

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>20</sup>

**Robert W. Errett,**  
*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

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### Self-Regulatory Organizations; ISE Gemini, LLC; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Related to the Nullification and Adjustment of Options Transactions Including Obvious Errors

May 7, 2015.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (the "Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that, on May 6, 2015 ISE Gemini, LLC (the "Exchange" or "ISE Gemini") filed with the Securities and Exchange Commission the proposed rule change, as described in Items I and II below, which items have been prepared by the self-regulatory organization. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

ISE Gemini proposes to amend current Rule 720 ("Current Rule"), and rename it "Nullification and Adjustment of Options Transactions including Obvious Errors" ("Proposed Rule"). Rule 720 relates to the adjustment and nullification of options transactions executed on the Exchange ("ISE Gemini Options"). The text of the proposed rule change is available on the Exchange's Web site (<http://www.ise.com>), at the principal office of the Exchange, and at the Commission's Public Reference Room.

#### 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 self-regulatory organization 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 self-regulatory organization 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

##### Background

For several months the Exchange has been working with other options exchanges to identify ways to improve the process related to the adjustment and nullification of erroneous options transactions. The goal of the process that the options exchanges have undertaken is to adopt harmonized rules related to the adjustment and nullification of erroneous options transactions as well as a specific provision related to coordination in connection with large-scale events involving erroneous options transactions. As described below, the Exchange believes that the changes the options exchanges and the Exchange have agreed to propose will provide transparency and finality with respect to the adjustment and nullification of erroneous options transactions. Particularly, the proposed changes seek to achieve consistent results for participants across U.S. options exchanges while maintaining a fair and orderly market, protecting investors and protecting the public interest.

The Proposed Rule is the culmination of this coordinated effort and reflects discussions by the options exchanges to universally adopt: (1) Certain provisions already in place on one or more options exchanges; and (2) new provisions that the options exchanges collectively believe will improve the handling of erroneous options transactions. Thus, although the Proposed Rule is in many ways similar to and based on the Exchange's Current Rule, the Exchange is adopting various provisions to conform with existing rules of one or more options exchanges and also to adopt rules that are not currently in place on any options exchange. As noted above, in order to adopt a rule that is similar in most material respects to the rules adopted by other options exchanges, the Exchange proposes to delete the Current Rule in its entirety, with one exception,<sup>3</sup> and to replace it with the Proposed Rule.

The Exchange notes that it has proposed additional objective standards in the Proposed Rule as compared to the Current Rule. The Exchange also notes that the Proposed Rule will ensure that the Exchange will have the same standards as all other options exchanges. However, there are still areas under the Proposed Rule where subjective determinations need to be made by Exchange personnel with respect to the calculation of Theoretical Price. The Exchange notes that the Exchange and all other options exchanges have been working to further improve the review of potentially erroneous transactions as well as their subsequent adjustment by creating an objective and universal way to determine Theoretical Price in the event a reliable NBBO is not available. For instance, the Exchange and all other options exchanges may utilize an independent third party to calculate and disseminate or make available Theoretical Price. However, this initiative requires additional exchange and industry discussion as well as additional time for development and implementation. The Exchange will continue to work with other options exchanges and the options industry towards the goal of additional objectivity and uniformity with respect to the calculation of Theoretical Price.

As additional background, the Exchange believes that the Proposed Rule supports an approach consistent with long-standing principles in the options industry under which the general policy is to adjust rather than nullify transactions. The Exchange acknowledges that adjustment of transactions is contrary to the operation of analogous rules applicable to the equities markets, where erroneous transactions are typically nullified rather than adjusted and where there is no distinction between the types of market participants involved in a transaction. For the reasons set forth below, the Exchange believes that the distinctions in market structure between equities and options markets continue to support these distinctions between the rules for handling obvious errors in the equities and options markets. The Exchange also believes that the Proposed Rule properly balances several

authorizes the Exchange to disclose the identity of parties to a trade to each other when the Market Control determines that an Obvious or Catastrophic Error has occurred. The Exchange believes that this provision is important to encourage conflict resolution between two parties to a trade.

With the remaining text in the Supplementary Material to Rule 720 now being deleted, the Exchange proposes to renumber Supplementary Material .01.

<sup>20</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> The Exchange proposes to keep language in Supplementary Material .01 to Rule 720 that

competing concerns based on the structure of the options markets.

Various general structural differences between the options and equities markets point toward the need for a different balancing of risks for options market participants and are reflected in the Proposed Rule. Option pricing is formulaic and is tied to the price of the underlying stock, the volatility of the underlying security and other factors. Because options market participants can generally create new open interest in response to trading demand, as new open interest is created, correlated trades in the underlying or related series are generally also executed to hedge a market participant's risk. This pairing of open interest with hedging interest differentiates the options market specifically (and the derivatives markets broadly) from the cash equities markets. In turn, the Exchange believes that the hedging transactions engaged in by market participants necessitates protection of transactions through adjustments rather than nullifications when possible and otherwise appropriate.

The options markets are also quote driven markets dependent on liquidity providers to an even greater extent than equities markets. In contrast to the approximately 7,000 different securities traded in the U.S. equities markets each day, there are more than 500,000 unique, regularly quoted option series. Given this breadth in options series the options markets are more dependent on liquidity providers than equities markets; such liquidity is provided most commonly by registered market makers but also by other professional traders. With the number of instruments in which registered market makers must quote and the risk attendant with quoting so many products simultaneously, the Exchange believes that those liquidity providers should be afforded a greater level of protection. In particular, the Exchange believes that liquidity providers should be allowed protection of their trades given the fact that they typically engage in hedging activity to protect them from significant financial risk to encourage continued liquidity provision and maintenance of the quote-driven options markets.

In addition to the factors described above, there are other fundamental differences between options and equities markets which lend themselves to different treatment of different classes of participants that are reflected in the Proposed Rule. For example, there is no trade reporting facility in the options markets. Thus, all transactions must occur on an options exchange. This leads to significantly greater retail

customer participation directly on exchanges than in the equities markets, where a significant amount of retail customer participation never reaches the Exchange but is instead executed in off-exchange venues such as alternative trading systems, broker-dealer market making desks and internalizers. In turn, because of such direct retail customer participation, the exchanges have taken steps to afford those retail customers—generally Customers—more favorable treatment in some circumstances.

#### Definitions

The Exchange proposes to adopt various definitions that will be used in the Proposed Rule, as described below.

First, the Exchange proposes to adopt a definition of "Customer," to make clear that this term has the same definition as Priority Customer in Rule 100(a)(37A). Although other portions of the Exchange's rules address the capacity of market participants, including customers, the proposed definition is consistent with such rules and the Exchange believes it is important for all options exchanges to have the same definition of Customer in the context of nullifying and adjusting trades in order to have harmonized rules. As set forth in detail below, orders on behalf of a Customer are in many cases treated differently than non-Customer orders in light of the fact that Customers are not necessarily immersed in the day-to-day trading of the markets, are less likely to be watching trading activity in a particular option throughout the day, and may have limited funds in their trading accounts.

Second, the Exchange proposes to adopt definitions for both an "erroneous sell transaction" and an "erroneous buy transaction." As proposed, 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. This provision helps to reduce the possibility that a party can intentionally submit an order hoping for the market to move in their favor while knowing that the transaction will be nullified or adjusted if the market does not. For instance, when a market participant who is buying options in a particular series sees an aggressively priced sell order posted on the Exchange, and the buyer believes that the price of the options is such that it might qualify for obvious error, the option buyer can trade with the aggressively priced order, then wait to see which direction the market moves. If the market moves in their direction, the buyer keeps the

trade and if it moves against them, the buyer calls the Exchange hoping to get the trade adjusted or busted.

Third, the Exchange proposes to adopt a definition of "Official," which would mean an Officer of the Exchange or such other employee designee of the Exchange that is trained in the application of the Proposed Rule.

Fourth, the Exchange proposes to adopt a new term, a "Size Adjustment Modifier," which would apply to individual transactions and would modify the applicable adjustment for orders under certain circumstances, as discussed in further detail below. As proposed, the Size Adjustment Modifier will be applied to individual transactions as follows:

Number of contracts per execution	Adjustment—TP plus/minus
1–50 .....	N/A.
51–250 .....	2 times adjustment amount.
251–1,000 .....	2.5 times adjustment amount.
1,001 or more	3 times adjustment amount.

The Size Adjustment Modifier attempts to account for the additional risk that the parties to the trade undertake for transactions that are larger in scope. The Exchange believes that the Size Adjustment Modifier creates additional incentives to prevent more impactful Obvious Errors and it lessens the impact on the contra-party to an adjusted trade. The Exchange notes that these contra-parties may have preferred to only trade the size involved in the transaction at the price at which such trade occurred, and in trading larger size has committed a greater level of capital and bears a larger hedge risk.

When setting the proposed size adjustment modifier thresholds the Exchange has tried to correlate the size breakpoints with typical small and larger "block" execution sizes of underlying stock. For instance, SEC Rule 10b–18(a)(5)(ii) defines a "block" as a quantity of stock that is at least 5,000 shares and a purchase price of at least \$50,000, among others.<sup>4</sup> Similarly, NYSE Rule 72 defines a "block" as an order to buy or sell "at least 10,000 shares or a quantity of stock having a market value of \$200,000 or more, whichever is less." Thus, executions of 51 to 100 option contracts, which are generally equivalent to executions of 5,100 and 10,000 shares of underlying stock, respectively, are proposed to be subject to the lowest size adjustment modifier. An execution of over 1,000 contracts is roughly equivalent to a

<sup>4</sup> See 17 CFR 240.10b–18(a)(5)(ii).

block transaction of more than 100,000 shares of underlying stock, and is proposed to be subject to the highest size adjustment modifier. The Exchange has correlated the proposed size adjustment modifier thresholds to smaller and larger scale blocks because the Exchange believes that the execution cost associated with transacting in block sizes scales according to the size of the block. In other words, in the same way that executing a 100,000 share stock order will have a proportionately larger market impact and will have a higher overall execution cost than executing a 500, 1,000 or 5,000 share order in the same stock, all other market factors being equal, executing a 1,000 option contract order will have a larger market impact and higher overall execution cost than executing a 5, 10 or 50 contract option order.

#### Calculation of Theoretical Price

##### Theoretical Price in Normal Circumstances

Under both the Current Rule and the Proposed Rule, when reviewing a transaction as potentially erroneous, the Exchange needs to first determine the "Theoretical Price" of the option, *i.e.*, the Exchange's estimate of the correct market price for the option. Pursuant to the Proposed Rule, if the applicable option series is traded on at least one other options exchange, then the Theoretical Price of an option series is the last national best bid ("NBB") just prior to the trade in question with respect to an erroneous sell transaction or the last national best offer ("NBO") just prior to the trade in question with respect to an erroneous buy transaction unless one of the exceptions described below exists. Thus, the Exchange proposes that whenever the Exchange has a reliable NBB or NBO, as applicable, just prior to the transaction, then the Exchange will use this NBB or NBO as the Theoretical Price.

The Exchange also proposes to specify in the Proposed Rule that when a single order received by the Exchange is executed at multiple price levels, the last NBB and last NBO just prior to the trade in question would be the last NBB and last NBO just prior to the Exchange's receipt of the order.

