party to the Obvious Error is not a market maker on the Exchange, the trade will be busted unless both parties agree to adjust the price of the transaction within thirty (30) minutes of being notified by Market Control of the Obvious Error. Upon taking final action, Market Control shall promptly notify both parties to the trade.

(e) Obvious Error Panel.

(1) Composition. An Obvious Error Panel will be comprised of representatives from four (4) Members. Two (2) of the representatives must be directly engaged in market making activity and two (2) of the representatives must be employed by an Electronic Access Member.

(2) Request for Review. If a party affected by a determination made under this Rule so requests within the time permitted below, the Obvious Error Panel will review decisions made by Market Control under this Rule, including whether an Obvious Error occurred, whether the correct Theoretical Price was used, and whether an adjustment was made at the correct price. A party may also request that the Obvious Error Panel provide relief under this Rule in cases where the party failed to provide the notification required in paragraph (d)(1) and Market Control declined to grant an extension, but unusual circumstances must merit special consideration. A request for review must be made in writing within thirty (30) minutes after a party receives verbal notification of a final determination by Market Control under this Rule, except that if notification is made after 3:30 p.m. Eastern Time, either party has until 9:30 a.m. Eastern Time 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 after 3:30 on the day of the transaction or where the request is properly made the next trade day.

(3) Panel Decision. The Obvious Error Panel may overturn or modify an action taken by Market Control under this Rule upon agreement by a majority of the Panel representatives. All determinations by the Obvious Error Panel shall constitute final Exchange action on the matter at issue.

Supplementary Material to Rule 720

.01 For purposes of paragraph (a) of this Rule, the maximum bid/ask spread shall be the maximum bid/ask spread allowed under Rule 803(b), unless a wider spread has been allowed by the Exchange for the option because of unusual market conditions, such as high market volatility.

.02 The Theoretical Price will be determined under paragraph (b)(1) above as follows: (i) the bid price from the exchange providing the most volume will be used with respect to an erroneous bid price entered on the Exchange, and (ii) the offer price from the exchange providing the most volume will be used with respect to an erroneous offer price entered on the Exchange.

.03 The price to which a transaction is adjusted under paragraph (c)(2) above will be as follows: (i) the bid price from the exchange providing the most volume for the option will be used with respect to an erroneous offer price entered on the Exchange, and (ii) the offer price from the exchange providing the most volume for the option 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 Market Control.

.04 When Market Control determines that an Obvious Error has occurred and action is warranted under paragraph (d)(2) above, the identity of the parties to the trade will be disclosed to each other in order to encourage conflict resolution.

.05 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 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 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.

[Adopted June 1, 2001 (SR-ISE-00-19)]