

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-60555; File No. SR-CBOE-2009-039)

August 21, 2009

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Approving Proposed Rule Change, as Modified by Amendment No. 1, to Extend the Delta Hedging Exemption From Equity Options Position Limits to Customers

On June 19, 2009, the Chicago Board Options Exchange, Incorporated (“Exchange” or “CBOE”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to extend the delta hedging exemption from equity option position limits to positions of customers who hedge those positions in accordance with a pricing model maintained and operated by The Options Clearing Corporation (“OCC”). On July 8, 2009, CBOE filed Amendment No. 1 to the proposed rule change. The proposed rule change was published for comment in the Federal Register on July 17, 2009.³ The Commission received no comment letters on the proposal. This order approves the proposed rule change, as modified by Amendment No. 1.

In December 2007, the Commission approved a CBOE proposal to create an exemption from position and exercise limits⁴ applicable to equity options (stock options and options on exchange-traded funds) for positions held by CBOE members and certain non-member affiliates

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 60271 (July 9, 2009), 74 FR 34842.

⁴ Rule 4.12 establishes exercise limits for an option at the same level as the option’s position limit under Rule 4.11.

that are “delta neutral”⁵ under a “permitted pricing model”⁶ (“Exemption”).⁷ When a position is not delta neutral, only the option contract equivalent of the net delta⁸ of the position remains subject to the position limits in Rule 4.11.⁹

CBOE now proposes to amend Rule 4.11.04(c) to extend the Exemption to positions of customers of members. Under the proposal, to avail themselves of the Exemption, such customers would be able to hedge their positions only in accordance with the OCC Model.

In connection with this amendment, CBOE proposes to add new subparagraph (4) to Rule 4.11.04(c)(E) to set forth the obligations of a member carrying an account that includes an equity option position for a customer who intends to rely on the Exemption. Specifically, the member

⁵ The term “delta neutral” is defined in Rule 4.11.04(c)(A) as referring to an equity option position that is hedged, in accordance with a permitted pricing model, by a position in the underlying security or one or more instruments relating to the underlying security, for the purpose of offsetting the risk that the value of the option position will change with incremental changes in the price of the security underlying the option position.

⁶ Under Rule 4.11.04(c)(C), “permitted pricing model” for purposes of the Exemption is a pricing model: (1) maintained and operated by the OCC (“OCC Model”); (2) maintained and used by a member or its non-member affiliate subject to consolidated supervision by the Commission pursuant to Appendix E of Rule 15c3-1, 17 CFR 240.15c3-1, under the Act ; (3) maintained and used by a financial holding company (“FHC”) or a company treated as an FHC under the Bank Holding Company Act of 1956, or its affiliate subject to consolidated holding company group supervision; (4) maintained and used by a Commission-registered OTC derivatives dealer; or (5) used by a national bank under the National Bank Act. See Rule 4.11.04(c)(C).

⁷ See Securities Exchange Act Release No. 56970 (December 14, 2007), 72 FR 72428 (December 20, 2007) (SR-CBOE-2007-99) (“Exemption Approval Order”).

⁸ “Net delta” means, at any time, the number of shares (either long or short) required to offset the risk that the value of an equity option position will change with incremental changes in the price of the security underlying the option position. “Options contract equivalent of the net delta” means the net delta divided by the number of shares underlying the options contract. See Rule 4.11.04(c)(B).

⁹ The Commission notes that CBOE Rule 4.11.04 provides for multiple, independent hedge exemptions. Of course, to the extent that a position is used to hedge for the purpose of one exemption from position limit requirements, such as the delta hedge exemption, such position cannot be used to take advantage of another exemption from position limit requirements. See Exemption Approval Order, supra note 7, at note 11.

would be required to obtain from the customer a written certification to the Exchange that the customer is using the OCC Model. In addition, the member would be required to obtain from the customer a written statement confirming that such customer: (a) is relying on the Exemption; (b) will use only the OCC Model for purposes of calculating the net delta of the customer's option positions for purposes of the Exemption; (c) will promptly notify the member if the customer ceases to rely on the Exemption; and (d) in connection with using the OCC Model, has duly executed and delivered to the Exchange such documents as the Exchange may require to be executed and delivered to the Exchange as a condition to reliance on the Exemption.

As under the current Exemption, each member that holds or carries an account that relies on the Exemption is required to report, in accordance with Rule 4.13,¹⁰ all equity option positions (including those that are delta neutral) that are reportable under that rule, and also is required to report on its own behalf or on behalf of a designated aggregation unit¹¹ the net delta and the options contract equivalent of the net delta of such positions for each account that holds an equity option position subject to the delta hedging exemption in excess of the levels specified in Rule 4.11.¹² Members carrying a customer account that relies on the Exemption would be subject to this requirement.

¹⁰ Rule 4.13 requires, among other things, that members report to the Exchange aggregate long or short positions on the same side of the market of 200 or more contracts of any single class of options contracts dealt in on the Exchange.

¹¹ See Rule 4.11.04(c)(D), which provides, under certain conditions, that the net delta of an options position held by an entity entitled to rely on the exemption could be calculated without regard to positions in or relating to the security underlying the option position held by an affiliated entity or another trading unit within the same entity, provided that, among other things, no control relationship exists between such affiliates or trading units and the entity has designated in writing in advance the affiliates or trading units that are to be considered separate and distinct from each other.

¹² See Rule 4.11.04(c)(F).

In addition, the Exchange proposes to amend Rule 4.11.04(c)(G) governing records so that it extends to members carrying customer accounts. Each member relying on the Exemption would be required to retain, and undertake reasonable efforts to ensure that its customers relying on the Exemption retain, a list of the options, securities, and other instruments underlying each option position net delta calculation reported to the Exchange; and to produce such information to the Exchange upon request.¹³

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder that are applicable to a national securities exchange.¹⁴ In particular, the Commission believes that the proposed rule change is consistent with Section 6(b)(5) of the Act,¹⁵ which requires, among other things, that CBOE rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

In approving the current Exemption, the Commission noted its previous statement in support of recognizing options positions hedged on a delta neutral basis as properly exempted from position limits.¹⁶ The Commission believes that it is appropriate and consistent with the Act to extend the current Exemption to customers.

The Commission notes that the Exchange has added provisions to Rule 4.11.04(c)(E)(4), specifically with respect to customers that seek to rely on the Exemption, that obligate members

¹³ See Rule 4.11.04(c)(G).

¹⁴ In approving this rule, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

¹⁵ 15 U.S.C. 78f(b)(5).

¹⁶ See Securities Exchange Act Release No. 40594 (October 23, 1998), 63 FR 59362, 59380 (November 3, 1998) (File No. S7-30-97) (adopting rules relating to OTC derivatives dealers), cited in Exemption Approval Order, supra note 7.

carrying accounts for those customers to obtain from them certain certifications and assurances as described above, including a written statement to the Exchange that the customer has duly executed and delivered to the member such documents as the Exchange may require to be executed and delivered to it.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁷ that the proposed rule change (SR-CBOE-2009-039), as modified by Amendment No. 1, be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁸

Florence E. Harmon
Deputy Secretary

¹⁷ 15 U.S.C. 78s(b)(2).

¹⁸ 17 CFR 200.30-3(a)(12).