The Exchange also proposes to set forth in the Proposed Rule various provisions governing specific situations where the NBB or NBO is not available or may not be reliable. Specifically, the Exchange is proposing additional detail specifying situations in which there are no quotes or no valid quotes (as defined below), when the national best bid or offer ("NBBO") is determined to be too

wide to be reliable, and at the open of trading on each trading day.

##### No Valid Quotes

As is true under the Current Rule, pursuant to the Proposed Rule the Exchange will determine the Theoretical Price if there are no quotes or no valid quotes for comparison purposes. As proposed, quotes that are not valid are all quotes in the applicable option series published at a time where the last NBB is higher than the last NBO in such series (a "crossed market"), quotes published by the Exchange that were submitted by either party to the transaction in question, and quotes published by another options exchange against which the Exchange has declared self-help. Thus, in addition to scenarios where there are literally no quotes to be used as Theoretical Price, the Exchange will exclude quotes in certain circumstances if such quotes are not deemed valid. The Proposed Rule is consistent with the Exchange's application of the Current Rule but the descriptions of the various scenarios where the Exchange considers quotes to be invalid represent additional detail that is not included in the Current Rule.

The Exchange notes that Exchange personnel currently are required to determine Theoretical Price in certain circumstances. While the Exchange continues to pursue alternative solutions that might further enhance the objectivity and consistency of determining Theoretical Price, the Exchange believes that the discretion currently afforded to Exchange Officials is appropriate in the absence of a reliable NBBO that can be used to set the Theoretical Price. Under the current Rule, Exchange personnel will generally consult and refer to data such as the prices of related series, especially the closest strikes in the option in question. Exchange personnel may also take into account the price of the underlying security and the volatility characteristics of the option as well as historical pricing of the option and/or similar options.

##### Wide Quotes

Similarly, pursuant to the Proposed Rule the Exchange will determine the Theoretical Price if the bid/ask differential of the NBB and NBO for the affected series just prior to the erroneous transaction was equal to or greater than the Minimum Amount set forth below and there was a bid/ask differential less than the Minimum Amount during the 10 seconds prior to the transaction. If there was no bid/ask differential less than the Minimum Amount during the 10 seconds prior to

the transaction then the Theoretical Price of an option series is the last NBB or NBO just prior to the transaction in question. The Exchange proposes to use the following chart to determine whether a quote is too wide to be reliable:

Bid price at time of trade	Minimum amount
Below \$2.00 .....	\$0.75
\$2.00 to \$5.00 .....	1.25
Above \$5.00 to \$10.00 .....	1.50
Above \$10.00 to \$20.00 .....	2.50
Above \$20.00 to \$50.00 .....	3.00
Above \$50.00 to \$100.00 .....	4.50
Above \$100.00 .....	6.00

The Exchange notes that the values set forth above generally represent a multiple of 3 times the bid/ask differential requirements of other options exchanges, with certain rounding applied (*e.g.*, \$1.25 as proposed rather than \$1.20).<sup>5</sup> The Exchange believes that basing the Wide Quote table on a multiple of the permissible bid/ask differential rule provides a reasonable baseline for quotations that are indeed so wide that they cannot be considered reliable for purposes of determining Theoretical Price unless they have been consistently wide. As described above, while the Exchange will determine Theoretical Price when the bid/ask differential equals or exceeds the amount set forth in the chart above and within the previous 10 seconds there was a bid/ask differential smaller than such amount, if a quote has been persistently wide for at least 10 seconds the Exchange will use such quote for purposes of Theoretical Price. The Exchange believes that there should be a greater level of protection afforded to market participants that enter the market when there are liquidity gaps and price fluctuations. The Exchange does not believe that a similar level of protection is warranted when market participants choose to enter a market that is wide and has been consistently wide for some time. The Exchange notes that it has previously determined that, given the largely electronic nature of today's markets, as little as one second (or less) is a long enough time for market participants to receive, process and account for and respond to new market information.<sup>6</sup> While introducing this

<sup>5</sup> See, *e.g.*, NYSE Arca Options Rule 6.37(b)(1).

<sup>6</sup> See, *e.g.*, Supplementary Material .04 to Exchange Rule 717, which requires certain orders to be exposed for at least one second before they can be executed; see also Securities Exchange Act Release No. 66306 (February 2, 2012), 77 FR 6608 (February 8, 2012) (SR-BX-2011-084) (order

new provision the Exchange believes it is being appropriately cautious by selecting a time frame that is an order of magnitude above and beyond what the Exchange has previously determined is sufficient for information dissemination. The table above bases the wide quote provision off of bid price in order to provide a relatively straightforward beginning point for the analysis.

As an example, assume an option is quoted \$3.00 by \$6.00 with 50 contracts posted on each side of the market for an extended period of time. If a market participant were to enter a market order to buy 20 contracts the Exchange believes that the buyer should have a reasonable expectation of paying \$6.00 for the contracts which they are buying. This should be the case even if immediately after the purchase of those options, the market conditions change and the same option is then quoted at \$3.75 by \$4.25. Although the quote was wide according to the table above at the time immediately prior to and the time of the execution of the market order, it was also well established and well known. The Exchange believes that an execution at the then prevailing market price should not in and of itself constitute an erroneous trade.

Transactions at the Open

Under the Proposed Rule, for a transaction occurring during the opening rotation the Exchange will determine the Theoretical Price where there is no NBB or NBO for the affected series just prior to the erroneous transaction or if the bid/ask differential of the NBBO just prior to the erroneous transaction is equal to or greater than the Minimum Amount set forth in the chart proposed for the wide quote provision described above. The Exchange believes that this discretion is necessary because it is consistent with other scenarios in which the Exchange will determine the Theoretical Price if there are no quotes or no valid quotes for comparison purposes, including the wide quote provision proposed by the Exchange as described above. If, however, there are valid quotes and the bid/ask differential of the NBBO is less than the Minimum Amount set forth in the chart proposed for the wide quote provision described above, then the Exchange will use the NBB or NBO just prior to the transaction as it would in any other normal review scenario.

As an example of an erroneous transaction for which the NBBO is wide

at the open, assume the NBBO at the time of the opening transaction is \$1.00 × \$5.00 and the opening transaction takes place at \$1.25. The Exchange would be responsible for determining the Theoretical Price because the NBBO was wider than the applicable minimum amount set forth in the wide quote provision as described above. The Exchange believes that it is necessary to determine theoretical price at the open in the event of a wide quote at the open for the same reason that the Exchange has proposed to determine theoretical price during the remainder of the trading day pursuant to the proposed wide quote provision, namely that a wide quote cannot be reliably used to determine Theoretical Price because the Exchange does not know which of the two quotes, the NBB or the NBO, is closer to the real value of the option.

Obvious Errors

The Exchange proposes to adopt numerical thresholds that would qualify transactions as “Obvious Errors.” These thresholds are similar to those in place under the Current Rule. As proposed, a transaction will qualify as an Obvious Error if the Exchange receives a properly submitted filing and the execution price of a transaction is higher or lower than the Theoretical Price for the series by an amount equal to at least the amount shown below:

Theoretical price	Minimum amount
Below \$2.00 .....	\$0.25
\$2.00 to \$5.00 .....	0.40
Above \$5.00 to \$10.00 .....	0.50
Above \$10.00 to \$20.00 .....	0.80
Above \$20.00 to \$50.00 .....	1.00
Above \$50.00 to \$100.00 .....	1.50
Above \$100.00 .....	2.00

Applying the Theoretical Price, as described above, to determine the applicable threshold and comparing the Theoretical Price to the actual execution price provides the Exchange with an objective methodology to determine whether an Obvious Error occurred. The Exchange believes that the proposed amounts are reasonable as they are generally consistent with the standards of the Current Rule and reflect a significant disparity from Theoretical Price. The Exchange notes that the Minimum Amounts in the Proposed Rule and as set forth above are identical to the Current Rule except for the last two categories, for options where the Theoretical Price is above \$50.00 to \$100.00 and above \$100.00. The Exchange believes that this additional granularity is reasonable because given the proliferation of additional strikes

that have been created in the past several years there are many more high-priced options that are trading with open interest for extended periods. The Exchange believes that it is appropriate to account for these high-priced options with additional Minimum Amount Levels for options with Theoretical Prices above \$50.00.

Under the Proposed Rule, a party that believes that it participated in a transaction that was the result of an Obvious Error must notify the Exchange’s Market Control<sup>7</sup> in the manner specified from time to time by the Exchange in a circular distributed to Members. The Exchange believes that maintaining flexibility in the Rule is important to allow for changes to the process.

The Exchange also proposes to adopt notification timeframes that must be met in order for a transaction to qualify as an Obvious Error. Specifically, as proposed a filing must be received by the Exchange within thirty (30) minutes of the execution with respect to an execution of a Customer order and within fifteen (15) minutes of the execution for any other participant. The Exchange also proposes to provide additional time for trades that are routed through other options exchanges to the Exchange. Under the Proposed Rule, any other options exchange will have a total of forty-five (45) minutes for Customer orders and thirty (30) minutes for non-Customer orders, measured from the time of execution on the Exchange, to file with the Exchange for review of transactions routed to the Exchange from that options exchange and executed on the Exchange (“linkage trades”). This includes filings on behalf of another options exchange filed by a third-party routing broker if such third-party broker identifies the affected transactions as linkage trades. In order to facilitate timely reviews of linkage trades the Exchange will accept filings from either the other options exchange or, if applicable, the third-party routing broker that routed the applicable order(s). The additional fifteen (15) minutes provided with respect to linkage trades shall only apply to the extent the options exchange that originally received and routed the order to the Exchange itself received a timely filing from the entering participant (i.e., within 30 minutes if a Customer order or 15 minutes if a non-Customer order). The Exchange believes that additional time for filings related to Customer orders is appropriate in light of the fact that Customers are not necessarily

granting approval of proposed rule change to reduce the duration of the PIP from one second to one hundred milliseconds).

<sup>7</sup> Market Control consists of designated personnel in the Exchange’s market control center.

immersed in the day-to-day trading of the markets and are less likely to be watching trading activity in a particular option throughout the day. The Exchange believes that the additional time afforded to linkage trades is appropriate given the interconnected nature of the markets today and the practical difficulty that an end user may face in getting requests for review filed in a timely fashion when the transaction originated at a different exchange than where the error took place. Without this additional time the Exchange believes it would be common for a market participant to satisfy the filing deadline at the original exchange to which an order was routed but that requests for review of executions from orders routed to other options exchanges would not qualify for review as potential Obvious Errors by the time filings were received by such other options exchanges, in turn leading to potentially disparate results under the applicable rules of options exchanges to which the orders were routed.

Pursuant to the Proposed Rule, an Official may review a transaction believed to be erroneous on his/her own motion in the interest of maintaining a

fair and orderly market and for the protection of investors. This proposed provision is designed to give an Official the ability to provide parties relief in those situations where they have failed to report an apparent error within the established notification period. A transaction reviewed pursuant to the proposed provision may be nullified or adjusted only if it is determined by the Official that the transaction is erroneous in accordance with the provisions of the Proposed Rule, provided that the time deadlines for filing a request for review described above shall not apply. The Proposed Rule would require the Official to act as soon as possible after becoming aware of the transaction; action by the Official would ordinarily be expected on the same day that the transaction occurred. However, because a transaction under review may have occurred near the close of trading or due to unusual circumstances, the Proposed Rule provides that the Official shall act no later than 8:30 a.m. Eastern Time on the next trading day following the date of the transaction in question.

The Exchange also proposes to state that a party affected by a determination to nullify or adjust a transaction after an

Official's review on his or her own motion may appeal such determination in accordance with paragraph (k), which is described below. The Proposed Rule would make clear that a determination by an Official not to review a transaction or determination not to nullify or adjust a transaction for which a review was conducted on an Official's own motion is not appealable and further that if a transaction is reviewed and a determination is rendered pursuant to another provision of the Proposed Rule, no additional relief may be granted by an Official.

If it is determined that an Obvious Error has occurred based on the objective numeric criteria and time deadlines described above, the Exchange will adjust or nullify the transaction as described below and promptly notify both parties to the trade electronically or via telephone. The Exchange proposes different adjustment and nullification criteria for Customers and non-Customers.

As proposed, where neither party to the transaction is a Customer, the execution price of the transaction will be adjusted by the Official pursuant to the table below.

Theoretical price (TP)	Buy transaction adjustment—TP plus	Sell transaction adjustment—TP minus
Below \$3.00 .....	\$0.15	\$0.15
At or above \$3.00 .....	0.30	0.30

The Exchange believes that it is appropriate to adjust to prices a specified amount away from Theoretical Price rather than to adjust to Theoretical Price because even though the Exchange has determined a given trade to be erroneous in nature, the parties in question should have had some expectation of execution at the price or prices submitted. Also, it is common that by the time it is determined that an obvious error has occurred additional hedging and trading activity has already occurred based on the executions that previously happened. The Exchange is concerned that an adjustment to Theoretical Price in all cases would not appropriately incentivize market participants to maintain appropriate controls to avoid potential errors.

Further, as proposed any non-Customer Obvious Error exceeding 50 contracts will be subject to the Size Adjustment Modifier described above. The Exchange believes that it is appropriate to apply the Size Adjustment Modifier to non-Customer orders because the hedging cost associated with trading larger sized

options orders and the market impact of larger blocks of underlying can be significant.

As an example of the application of the Size Adjustment Modifier, assume Exchange A has a quoted bid to buy 50 contracts at \$2.50, Exchange B has a quoted bid to buy 100 contracts at \$2.05 and there is no other options exchange quoting a bid priced higher than \$2.00. Assume that the NBBO is \$2.50 by \$3.00. Finally, assume that all orders quoted and submitted to Exchange B in connection with this example are non-Customer orders.

- Assume Exchange A's quoted bid at \$2.50 is either executed or cancelled.
- Assume Exchange B immediately thereafter receives an incoming market order to sell 100 contracts.
- The incoming order would be executed against Exchange B's resting bid at \$2.05 for 100 contracts.
- Because the 100 contract execution of the incoming sell order was priced at \$2.05, which is \$0.45 below the Theoretical Price of \$2.50, the 100 contract execution would qualify for adjustment as an Obvious Error.

- The normal adjustment process would adjust the execution of the 100 contracts to \$2.35 per contract, which is the Theoretical Price minus \$0.15.

- However, because the execution would qualify for the Size Adjustment Modifier of 2 times the adjustment price, the adjusted transaction would instead be to \$2.20 per contract, which is the Theoretical Price minus \$0.30.

By reference to the example above, the Exchange reiterates that it believes that a Size Adjustment Modifier is appropriate, as the buyer in this example was originally willing to buy 100 contracts at \$2.05 and ended up paying \$2.20 per contract for such execution. Without the Size Adjustment Modifier the buyer would have paid \$2.35 per contract. Such buyer may be advantaged by the trade if the Theoretical Price is indeed closer to \$2.50 per contract, however the buyer may not have wanted to buy so many contracts at a higher price and does incur increasing cost and risk due to the additional size of their quote. Thus, the proposed rule is attempting to strike a balance between various competing

objectives, including recognition of cost and risk incurred in quoting larger size and incentivizing market participants to maintain appropriate controls to avoid errors.

In contrast to non-Customer orders, where trades will be adjusted if they qualify as Obvious Errors, pursuant the Proposed Rule a trade that qualifies as an Obvious Error will be nullified where at least one party to the Obvious Error is a Customer. The Exchange also proposes, however, that if any Member submits requests to the Exchange for review of transactions pursuant to the Proposed Rule, and in aggregate that Member has 200 or more Customer transactions under review concurrently and the orders resulting in such transactions were submitted during the course of 2 minutes or less, where at least one party to the Obvious Error is a non-Customer, the Exchange will apply the non-Customer adjustment criteria described above to such transactions. The Exchange based its proposal of 200 transactions on the fact that the proposed level is reasonable as it is representative of an extremely large number of orders submitted to the Exchange that are, in turn, possibly erroneous. Similarly, the Exchange based its proposal of orders received in 2 minutes or less on the fact that this is a very short amount of time under which one Member could generate multiple erroneous transactions. In order for a participant to have more than 200 transactions under review concurrently when the orders triggering such transactions were received in 2 minutes or less, the market participant will have far exceeded the normal behavior of customers deserving protected status.<sup>8</sup> While the Exchange continues to believe that it is appropriate to nullify transactions in such a circumstance if both participants to a transaction are Customers, the

Exchange does not believe it is appropriate to place the overall risk of a significant number of trade breaks on non-Customers that in the normal course of business may have engaged in additional hedging activity or trading activity based on such transactions. Thus, the Exchange believes it is necessary and appropriate to protect non-Customers in such a circumstance by applying the non-Customer adjustment criteria, and thus adjusting transactions as set forth above, in the event a Member has more than 200 transactions under review concurrently.

**Catastrophic Errors**

Consistent with the Current Rule, the Exchange proposes to adopt separate numerical thresholds for review of transactions for which the Exchange does not receive a filing requesting review within the Obvious Error timeframes set forth above. Based on this review these transactions may qualify as “Catastrophic Errors.” As proposed, a Catastrophic Error will be deemed to have occurred when the execution price of a transaction is higher or lower than the Theoretical Price for the series by an amount equal to at least the amount shown below:

Theoretical price	Minimum amount
Below \$2.00 .....	\$0.50
\$2.00 to \$5.00 .....	1.00
Above \$5.00 to \$10.00 .....	1.50
Above \$10.00 to \$20.00 .....	2.00
Above \$20.00 to \$50.00 .....	2.50
Above \$50.00 to \$100.00 .....	3.00
Above \$100.00 .....	4.00

Based on industry feedback on the Catastrophic Error thresholds set forth under the Current Rule, the thresholds proposed as set forth above are more granular and lower (*i.e.*, more likely to qualify) than the thresholds under the Current Rule. As noted above, under the

Proposed Rule as well as the Current Rule, parties have additional time to submit transactions for review as Catastrophic Errors. As proposed, notification requesting review must be received by the Exchange’s Market Control by 8:30 a.m. Eastern Time on the first trading day following the execution. For transactions in an expiring options series that take place on an expiration day, a party must notify the Exchange’s Market Control within 45 minutes after the close of trading that same day. As is true for requests for review under the Obvious Error provision of the Proposed Rule, a party requesting review of a transaction as a Catastrophic Error must notify the Exchange’s Market Control in the manner specified from time to time by the Exchange in a circular distributed to Members. By definition, any execution that qualifies as a Catastrophic Error is also an Obvious Error. However, the Exchange believes it is appropriate to maintain these two types of errors because the Catastrophic Error provisions provide market participants with a longer notification period under which they may file a request for review with the Exchange of a potential Catastrophic Error than a potential Obvious Error. This provides an additional level of protection for transactions that are severely erroneous even in the event a participant does not submit a request for review in a timely fashion.

The Proposed Rule would specify the action to be taken by the Exchange if it is determined that a Catastrophic Error has occurred, as described below, and would require the Exchange to promptly notify both parties to the trade electronically or via telephone. In the event of a Catastrophic Error, the execution price of the transaction will be adjusted by the Official pursuant to the table below.

Theoretical price (TP)	Buy transaction adjustment—TP plus	Sell transaction adjustment—TP minus
Below \$2.00 .....	\$0.50	\$0.50
\$2.00 to \$5.00 .....	1.00	1.00
Above \$5.00 to \$10.00 .....	1.50	1.50
Above \$10.00 to \$20.00 .....	2.00	2.00
Above \$20.00 to \$50.00 .....	2.50	2.50
Above \$50.00 to \$100.00 .....	3.00	3.00
Above \$100.00 .....	4.00	4.00

Although Customer orders would be adjusted in the same manner as non-

Customer orders, any Customer order that qualifies as a Catastrophic Error

will be nullified if the adjustment would result in an execution price

<sup>8</sup> The Exchange notes that in the third quarter of this year across all options exchanges the average number of valid Customer orders received and

executed was less than 38 valid orders every two minutes. The number of obvious errors resulting

from valid orders is, of course, a very small fraction of such orders.

higher (for buy transactions) or lower (for sell transactions) than the Customer's limit price. Based on industry feedback, the levels proposed above with respect to adjustment amounts are the same levels as the thresholds at which a transaction may be deemed a Catastrophic Error pursuant to the chart set forth above.

As is true for Obvious Errors as described above, the Exchange believes that it is appropriate to adjust to prices a specified amount away from Theoretical Price rather than to adjust to Theoretical Price because even though the Exchange has determined a given trade to be erroneous in nature, the parties in question should have had some expectation of execution at the price or prices submitted. Also, it is common that by the time it is determined that a Catastrophic Error has occurred additional hedging and trading activity has already occurred based on the executions that previously happened. The Exchange is concerned that an adjustment to Theoretical Price in all cases would not appropriately incentivize market participants to maintain appropriate controls to avoid potential errors. Further, the Exchange believes it is appropriate to maintain a higher adjustment level for Catastrophic Errors than Obvious Errors given the significant additional time that can potentially pass before an adjustment is requested and applied and the amount of hedging and trading activity that can occur based on the executions at issue during such time. For the same reasons, other than honoring the limit prices established for Customer orders, the Exchange has proposed to treat all market participants the same in the context of the Catastrophic Error provision. Specifically, the Exchange believes that treating market participants the same in this context will provide additional certainty to market participants with respect to their potential exposure and hedging activities, including comfort that even if a transaction is later adjusted (*i.e.*, past the standard time limit for filing under the Obvious Error provision), such transaction will not be fully nullified. However, as noted above, under the Proposed Rule where at least one party to the transaction is a Customer, the trade will be nullified if the adjustment would result in an execution price higher (for buy transactions) or lower (for sell transactions) than the Customer's limit price. The Exchange has retained the protection of a Customer's limit price in order to avoid a situation where the adjustment could be to a price that the Customer could

not afford, which is less likely to be an issue for a market professional.

#### Significant Market Events

In order to improve consistency for market participants in the case of a widespread market event and in light of the interconnected nature of the options exchanges, the Exchange proposes to adopt a new provision that calls for coordination between the options exchanges in certain circumstances and provides limited flexibility in the application of other provisions of the Proposed Rule in order to promptly respond to a widespread market event.<sup>9</sup> The Exchange proposes to describe such an event as a Significant Market Event, and to set forth certain objective criteria that will determine whether such an event has occurred. The Exchange developed these objective criteria in consultation with the other options exchanges by reference to historical patterns and events with a goal of setting thresholds that very rarely will be triggered so as to limit the application of the provision to truly significant market events. As proposed, a Significant Market Event will be deemed to have occurred when proposed criterion (A) below is met or exceeded or the sum of all applicable event statistics, where each is expressed as a percentage of the relevant threshold in criteria (A) through (D) below, is greater than or equal to 150% and 75% or more of at least one category is reached, provided that no single category can contribute more than 100% to the sum. All criteria set forth below will be measured in aggregate across all exchanges.

The proposed criteria for determining a Significant Market Event are as follows:

(A) Transactions that are potentially erroneous would result in a total Worst-Case Adjustment Penalty of \$30,000,000, where the Worst-Case Adjustment Penalty is computed as the sum, across all potentially erroneous trades, of: (i) \$0.30 (*i.e.*, the largest Transaction Adjustment value listed in sub-paragraph (e)(3)(A) below); times; (ii) the contract multiplier for each

<sup>9</sup> Although the Exchange has proposed a specific provision related to coordination amongst options exchanges in the context of a widespread event, the Exchange does not believe that the Significant Market Event provision or any other provision of the proposed rule alters the Exchange's ability to coordinate with other options exchanges in the normal course of business with respect to market events or activity. The Exchange does already coordinate with other options exchanges to the extent possible if such coordination is necessary to maintain a fair and orderly market and/or to fulfill the Exchange's duties as a self-regulatory organization.

traded contract; times (iii) the number of contracts for each trade; times (iv) the appropriate Size Adjustment Modifier for each trade, if any, as defined in sub-paragraph (e)(3)(A) below;

(B) Transactions involving 500,000 options contracts are potentially erroneous;

(C) Transactions with a notional value (*i.e.*, number of contracts traded multiplied by the option premium multiplied by the contract multiplier) of \$100,000,000 are potentially erroneous;

(D) 10,000 transactions are potentially erroneous.

As described above, the Exchange proposes to adopt a Worst Case Adjustment Penalty, proposed as criterion (A), which is the only criterion that can on its own result in an event being designated as a significant market event. The Worst Case Adjustment Penalty is intended to develop an objective criterion that can be quickly determined by the Exchange in consultation with other options exchanges that approximates the total overall exposure to market participants on the negatively impacted side of each transaction that occurs during an event. If the Worst Case Adjustment criterion is equal to or exceeds \$30,000,000, then an event is a Significant Market Event. As an example of the Worst Case Adjustment Penalty, assume that a single potentially erroneous transaction in an event is as follows: Sale of 100 contracts of a standard option (*i.e.*, an option with a 100 share multiplier). The highest potential adjustment penalty for this single transaction would be \$6,000, which would be calculated as \$0.30 times 100 (contract multiplier) times 100 (number of contracts) times 2 (applicable Size Adjustment Modifier). The Exchange would calculate the highest potential adjustment penalty for each of the potentially erroneous transactions in the event and the Worst Case Adjustment Penalty would be the sum of such penalties on the Exchange and all other options exchanges with affected transactions.

As described above, under the Proposed Rule if the Worst Case Adjustment Penalty does not equal or exceed \$30,000,000, then a Significant Market Event has occurred if the sum of all applicable event statistics (expressed as a percentage of the relevant thresholds), is greater than or equal to 150% and 75% or more of at least one category is reached. The Proposed Rule further provides that no single category can contribute more than 100% to the sum. As an example of the application of this provision, assume that in a given event across all options exchanges that: (A) The Worst Case Adjustment Penalty

is \$12,000,000 (40% of \$30,000,000), (B) 300,000 options contracts are potentially erroneous (60% of 500,000), (C) the notional value of potentially erroneous transactions is \$30,000,000 (30% of \$100,000,000), and (D) 12,000 transactions are potentially erroneous (120% of 10,000). This event would qualify as a Significant Market Event because the sum of all applicable event statistics would be 230%, far exceeding the 150% threshold. The 230% sum is reached by adding 40%, 60%, 30% and last, 100% (*i.e.*, rounded down from 120%) for the number of transactions. The Exchange notes that no single category can contribute more than 100% to the sum and any category contributing more than 100% will be rounded down to 100%.

As an alternative example, assume a large-scale event occurs involving low-priced options with a small number of contracts in each execution. Assume in this event across all options exchanges that: (A) The Worst Case Adjustment Penalty is \$600,000 (2% of \$30,000,000), (B) 20,000 options contracts are potentially erroneous (4% of 500,000), (C) the notional value of potentially erroneous transactions is \$20,000,000 (20% of \$100,000,000), and (D) 20,000 transactions are potentially erroneous (200% of 10,000, but rounded down to 100%). This event would not qualify as a Significant Market Event because the sum of all applicable event statistics would be 126%, below the 150% threshold. The Exchange reiterates that as proposed, even when a single category other than criterion (A) is fully met, that does not necessarily qualify an event as a Significant Market Event.

The Exchange believes that the breadth and scope of the obvious error rules are appropriate and sufficient for handling of typical and common obvious errors. Coordination between and among the exchanges should generally not be necessary even when a member has an error that results in executions on more than one exchange. In setting the thresholds above the Exchange believes that the requirements will be met only when truly widespread and significant errors happen and the benefits of coordination and information

sharing far outweigh the costs of the logistics of additional intra-exchange coordination. The Exchange notes that in addition to its belief that the proposed thresholds are sufficiently high, the Exchange has proposed the requirement that either criterion (A) is met or exceeded or the sum of applicable event statistics for proposed (A) through (D) equals or exceeds 150% in order to ensure that an event is sufficiently large but also to avoid situations where an event is extremely large but just misses potential qualifying thresholds. For instance, the proposal is designed to help avoid a situation where the Worst Case Adjustment Penalty is \$15,000,000, so the event does not qualify based on criterion (A) alone, but there are transactions in 490,000 options contracts that are potentially erroneous (missing criterion (B) by 10,000 contracts), there are transactions with a notional value of \$99,000,000 (missing criterion (C) by \$1,000,000), and there are 9,000 potentially erroneous transactions overall (missing criterion (D) by 1,000 transactions). The Exchange believes that the proposed formula, while slightly more complicated than simply requiring a certain threshold to be met in each category, may help to avoid inapplicability of the proposed provisions in the context of an event that would be deemed significant by most subjective measures but that barely misses each of the objective criteria proposed by the Exchange.

To ensure consistent application across options exchanges, in the event of a suspected Significant Market Event, the Exchange shall initiate a coordinated review of potentially erroneous transactions with all other affected options exchanges to determine the full scope of the event. Under the Proposed Rule, the Exchange will promptly coordinate with the other options exchanges to determine the appropriate review period as well as select one or more specific points in time prior to the transactions in question and use one or more specific points in time to determine Theoretical Price. Other than the selected points in time, if applicable, the Exchange will determine Theoretical Price as

described above. For example, around the start of a SME that is triggered by a large and aggressively priced buy order, three exchanges have multiple orders on the offer side of the market: Exchange A has offers priced at \$2.20, \$2.25, \$2.30 and several other price levels to \$3.00, Exchange B has offers at \$2.45, \$2.30 and several other price levels to \$3.00, Exchange C has offers at price levels between \$2.50 and \$3.00. Assume an event occurs starting at 10:05:25 a.m. ET and in this particular series the executions begin on Exchange A and subsequently begin to occur on Exchanges B and C. Without coordination and information sharing between the exchanges, Exchange B and Exchange C cannot know with certainty that whether or not the execution at Exchange A that happened at \$2.20 immediately prior to their executions at \$2.45 and \$2.50 is part of the same erroneous event or not. With proper coordination, the exchanges can determine that in this series, the proper point in time from which the event should be analyzed is 10:05:25 a.m. ET, and thus, the NBO of \$2.20 should be used as the Theoretical Price for purposes of all buy transactions in such options series that occurred during the event.

If it is determined that a Significant Market Event has occurred then, using the parameters agreed with respect to the times from which Theoretical Price will be calculated, if applicable, an Official will determine whether any or all transactions under review qualify as Obvious Errors. The Proposed Rule would require the Exchange to use the criteria in Proposed Rule 720(c), as described above, to determine whether an Obvious Error has occurred for each transaction that was part of the Significant Market Event. Upon taking any final action, the Exchange would be required to promptly notify both parties to the trade electronically or via telephone.

The execution price of each affected transaction will be adjusted by an Official to the price provided below, unless both parties agree to adjust the transaction to a different price or agree to bust the trade.

Theoretical price (TP)	Buy transaction adjustment—TP plus	Sell transaction adjustment—TP minus
Below \$3.00 .....	\$0.15	\$0.15
At or above \$3.00 .....	0.30	0.30

Thus, the proposed adjustment criteria for Significant Market Events are

identical to the proposed adjustment levels for Obvious Errors generally. In

addition, in the context of a Significant Market Event, any error exceeding 50



contracts will be subject to the Size Adjustment Modifier described above. Also, the adjustment criteria would apply equally to all market participants (*i.e.*, Customers and non-Customers) in a Significant Market Event. However, as is true for the proposal with respect to Catastrophic Errors, under the Proposed Rule where at least one party to the transaction is a Customer, the trade will be nullified if the adjustment would result in an execution price higher (for buy transactions) or lower (for sell transactions) than the Customer's limit price. The Exchange has retained the protection of a Customer's limit price in order to avoid a situation where the adjustment could be to a price that the Customer could not afford, which is less likely to be an issue for a market professional. The Exchange has otherwise proposed to treat all market participants the same in the context of a Significant Market Event to provide additional certainty to market participants with respect to their potential exposure as soon as an event has occurred.

Another significant distinction between the proposed Obvious Error provision and the proposed Significant Market Event provision is that if the Exchange, in consultation with other options exchanges, determines that timely adjustment is not feasible due to the extraordinary nature of the situation, then the Exchange will nullify some or all transactions arising out of the Significant Market Event during the review period selected by the Exchange and other options exchanges. To the extent the Exchange, in consultation with other options exchanges, determines to nullify less than all transactions arising out of the Significant Market Event, those transactions subject to nullification will be selected based upon objective criteria with a view toward maintaining a fair and orderly market and the protection of investors and the public interest. For example, assume a Significant Market Event causes 25,000 potentially erroneous transactions and impacts 51 options classes. Of the 25,000 transactions, 24,000 of them are concentrated in a single options class. The exchanges may decide the most appropriate solution because it will provide the most certainty to participants and allow for the prompt resumption of regular trading is to bust all trades in the most heavily affected class between two specific points in time, while the other 1,000 trades across the other 50 classes are reviewed and adjusted as appropriate. A similar situation might arise directionally

where a Customer submits both erroneous buy and sell orders and the number of errors that happened that were erroneously low priced (*i.e.*, erroneous sell orders) were 50,000 in number but the number of errors that were erroneously high (*i.e.*, erroneous buy orders) were only 500 in number. The most effective and efficient approach that provides the most certainty to the marketplace in a reasonable amount of time while most closely following the generally prescribed obvious error rules could be to bust all of the erroneous sell transactions but to adjust the erroneous buy transactions.

With respect to rulings made pursuant to the proposed Significant Market Event provision the Exchange believes that the number of affected transactions is such that immediate finality is necessary to maintain a fair and orderly market and to protect investors and the public interest. Accordingly, rulings by the Exchange pursuant to the Significant Market Event provision would be non-appealable pursuant to the Proposed Rule.

#### Additional Provisions

##### Mutual Agreement

In addition to the objective criteria described above, the Proposed Rule also proposes to make clear that the determination as to whether a trade was executed at an erroneous price may be made by mutual agreement of the affected parties to a particular transaction. The Proposed Rule would state that a trade may be nullified or adjusted on the terms that all parties to a particular transaction agree, provided, however, that such agreement to nullify or adjust must be conveyed to the Exchange in a manner prescribed by the Exchange prior to 8:30 a.m. Eastern Time on the first trading day following the execution.

The Exchange also proposes to explicitly state that it is considered conduct inconsistent with just and equitable principles of trade for any Member to use the mutual adjustment process to circumvent any applicable Exchange rule, the Act or any of the rules and regulations thereunder. Thus, for instance, a Member is precluded from seeking to avoid applicable trade-through rules by executing a transaction and then adjusting such transaction to a price at which the Exchange would not have allowed it to execute at the time of the execution because it traded through the quotation of another options exchange. The Exchange notes that in connection with its obligations as a self-regulatory organization, the Exchange's

Surveillance Department reviews adjustments to transactions to detect potential violations of Exchange rules or the Act and the rules and regulations thereunder.

##### Trading Halts

Exchange Rule 702 describes the Exchange's authority to declare trading halts in one or more options traded on the Exchange. The Exchange proposes to make clear in the Proposed Rule that it will nullify any transaction that occurs during a trading halt in the affected option on the Exchange pursuant to Rule 702, or with respect to equity options (including options overlying ETFs), during a regulatory halt as declared by the primary listing market for the underlying security.<sup>10</sup> If any trades occur notwithstanding a trading halt then the Exchange believes it appropriate to nullify such transactions. While trading may be halted for various reasons, such a scenario almost certainly is due to extraordinary circumstances and is potentially the result of market-wide coordination to halt options trading or trading generally. Accordingly, the Exchange does not believe it is appropriate to allow trades to stand if such trades should not have occurred in the first place.

The Exchange currently does not have a rule that permits the nullification of transactions that occur during a trading halt of an option class on the Exchange, or with respect to equity options (including options overlying ETFs), during a regulatory halt as declared by the primary listing market for the underlying security. As part of the harmonization effort, the Exchange proposes to adopt rule text to permit the Exchange to nullify transactions, as described above. The Exchange's ability to nullify the affected transactions will ensure consistency with the trading halt provision of the Proposed Rule.

##### Erroneous Print and Quotes in Underlying Security

Market participants on the Exchange likely base the pricing of their orders submitted to the Exchange on the price of the underlying security for the option. Thus, the Exchange believes it is appropriate to adopt provisions that allow adjustment or nullification of transactions based on erroneous prints or erroneous quotes in the underlying security.

<sup>10</sup> After a regulatory halt, if it is determined that trading should resume according to Rule 702(b), trades occurring after the resumption will be valid and not subject to nullification under Supplementary Material .01(b) to Rule 702, unless trading is subsequently subject to another separate regulatory halt.

The Exchange proposes to adopt language in the Proposed Rule stating that a trade resulting from an erroneous print(s) disseminated by the underlying market that is later nullified by that underlying market shall be adjusted or busted as set forth in the Obvious Error provisions of the Proposed Rule, provided a party notifies the Exchange's Market Control in a timely manner, as further described below. The Exchange proposes to define a trade resulting from an erroneous print(s) as any options trade executed during a period of time for which one or more executions in the underlying security are nullified and for one second thereafter. The Exchange believes that one second is an appropriate amount of time in which an options trade would be directly based on executions in the underlying equity security. The Exchange also proposes to require that if a party believes that it participated in an erroneous transaction resulting from an erroneous print(s) pursuant to the proposed erroneous print provision it must notify the Exchange's Market Control within the timeframes set forth in the Obvious Error provision described above. The Exchange has also proposed to state that the allowed notification timeframe commences at the time of notification by the underlying market(s) of nullification of transactions in the underlying security. Further, the Exchange proposes that if multiple underlying markets nullify trades in the underlying security, the allowed notification timeframe will commence at the time of the first market's notification.

As an example of a situation in which a trade results from an erroneous print disseminated by the underlying market that is later nullified by the underlying market, assume that a given underlying is trading in the \$49.00–\$50.00 price range then has an erroneous print at \$5.00. Given that there is the potential perception that the underlying has gone through a dramatic price revaluation, numerous options trades could promptly trigger based off of this new price. However, because the price that triggered them was not a valid price it would be appropriate to review said option trades when the underlying print that triggered them is removed.

The Exchange also proposes to add a provision stating that a trade resulting from an erroneous quote(s) in the underlying security shall be adjusted or busted as set forth in the Obvious Error provisions of the Proposed Rule, provided a party notifies the Exchange's Market Control in a timely manner, as further described below. Pursuant to the Proposed Rule, an erroneous quote

occurs when the underlying security has a width of at least \$1.00 and has a width 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 purposes of the Proposed Rule, 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 (excluding the quote(s) in question) and dividing by the number of quotes during such time period (excluding the quote(s) in question).<sup>11</sup> Similar to the proposal with respect to erroneous prints described above, if a party believes that it participated in an erroneous transaction resulting from an erroneous quote(s) it must notify the Exchange's Market Control in accordance with the notification provisions of the Obvious Error provision described above. The Proposed Rule, therefore, puts the onus on each Member to notify the Exchange if such Member believes that a trade should be reviewed pursuant to either of the proposed provisions, as the Exchange is not in position to determine the impact of erroneous prints or quotes on individual Members. The Exchange notes that it does not believe that additional time is necessary with respect to a trade based on an erroneous quote because a Member has all information necessary to detect the error at the time of an option transaction that was triggered by an erroneous quote, which is in contrast to the proposed erroneous print provision that includes a dependency on an action by the market where the underlying security traded.

As an example of a situation in which a trade results from an erroneous quote in the underlying security, assume again that a given underlying is quoting and trading in the \$49.00–\$50.00 price range then a liquidity gap occurs, with bidders not representing quotes in the market place and an offer quoted at \$5.00. Quoting may quickly return to normal, again in the \$49.00–\$50.00 price range, but due to the potential perception that the underlying has gone through a dramatic price revaluation, numerous options trades could trigger based off of

<sup>11</sup> The Exchange has proposed the price and time parameters for quote width and average quote width used to determine whether an erroneous quote has occurred based on established rules of options exchanges that currently apply such parameters. See, e.g., CBOE Rule 6.25(a)(5); NYSE Arca Rule 6.87(a)(5). Based on discussions with these exchanges, the Exchange believes that the parameters are a reasonable approach to determine whether an erroneous quote has occurred for purposes of the proposed rule.

this new quoted price in the interim. Because the price that triggered such trades was not a valid price it would be appropriate to review said option trades.

#### Stop (and Stop-Limit) Order Trades Triggered by Erroneous Trades

The Exchange notes that certain market participants and their customers enter stop or stop limit orders that are triggered based on executions in the marketplace. As proposed, transactions resulting from the triggering of a stop or stop-limit order by an erroneous trade in an option contract shall be nullified by the Exchange, provided a party notifies the Exchange's Market Control in a timely manner as set forth below. The Exchange believes it is appropriate to nullify executions of stop or stop-limit orders that were wrongly triggered because such transactions should not have occurred. If a party believes that it participated in an erroneous transaction pursuant to the Proposed Rule it must notify the Exchange's Market Control within the timeframes set forth in the Obvious Error Rule above, with the allowed notification timeframe commencing at the time of notification of the nullification of transaction(s) that triggered the stop or stop-limit order.

#### Linkage Trades

The Exchange also proposes to adopt language that clearly provides the Exchange with authority to take necessary actions when another options exchange nullifies or adjusts a transaction pursuant to its respective rules and the transaction resulted from an order that has passed through the Exchange and been routed on to another options exchange on behalf of the Exchange. Specifically, if the Exchange routes an order pursuant to the Options Order Protection and Locked/Crossed Market Plan<sup>12</sup> that results in a transaction on another options exchange (a "Linkage Trade") and such options exchange subsequently nullifies or adjusts the Linkage Trade pursuant to its rules, the Exchange will perform all actions necessary to complete the nullification or adjustment of the Linkage Trade. Although the Exchange is not utilizing its own authority to nullify or adjust a transaction related to an action taken on a Linkage Trade by another options exchange, the Exchange does have to assist in the processing of the adjustment or nullification of the order, such as notification to the Member and the OCC of the adjustment or nullification. Thus, the Exchange believes that the proposed provision

<sup>12</sup> As defined in Exchange Rule 1900(n).

adds additional transparency to the Proposed Rule.

#### Appeals

The Exchange proposes to generally maintain its current appeals process in connection with the Proposed Rule with minor adjustments to accommodate a harmonized rule. Specifically, if a Member affected by a determination made under the Proposed Rule requests within the time permitted below, the Obvious Error Panel (“Obvious Error Panel”) will review decisions made by the Exchange Official, including whether an obvious error occurred and whether the correct determination was made.

In order to maintain a diverse group of participants, the Obvious Error Panel will be comprised of representatives from four (4) Members. Two (2) of the representatives must be directly engaged in market making (any such representative, a “MM Representative”) and the other two (2) representatives must be employed by an Electronic Access Member (any such representative, a “Non-MM Representative”).<sup>13</sup> To qualify as a Non-MM Representative a person must: Be employed by a Member whose revenues from options market making activity do not exceed ten percent (10%) of its total revenues; or 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.

In order to further assure a diverse group of potential participants on an Obvious Error Panel, the Exchange shall designate at least ten (10) MM Representatives and at least ten (10) Non-MM Representatives to be called upon to serve on the Obvious Error Panel as needed. To assure fairness, in no case shall an Obvious Error Panel include a person affiliated with a party to the trade in question. Also, 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.

Under the Proposed Rule a request for review on appeal must be made in writing via email or other electronic means specified from time to time by the Exchange in a circular distributed to Members within thirty (30) minutes

after the party making the appeal is given notification of the initial determination being appealed. The Obvious Error Panel shall review the facts and render a decision as soon as practicable, but generally on the same trading day as the execution(s) under review. On requests for appeal received after 3:00 p.m. Eastern Time, a decision will be rendered as soon as practicable, but in no case later than the trading day following the date of the execution under review.

The Obvious Error Panel may overturn or modify an action taken by the Exchange Official under this Rule. All determinations by the Obvious Error Panel shall constitute final action by the Exchange on the matter at issue. The Exchange believes that this is necessary given the purpose of the appeal is finality.

In order to deter frivolous appeals, if the Obvious Error Panel votes to uphold the decision made pursuant to the Proposed Rule, the Exchange will assess a \$5,000.00 fee against the Member(s) who initiated the request for appeal. In addition, in instances where the Exchange, on behalf of a Member, requests a determination by another market center that a transaction is clearly erroneous, the Exchange will pass any resulting charges through to the relevant Member.

Any determination by an Official or by the Obvious Error Panel shall be rendered without prejudice as to the rights of the parties to the transaction to submit their dispute to arbitration.

#### Limit Up-Limit Down Plan

The Exchange is proposing to adopt Supplementary Material .01 to the Proposed Rule to provide for how the Exchange will treat Obvious and Catastrophic Errors in response to the Regulation NMS Plan to Address Extraordinary Market Volatility Pursuant to Rule 608 of Regulation NMS under the Act (the “Limit Up-Limit Down Plan” or the “Plan”),<sup>14</sup> which is applicable to all NMS stocks, as defined in Regulation NMS Rule 600(b)(47).<sup>15</sup> Under the Proposed Rule, during a pilot period to coincide with the pilot period for the Plan, including any extensions to the pilot period for the Plan, an execution will not be subject to review as an Obvious Error or Catastrophic Error pursuant to paragraph (c) or (d) of the Proposed Rule if it occurred while the underlying security was in a “Limit State” or “Straddle State,” as defined in

the Plan. The Exchange, however, proposes to retain authority to review transactions on an Official’s own motion pursuant to sub-paragraph (c)(3) of the Proposed Rule and to bust or adjust transactions pursuant to the proposed Significant Market Event provision, the proposed trading halts provision, the proposed provisions with respect to erroneous prints and quotes in the underlying security, or the proposed provision related to stop and stop limit orders that have been triggered by an erroneous execution. The Exchange believes that these safeguards will provide the Exchange with the flexibility to act when necessary and appropriate to nullify or adjust a transaction, while also providing market participants with certainty that, under normal circumstances, the trades they affect with quotes and/or orders having limit prices will stand irrespective of subsequent moves in the underlying security.

During a Limit or Straddle State, options prices may deviate substantially from those available immediately prior to or following such States. Thus, determining a Theoretical Price in such situations would often be very subjective, creating unnecessary uncertainty and confusion for investors. Because of this uncertainty, the Exchange is proposing to amend Rule 720 to provide that the Exchange will not review transactions as Obvious Errors or Catastrophic Errors when the underlying security is in a Limit or Straddle State.

The Exchange notes that there are additional protections in place outside of the Obvious and Catastrophic Error Rule that will continue to safeguard customers. First, the Exchange rejects all un-priced options orders received by the Exchange (*i.e.*, Market Orders) during a Limit or Straddle State for the underlying security. Second, SEC Rule 15c3-5 requires that, “financial risk management controls and supervisory procedures must be reasonably designed to prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds, or that appear to be erroneous.”<sup>16</sup> Third, the Exchange has price checks applicable to limit orders that reject limit orders that are priced sufficiently far through the national best bid or national best offer (“NBBO”) that it seems likely an error occurred. The rejection of Market Orders, the requirements placed upon broker dealers to adopt controls to prevent the entry of orders that appear to be

<sup>13</sup> The composition of the Obvious Error Panel will be similar to that of the Review Panel currently utilized by the Exchange to determine whether erroneous trades due to system disruptions and malfunctions should be adjusted or nullified. See ISE Gemini Rule 720A.

<sup>14</sup> Securities Exchange Act Release No. 67091 (May 31, 2012), 77 FR 33498 (June 6, 2012) (order approving the Plan on a pilot basis).

<sup>15</sup> 17 CFR 242.600(b)(47).

<sup>16</sup> See Securities and Exchange Act Release No. 63241 (November 3, 2010), 75 FR 69791 (November 15, 2010) (File No. S7-03-10).

erroneous, and Exchange functionality that filters out orders that appear to be erroneous, will all serve to sharply reduce the incidence of erroneous transactions.

The Exchange represents that it will conduct its own analysis concerning the elimination of the Obvious Error and Catastrophic Error provisions during Limit and Straddle States and agrees to provide the Commission with relevant data to assess the impact of this proposed rule change. As part of its analysis, the Exchange will evaluate (1) the options market quality during Limit and Straddle States, (2) assess the character of incoming order flow and transactions during Limit and Straddle States, and (3) review any complaints from Members and their customers concerning executions during Limit and Straddle States. The Exchange also agrees to provide to the Commission data requested to evaluate the impact of the inapplicability of the Obvious Error and Catastrophic Error provisions, including data relevant to assessing the various analyses noted above.

In connection with this proposal, the Exchange will provide to the Commission and the public a dataset containing the data for each Straddle State and Limit State in NMS Stocks underlying options traded on the Exchange beginning in the month during which the proposal is approved, limited to those option classes that have at least one (1) trade on the Exchange during a Straddle State or Limit State. For each of those option classes affected, each data record will contain the following information:

- Stock symbol, option symbol, time at the start of the Straddle or Limit State, an indicator for whether it is a Straddle or Limit State.
    - For activity on the Exchange:
      - Executed volume, time-weighted quoted bid-ask spread, time-weighted average quoted depth at the bid, time-weighted average quoted depth at the offer;
        - high execution price, low execution price;
        - number of trades for which a request for review for error was received during Straddle and Limit States;
        - an indicator variable for whether those options outlined above have a price change exceeding 30% during the underlying stock's Limit or Straddle State compared to the last available option price as reported by OPRA before the start of the Limit or Straddle State (1 if observe 30% and 0 otherwise).
- Another indicator variable for whether the option price within five minutes of the underlying stock leaving the Limit or Straddle state (or halt if applicable)

is 30% away from the price before the start of the Limit or Straddle State.

In addition, by May 29, 2015, the Exchange shall provide to the Commission and the public assessments relating to the impact of the operation of the Obvious Error rules during Limit and Straddle States as follows: (1) Evaluate the statistical and economic impact of Limit and Straddle States on liquidity and market quality in the options markets; and (2) Assess whether the lack of Obvious Error rules in effect during the Straddle and Limit States are problematic. The timing of this submission would coordinate with Participants' proposed time frame to submit to the Commission assessments as required under Appendix B of the Plan. The Exchange notes that the pilot program is intended to run concurrent with the pilot period of the Plan, which has been extended to October 23, 2015. The Exchange proposes to reflect this date in the Proposed Rule.

#### No Adjustments to a Worse Price

Finally, the Exchange proposes to include Supplementary Material .02 to the Proposed Rule, which would make clear that to the extent the provisions of the proposed Rule would result in the Exchange applying an adjustment of an erroneous sell transaction to a price lower than the execution price or an erroneous buy transaction to a price higher than the execution price, the Exchange will not adjust or nullify the transaction, but rather, the execution price will stand.

#### Implementation Date

In order to ensure that other options exchanges are able to adopt rules consistent with this proposal and to coordinate the effectiveness of such harmonized rules, the Exchange proposes to delay the operative date of this proposal to May 8, 2015.

#### 2. Statutory Basis

The Exchange believes that its proposal is consistent with the requirements of the Act and the rules and regulations thereunder that are applicable to a national securities exchange, and, in particular, with the requirements of section 6(b) of the Act.<sup>17</sup> Specifically, the proposal is consistent with section 6(b)(5) of the Act<sup>18</sup> because it would promote just and equitable principles of trade, remove impediments to, and perfect the mechanism of, a free and open market and a national market system, and, in

general, protect investors and the public interest.

As described above, the Exchange and other options exchanges are seeking to adopt harmonized rules related to the adjustment and nullification of erroneous options transactions. The Exchange believes that the Proposed Rule will provide greater transparency and clarity with respect to the adjustment and nullification of erroneous options transactions. Particularly, the proposed changes seek to achieve consistent results for participants across U.S. options exchanges while maintaining a fair and orderly market, protecting investors and protecting the public interest. Based on the foregoing, the Exchange believes that the proposal is consistent with section 6(b)(5) of the Act<sup>19</sup> in that the Proposed Rule will foster cooperation and coordination with persons engaged in regulating and facilitating transactions.

The Exchange believes the various provisions allowing or dictating adjustment rather than nullification of a trade are necessary given the benefits of adjusting a trade price rather than nullifying the trade completely. Because options trades are used to hedge, or are hedged by, transactions in other markets, including securities and futures, many Members, and their customers, would rather adjust prices of executions rather than nullify the transactions and, thus, lose a hedge altogether. As such, the Exchange believes it is in the best interest of investors to allow for price adjustments as well as nullifications. The Exchange further discusses specific aspects of the Proposed Rule below.

The Exchange does not believe that the proposal is unfairly discriminatory, even though it differentiates in many places between Customers and non-Customers. The rules of the options exchanges, including the Exchange's existing Obvious Error provision, often treat Customers differently, often affording them preferential treatment. This treatment is appropriate in light of the fact that Customers are not necessarily immersed in the day-to-day trading of the markets, are less likely to be watching trading activity in a particular option throughout the day, and may have limited funds in their trading accounts. At the same time, the Exchange reiterates that in the U.S. options markets generally there is significant retail customer participation that occurs directly on (and only on) options exchanges such as the Exchange. Accordingly, differentiating

<sup>17</sup> 15 U.S.C. 78f(b).

<sup>18</sup> 15 U.S.C. 78f(b)(5).

<sup>19</sup> 15 U.S.C. 78f(b)(5).

among market participants with respect to the adjustment and nullification of erroneous options transactions is not unfairly discriminatory because it is reasonable and fair to provide Customers with additional protections as compared to non-Customers.

The Exchange believes that its proposal with respect to the allowance of mutual agreed upon adjustments or nullifications is appropriate and consistent with the Act, as such proposal removes impediments to and perfects the mechanism of a free and open market and a national market system, allowing participants to mutually agree to correct an erroneous transactions without the Exchange mandating the outcome. The Exchange also believes that its proposal with respect to mutual adjustments is consistent with the Act because it is designed to prevent fraudulent and manipulative acts and practices by explicitly stating that it is considered conduct inconsistent with just and equitable principles of trade for any Member to use the mutual adjustment process to circumvent any applicable Exchange rule, the Act or any of the rules and regulations thereunder.

The Exchange believes its proposal to provide within the Proposed Rule definitions of Customer, erroneous sell transaction and erroneous buy transaction, and Official is consistent with section 6(b)(5) of the Act because such terms will provide more certainty to market participants as to the meaning of the Proposed Rule and reduce the possibility that a party can intentionally submit an order hoping for the market to move in their favor in reliance on the Rule as a safety mechanism, thereby promoting just and fair principles of trade. Similarly, the Exchange believes that proposed Supplementary Material .02 is consistent with the Act as it would make clear that the Exchange will not adjust or nullify a transaction, but rather, the execution price will stand when the applicable adjustment criteria would actually adjust the price of the transaction to a worse price (*i.e.*, higher for an erroneous buy or lower for an erroneous sell order).

As set forth below, the Exchange believes it is consistent with section 6(b)(5) of the Act for the Exchange to determine Theoretical Price when the NBBO cannot reasonably be relied upon because the alternative could result in transactions that cannot be adjusted or nullified even when they are otherwise clearly at a price that is significantly away from the appropriate market for the option. Similarly, reliance on an NBBO that is not reliable could result in adjustment to prices that are still

significantly away from the appropriate market for the option.

The Exchange believes that its proposal with respect to determining Theoretical Price is consistent with the Act in that it has retained the standard of the current rule, which is to rely on the NBBO to determine Theoretical Price if such NBBO can reasonably be relied upon. Because, however, there is not always an NBBO that can or should be used in order to administer the rule, the Exchange has proposed various provisions that provide the Exchange with the authority to determine a Theoretical Price. The Exchange believes that the Proposed Rule is transparent with respect to the circumstances under which the Exchange will determine Theoretical Price, and has sought to limit such circumstances as much as possible. The Exchange notes that Exchange personnel currently are required to determine Theoretical Price in certain circumstances. While the Exchange continues to pursue alternative solutions that might further enhance the objectivity and consistency of determining Theoretical Price, the Exchange believes that the discretion currently afforded to Exchange Officials is appropriate in the absence of a reliable NBBO that can be used to set the Theoretical Price.

With respect to the specific proposed provisions for determining Theoretical Price for transactions that occur during the opening rotation and in situations where there is a wide quote, the Exchange believes both provisions are consistent with the Act because they provide objective criteria that will determine Theoretical Price with limited exceptions for situations where the Exchange does not believe the NBBO is a reasonable benchmark or there is no NBBO. The Exchange notes in particular with respect to the wide quote provision that the Proposed Rule will result in the Exchange determining Theoretical Price less frequently than it would pursuant to wide quote provisions that have previously been approved. The Exchange believes that it is appropriate and consistent with the Act to afford protections to market participants by not relying on the NBBO to determine Theoretical Price when the quote is extremely wide but had been, in the prior 10 seconds, at much more reasonable width. The Exchange also believes it is appropriate and consistent with the Act to use the NBBO to determine Theoretical Price when the quote has been wider than the applicable amount for more than 10 seconds, as the Exchange does not believe it is necessary to apply any other

criteria in such a circumstance. The Exchange believes that market participants can easily use or adopt safeguards to prevent errors when such market conditions exist. When entering an order into a market with a persistently wide quote, the Exchange does not believe that the entering party should reasonably expect anything other than the quoted price of an option.

The Exchange believes that its proposal to adopt clear but disparate standards with respect to the deadline for submitting a request for review of Customer and non-Customer transactions is consistent with the Act, particularly in that it creates a greater level of protection for Customers. As noted above, the Exchange believes that this is appropriate and not unfairly discriminatory in light of the fact that Customers are not necessarily immersed in the day-to-day trading of the markets and are less likely to be watching trading activity in a particular option throughout the day. Thus, Members representing Customer orders reasonably may need additional time to submit a request for review. The Exchange also believes that its proposal to provide additional time for submission of requests for review of linkage trades is reasonable and consistent with the protection of investors and the public interest due to the time that it might take an options exchange or third-party routing broker to file a request for review with the Exchange if the initial notification of an error is received by the originating options exchange near the end of such options exchange's filing deadline. Without this additional time, there could be disparate results based purely on the existence of intermediaries and an interconnected market structure.

In relation to the aspect of the proposal giving Officials the ability to review transactions for obvious errors on their own motion, the Exchange notes that an Official can adjust or nullify a transaction under the authority granted by this provision only if the transaction meets the specific and objective criteria for an Obvious Error under the Proposed Rule. As noted above, this is designed to give an Official the ability to provide parties relief in those situations where they have failed to report an apparent error within the established notification period. However, the Exchange will only grant relief if the transaction meets the requirements for an Obvious Error as described in the Proposed Rule.

The Exchange believes that its proposal to adjust non-Customer transactions and to nullify Customer transactions that qualify as Obvious

Errors is appropriate for reasons consistent with those described above. In particular, Customers are not necessarily immersed in the day-to-day trading of the markets, are less likely to be watching trading activity in a particular option throughout the day, and may have limited funds in their trading accounts.

The Exchange acknowledges that the proposal contains some uncertainty regarding whether a trade will be adjusted or nullified, depending on whether one of the parties is a Customer, because a party may not know whether the other party to a transaction was a Customer at the time of entering into the transaction. However, the Exchange believes that the proposal nevertheless promotes just and equitable principles of trade and protects investors as well as the public interest because it eliminates the possibility that a Customer's order will be adjusted to a significantly different price. As noted above, the Exchange believes it is consistent with the Act to afford Customers greater protections under the Proposed Rule than are afforded to non-Customers. Thus, the Exchange believes that its proposal is consistent with the Act in that it protects investors and the public interest by providing additional protections to those that are less informed and potentially less able to afford an adjustment of a transaction that was executed in error. Customers are also less likely to have engaged in significant hedging or other trading activity based on earlier transactions, and thus, are less in need of maintaining a position at an adjusted price than non-Customers.

If any Member submits requests to the Exchange for review of transactions pursuant to the Proposed Rule, and in aggregate that Member has 200 or more Customer transactions under review concurrently and the orders resulting in such transactions were submitted during the course of 2 minutes or less, the Exchange believes it is appropriate for the Exchange apply the non-Customer adjustment criteria described above to such transactions. The Exchange believes that the proposed aggregation is reasonable as it is representative of an extremely large number of orders submitted to the Exchange over a relatively short period of time that are, in turn, possibly erroneous (and within a time frame significantly less than an entire day), and thus is most likely to occur because of a systems issue experienced by a Member representing Customer orders or a systems issue coupled with the erroneous marking of orders. The

Exchange does not believe it is possible at a level of 200 Customer orders over a 2 minute period that are under review at one time that multiple, separate Customers were responsible for the errors in the ordinary course of trading. In the event of a large-scale issue caused by a Member that has submitted orders over a 2 minute period marked as Customer that resulted in more than 200 transactions under review, the Exchange does not believe it is appropriate to nullify all such transactions because of the negative impact that nullification could have on the market participants on the contra-side of such transactions, who might have engaged in hedging and trading activity following such transactions. In order for a participant to have more than 200 transactions under review concurrently when the orders triggering such transactions were received in 2 minutes or less, the Exchange believes that a market participant will have far exceeded the normal behavior of customers deserving protected status. While the Exchange continues to believe that it is appropriate to nullify transactions in such a circumstance if both participants to a transaction are Customers, the Exchange does not believe it is appropriate to place the overall risk of a significant number of trade breaks on non-Customers that in the normal course of business may have engaged in additional hedging activity or trading activity based on such transactions. Thus, the Exchange believes it is necessary and appropriate to protect non-Customers in such a circumstance by applying the non-Customer adjustment criteria, and thus adjusting transactions as set forth above, in the event a Member has more than 200 transactions under review concurrently. In summary, due to the extreme level at which the proposal is set, the Exchange believes that the proposal is consistent with section 6(b)(5) of the Act in that it promotes just and equitable principles of trade by encouraging market participants to retain appropriate controls over their systems to avoid submitting a large number of erroneous orders in a short period of time.

Similarly, the Exchange believes that the proposed Size Adjustment Modifier, which would increase the adjustment amount for non-Customer transactions, is appropriate because it attempts to account for the additional risk that the parties to the trade undertake for transactions that are larger in scope. The Exchange believes that the Size Adjustment Modifier creates additional incentives to prevent more impactful Obvious Errors and it lessens the impact

on the contra-party to an adjusted trade. The Exchange notes that these contra-parties may have preferred to only trade the size involved in the transaction at the price at which such trade occurred, and in trading larger size has committed a greater level of capital and bears a larger hedge risk.

The Exchange similarly believes that its Proposed Rule with respect to Catastrophic Errors is consistent with the Act as it affords additional time for market participants to file for review of erroneous transactions that were further away from the Theoretical Price. At the same time, the Exchange believes that the Proposed Rule is consistent with the Act in that it generally would adjust transactions, including Customer transactions, because this will protect against hedge risk, particularly for transactions that may have occurred several hours earlier and thus, which all parties to the transaction might presume are protected from further modification. Similarly, by providing larger adjustment amounts away from Theoretical Price than are set forth under the Obvious Error provision, the Catastrophic Error provision also takes into account the possibility that the party that was advantaged by the erroneous transaction has already taken actions based on the assumption that the transaction would stand. The Exchange believes it is reasonable to specifically protect Customers from adjustments through their limit prices for the reasons stated above, including that Customers are less likely to be watching trading throughout the day and that they may have less capital to afford an adjustment price. The Exchange believes that the proposal provides a fair process that will ensure that Customers are not forced to accept a trade that was executed in violation of their limit order price. In contrast, market professionals are more likely to have engaged in hedging or other trading activity based on earlier trading activity, and thus, are more likely to be willing to accept an adjustment rather than a nullification to preserve their positions even if such adjustment is to a price through their limit price.

The Exchange believes that proposed rule change to adopt the Significant Market Event provision is consistent with section 6(b)(5) of the Act in that it will foster cooperation and coordination with persons engaged in regulating the options markets. In particular, the Exchange believes it is important for options exchanges to coordinate when there is a widespread and significant event, as commonly, multiple options exchanges are impacted in such an event. Further, while the Exchange

recognizes that the Proposed Rule will not guarantee a consistent result for all market participants on every market, the Exchange does believe that it will assist in that outcome. For instance, if options exchanges are able to agree as to the time from which Theoretical Price should be determined and the period of time that should be reviewed, the likely disparity between the Theoretical Prices used by such exchanges should be very slight and, in turn, with otherwise consistent rules, the results should be similar. The Exchange also believes that the Proposed Rule is consistent with the Act in that it generally would adjust transactions, including Customer transactions, because this will protect against hedge risk, particularly for liquidity providers that might have been quoting in thousands or tens of thousands of different series and might have affected executions throughout such quoted series. The Exchange believes that when weighing the competing interests between preferring a nullification for a Customer transaction and an adjustment for a transaction of a market professional, while nullification is appropriate in a typical one-off situation that it is necessary to protect liquidity providers in a widespread market event because, presumably, they will be the most affected by such an event (in contrast to a Customer who, by virtue of their status as such, likely would not have more than a small number of affected transactions). The Exchange believes that the protection of liquidity providers by favoring adjustments in the context of Significant Market Events can also benefit Customers indirectly by better enabling liquidity providers, which provides a cumulative benefit to the market. Also, as stated above with respect to Catastrophic Errors, the Exchange believes it is reasonable to specifically protect Customers from adjustments through their limit prices for the reasons stated above, including that Customers are less likely to be watching trading throughout the day and that they may have less capital to afford an adjustment price. The Exchange believes that the proposal provides a fair process that will ensure that Customers are not forced to accept a trade that was executed in violation of their limit order price. In contrast, market professionals are more likely to have engaged in hedging or other trading activity based on earlier trading activity, and thus, are more likely to be willing to accept an adjustment rather than a nullification to preserve their positions even if such adjustment is to a price through their limit price. In

addition, the Exchange believes it is important to have the ability to nullify some or all transactions arising out of a Significant Market Event in the event timely adjustment is not feasible due to the extraordinary nature of the situation. In particular, although the Exchange has worked to limit the circumstances in which it has to determine Theoretical Price, in a widespread event it is possible that hundreds if not thousands of series would require an Exchange determination of Theoretical Price. In turn, if there are hundreds or thousands of trades in such series, it may not be practicable for the Exchange to determine the adjustment levels for all non-Customer transactions in a timely fashion, and in turn, it would be in the public interest to instead more promptly deliver a simple, consistent result of nullification.

The Exchange believes that proposed rule change related to review, nullification and/or adjustment of erroneous transactions during a trading halt (including the proposed modification to Rule 702), an erroneous print in the underlying security, an erroneous quote in the underlying security, or an erroneous transaction in the option with respect to stop and stop limit orders is likewise consistent with section 6(b)(5) of the Act because the proposal provides for the adjustment or nullification of trades executed at erroneous prices through no fault on the part of the trading participants. Allowing for Exchange review in such situations will promote just and fair principles of trade by protecting investors from harm that is not of their own making. Specifically with respect to the proposed provisions governing erroneous prints and quotes in the underlying security, the Exchange notes that market participants on the Exchange base the value of their quotes and orders on the price of the underlying security. The provisions regarding errors in prints and quotes in the underlying security cover instances where the information market participants use to price options is erroneous through no fault of their own. In these instances, market participants have little, if any, chance of pricing options accurately. Thus, these provisions are designed to provide relief to market participants harmed by such errors in the prints or quotes of the underlying security.

The Exchange believes that the proposed provision related to Linkage Trades is consistent with the Act because it adds additional transparency to the Proposed Rule and makes clear that when a Linkage Trade is adjusted or nullified by another options

exchange, the Exchange will take necessary actions to complete the nullification or adjustment of the Linkage Trade.

The Exchange believes that retaining the same appeals process as the Exchange maintains under the Current Rule is consistent with the Act because such process provides Members with due process in connection with decisions made by Exchange Officials under the Proposed Rule. The Exchange believes that this process provides fair representation of Members by ensuring diversity amongst the members of any Obvious Error Review Panel, which is consistent with sections 6(b)(3) and 6(b)(7) of the Act. The Exchange also believes that the proposed appeals process is appropriate with respect to financial penalties for appeals that result in a decision of the Exchange being upheld because it discourages frivolous appeals, thereby reducing the possibility of overusing Exchange resources that can instead be focused on other, more productive activities. The fees with respect to such financial penalties are the same as under the Current Rule, and are equitable and not unfairly discriminatory because they will be applied uniformly to all Members and are designed to reduce administrative burden on the Exchange as well as market participants that volunteer to participate on Obvious Error Review Panels.

With regard to the portion of the Exchange's proposal related to the applicability of the Obvious Error Rule when the underlying security is in a Limit or Straddle State, the Exchange believes that the proposed rule change is consistent with section 6(b)(5) of the Act because it will provide certainty about how errors involving options orders and trades will be handled during periods of extraordinary volatility in the underlying security. Further, the Exchange believes that it is necessary and appropriate in the interest of promoting fair and orderly markets to exclude from Rule 720 those transactions executed during a Limit or Straddle State.

The Exchange believes the application of the Proposed Rule without the proposed provision would be impracticable given the lack of reliable NBBO in the options market during Limit and Straddle States, and that the resulting actions (*i.e.*, nullified trades or adjusted prices) may not be appropriate given market conditions. The Proposed Rule change would ensure that limit orders that are filled during a Limit State or Straddle State would have certainty of execution in a manner that promotes just and equitable principles

of trade, removes impediments to, and perfects the mechanism of a free and open market and a national market system.

Moreover, given the fact that options prices during brief Limit or Straddle States may deviate substantially from those available shortly following the Limit or Straddle State, the Exchange believes giving market participants time to re-evaluate a transaction would create an unreasonable adverse selection opportunity that would discourage participants from providing liquidity during Limit or Straddle States. In this respect, the Exchange notes that only those orders with a limit price will be executed during a Limit or Straddle State. Therefore, on balance, the Exchange believes that removing the potential inequity of nullifying or adjusting executions occurring during Limit or Straddle States outweighs any potential benefits from applying certain provisions during such unusual market conditions. Additionally, as discussed above, there are additional pre-trade protections in place outside of the Obvious and Catastrophic Error Rule that will continue to safeguard customers.

The Exchange notes that under certain limited circumstances the Proposed Rule will permit the Exchange to review transactions in options that overlay a security that is in a Limit or Straddle State. Specifically, an Official will have authority to review a transaction on his or her own motion in the interest of maintaining a fair and orderly market and for the protection of investors. Furthermore, the Exchange will have the authority to adjust or nullify transactions in the event of a Significant Market Event, a trading halt in the affected option, an erroneous print or quote in the underlying security, or with respect to stop and stop limit orders that have been triggered based on erroneous trades. The Exchange believes that the safeguards described above will protect market participants and will provide the Exchange with the flexibility to act when necessary and appropriate to nullify or adjust a transaction, while also providing market participants with certainty that, under normal circumstances, the trades they effect with quotes and/or orders having limit prices will stand irrespective of subsequent moves in the underlying security. The right to review those transactions that occur during a Limit or Straddle State would allow the Exchange to account for unforeseen circumstances that result in Obvious or Catastrophic Errors for which a nullification or adjustment may be necessary in the interest of maintaining

a fair and orderly market and for the protection of investors. Similarly, the ability to nullify or adjust transactions that occur during a Significant Market Event or trading halt, erroneous print or quote in the underlying security, or erroneous trade in the option (*i.e.*, stop and stop limit orders) may also be necessary in the interest of maintaining a fair and orderly market and for the protection of investors. Furthermore, the Exchange will administer this provision in a manner that is consistent with the principles of the Act and will create and maintain records relating to the use of the authority to act on its own motion during a Limit or Straddle State or any adjustments or trade breaks based on other proposed provisions under the Rule.

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

ISE Gemini believes the entire proposal is consistent with section 6(b)(8) of the Act<sup>20</sup> in that it does not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act as explained below.

Importantly, the Exchange believes the proposal will not impose a burden on intermarket competition but will rather alleviate any burden on competition because it is the result of a collaborative effort by all options exchanges to harmonize and improve the process related to the adjustment and nullification of erroneous options transactions. The Exchange does not believe that the rules applicable to such process is an area where options exchanges should compete, but rather, that all options exchanges should have consistent rules to the extent possible. Particularly where a market participant trades on several different exchanges and an erroneous trade may occur on multiple markets nearly simultaneously, the Exchange believes that a participant should have a consistent experience with respect to the nullification or adjustment of transactions. The Exchange understands that all other options exchanges intend to file proposals that are substantially similar to this proposal.

The Exchange does not believe that the proposed rule change imposes a burden on intramarket competition because the provisions apply to all market participants equally within each participant category (*i.e.*, Customers and non-Customers). With respect to competition between Customer and non-Customer market participants, the Exchange believes that the Proposed

Rule acknowledges competing concerns and tries to strike the appropriate balance between such concerns. For instance, as noted above, the Exchange believes that protection of Customers is important due to their direct participation in the options markets as well as the fact that they are not, by definition, market professionals. At the same time, the Exchange believes due to the quote-driven nature of the options markets, the importance of liquidity provision in such markets and the risk that liquidity providers bear when quoting a large breadth of products that are derivative of underlying securities, that the protection of liquidity providers and the practice of adjusting transactions rather than nullifying them is of critical importance. As described above, the Exchange will apply specific and objective criteria to determine whether an erroneous transaction has occurred and, if so, how to adjust or nullify a transaction.

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

The Exchange has not solicited, and does not intend to solicit, comments on this proposed rule change. The Exchange has not received any unsolicited written comments from members or other interested parties.

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

Because the proposed rule change does not (i) significantly affect the protection of investors or the public interest; (ii) impose any significant burden on competition; and (iii) become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest, the proposed rule change has become effective pursuant to section 19(b)(3)(A) of the Act<sup>21</sup> and Rule 19b-4(f)(6) thereunder.<sup>22</sup>

The Exchange has asked the Commission to waive the 30-day operative delay so that the proposal may become operative immediately upon filing. The Commission believes that waiving the 30-day operative delay is

<sup>21</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>22</sup> 17 CFR 240.19b-4(f)(6). As required under Rule 19b-4(f)(6)(iii), the Exchange provided the Commission with written notice of its intent to file the proposed rule change, along with a brief description and the text of the proposed rule change, at least five business days prior to the date of filing of the proposed rule change, or such shorter time as designated by the Commission.

<sup>20</sup> 15 U.S.C. 78f(b)(8).



consistent with the protection of investors and the public interest, as it will enable the Exchange to meet its proposed implementation date of May 8, 2015, which will help facilitate the implementation of harmonized rules related to the adjustment and nullification of erroneous options transactions across the options exchanges. For this reason, the Commission designates the proposed rule change to be operative upon filing.<sup>23</sup>

At any time within 60 days of the filing of the proposed rule change, the Commission summarily may temporarily suspend such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act. If the Commission takes such action, the Commission shall institute proceedings to determine whether the proposed rule should be approved or disapproved.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

##### *Electronic Comments*

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-ISEGemini-2015-11 on the subject line.

##### *Paper Comments*

- Send paper comments in triplicate to Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549-1090.

All submissions should refer to File Number *SR-ISEGemini-2015-11*. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). 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 Web site viewing and printing in the Commission's Public Reference Room, 100 F Street NE., Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-ISEGemini-2015-11 and should be submitted on or before June 3, 2015.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>24</sup>

**Robert W. Errett,**  
*Deputy Secretary.*

[FR Doc. 2015-11483 Filed 5-12-15; 8:45 am]

**BILLING CODE 8011-01-P**

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-74894; File No. SR-OCC-2015-007]

### Self-Regulatory Organizations; The Options Clearing Corporation; Order Approving Proposed Rule Change To Enhance the Measurement Used To Establish Minimum Capital Requirements for Banks Approved To Issue Letters of Credit

May 7, 2015.

On March 6, 2015, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change SR-OCC-2015-007 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder.<sup>2</sup> On March 25, 2015, the proposed rule change was published for comment in the **Federal Register**.<sup>3</sup> The Commission did not receive any comments on the proposed rule change. This order approves the proposed rule change.

<sup>24</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> Securities Exchange Act Release No. 74536 (March 19, 2015), 80 FR 15846 (March 25, 2015) (SR-OCC-2015-007).

## I. Description

OCC is amending its by-laws and rules in order to enhance the measurement used to establish minimum capital requirements for banks approved to issue letters of credit that may be deposited by clearing members as a form of margin asset. Currently, OCC's Rule 604, Interpretation and Policy .01, requires U.S. banks to have \$100,000,000 or more in shareholders' equity, and non-U.S. banks to have \$200,000,000 or more in shareholders' equity, in order to be approved as an issuer of letters of credit that may be deposited by clearing members to meet their margin obligations at OCC. The purpose of these minimum capital requirements is to ensure that issuers of letters of credit whose letters of credit are deposited at OCC as a margin asset by clearing members have the ability to honor a demand for payment by OCC under such letters of credit should a need to do so arise, such as in the case of a clearing member default.

The financial requirements set forth in OCC's Rule 604 concerning issuers of letters of credit have been in place for many years.<sup>4</sup> However, since OCC adopted Rule 604 and Interpretation and Policy .01 under Rule 604, bank financial reporting standards have changed. Today, bank regulators place a greater emphasis on Tier 1 Capital as opposed to shareholders' equity<sup>5</sup> such that Tier 1 Capital is now considered the primary component of a bank's total regulatory capital.<sup>6</sup> Moreover, OCC notes that Tier 1 Capital is a more conservative measure of a bank's financial health as it ignores subordinated debt, intermediate-term preferred stock, cumulative and long-term preferred stock and a portion of a bank's allowance for loan and lease losses.

OCC believes that by measuring a bank's financial health based on Tier 1 Capital, instead of shareholders' equity, OCC will reduce its credit risk to banks issuing letters of credit deposited by clearing members as a form of margin asset. As stated above, Tier 1 Capital is a more conservative measure of a bank's

<sup>4</sup> See Securities and Exchange Act Release No. 19422 (January 12, 1983), 48 FR 2481 (SR-OCC-1982-08).

<sup>5</sup> Tier 1 Capital is the measure used by the Basel Committee on Banking Supervision to measure the financial health of a bank. The goal of the Basel Committee on Banking Supervision is to strengthen the regulation, supervision and risk management of the banking sector. The Basel Committee on Banking Supervision's most recent set of reform measures, Basel III, is located at: <http://www.bis.org/publ/bcbs189.pdf>.

<sup>6</sup> See <https://www.kansascityfed.org/Publicat/BasicsforBankDirectors/BasicsforBankDirectors.pdf>.

<sup>23</sup> For purposes only of waiving the 30-day operative delay, the Commission has also considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).