SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-62190; File No. SR-CBOE-2010-021)

May 27, 2010

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Approving Proposed Rule Change as Modified by Amendment No. 1 Thereto Relating to Correlated Instrument Delta Hedge Exemption

On March 19, 2010, 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 (i) expand the delta hedging exemption available for equity options position limits; (ii) amend the reporting requirements applicable to members relying on the delta hedging exemption; and (iii) adopt a delta hedging exemption from certain index options position limits. The proposed rule change was published for comment in the Federal Register on April 2, 2010.[3] On May 19, 2010, CBOE filed Amendment No. 1 to the proposal.[4] 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 limits applicable to equity options (stock options and options on exchange-traded funds) for positions held by CBOE members and certain non-member affiliates

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 See Securities Exchange Act Release No. 61785 (March 25, 2010), 75 FR 16888.

4 Amendment No. 1 deleted the word "or" from the rule text of the proposal and deleted a footnote from the purpose section and Exhibit 1 of the proposal. Because the amendment does not affect the substance of the rule filing, the amendment does not require notice and comment.

that are delta neutral[5] under a "permitted pricing model"[6] ("Equity Exemption").[7] When a position is not delta neutral, only the option contract equivalent of the net delta[8] of the position remains subject to the position limits in Rule 4.11. Currently, the Equity Exemption is available only for securities that directly underlie the applicable option position. For example, with respect to options on exchange-traded funds ("ETF options"), index options overlying the same index on which the ETF is based currently cannot be combined with the ETF options to calculate a net delta for purposes of the Equity Exemption.

The proposed rule change would expand the Equity Exemption by permitting equity option positions for which the underlying security is an ETF that is based on the same index as an index option to be combined with any position in the underlying ETF as well as any position in an index option and/or a correlated instrument for calculation of the Equity Exemption.[9] The

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[5] "Delta neutral" is defined as a precise term for purposes of the Equity Exemption in Rule 4.11.04(c)(A).

[6] Under Rule 4.11.04(c)(C), "permitted pricing model" for purposes of the Equity Exemption is a pricing model: (1) maintained and operated by the Options Clearing Corporation ("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.

[7] See Securities Exchange Act Release No. 56970 (December 14, 2007), 72 FR 72428 (December 20, 2007) (SR-CBOE-2007-99) ("Exemption Approval Order"). In August 2009, the Commission approved a CBOE proposal to extend the Equity Exemption to customers. See Securities Exchange Act Release No. 60555 (August 21, 2009), 74 FR 43741 (August 27, 2009) (SR-CBOE-2009-39). The Commission notes that the Equity Exemption is not currently available to customers. See Securities Exchange Act Release No. 61857 (April 7, 2010), 75 FR 18931 (April 13, 2010) (SR-CBOE-2010-30).

[8] "Net delta" is defined as a precise term for the purposes of the Equity Exemption in Rule 4.11.04(c)(B).

[9] However, this would not include baskets of securities for purposes of the delta hedging exemptions.

term "correlated instrument" would be defined to mean securities and/or other instruments that track the performance of or are based on the same underlying index as the index underlying the option position. Thus, the proposed rule change would allow financial products such as securities index options, index futures, and options on index futures to be included along with the ETF in an equity option's net delta calculation.[10]

To accommodate the use of index options and correlated instruments in the calculation of the Equity Exemption, the Exchange proposes to amend the definition of "net delta" in Rule 4.11.04(c)(B) to mean, at any time, the number of shares and/or other units of trade (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, as determined in accordance with a permitted pricing model. The Exchange also proposes to amend the definition of the "option contract equivalent of the net delta" to mean the net delta divided by the number of shares that equate to one option contract on a delta basis. Index options and equity options (i.e., ETF options) that are eligible to be combined for computing a delta-based hedge exemption, along with all securities and/or other instruments that are based on or track the performance of the same underlying security or index, will be grouped and the net delta and options contract equivalent of the net delta will be calculated for each respective option class based on offsets realized from the grouping as a whole.

In another aspect of the proposal, CBOE proposes to relieve Exchange Market-Makers and Designated Primary Market-Makers ("DPMs") using the OCC Model from the reporting

10 For example, the proposed rule would allow options on Standard & Poor's Depositary Receipts ("SPY"), which tracks the performance of the S&P 500 index, to be hedged not only with SPY shares, but with S&P 500 options, S&P 500 futures, options on S&P 500 futures or any other instrument that tracks the performance of or is based on the S&P 500 index.

requirements of the Equity Exemption because, as explained by CBOE, Market-Maker and DPM position and delta information can be accessed through the Exchange's market surveillance systems. The Exchange noted that this proposal is consistent with similar exemptions from the reporting requirements under Rule 4.13 and those applicable to broad-based index options and FLEX options.

Finally, CBOE proposes to adopt an exemption from position and exercise limits[11] for positions in index options[12] held by CBOE members, certain of their affiliates, and customers that are delta neutral[13] under a permitted pricing model ("Index Exemption").[14] The options contract equivalent of the net delta[15] of such position would be subject to the appropriate position limit (subject to the availability of any other position limit exemptions).[16]

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11 Exchange Rule 24.5 establishes exercise limits for an index option at the same level as the index option's position limit under index options position limit rules, therefore no changes are proposed to Rule 24.5.

12 The Index Exemption would apply to broad-based index options as well as industry index options. See proposed Rules 24.4.05 and Rule 24.4A.03.

13 The term "delta neutral" would be defined as referring to an index option position that is hedged, in accordance with a permitted pricing model, by a position in one or more correlated instruments for the purpose of offsetting the risk that the value of the option position will change with incremental changes in the value of the underlying index. The term "correlated instruments" would be defined to mean securities and/or other instruments that track the performance of or are based on the same underlying index as the index underlying the option position. See proposed Rules 24.4.05(A). These definitions would allow financial products such as ETF options, index futures, options on index futures and ETFs that track the performance of or are based on the same underlying index to be included in an index option's net delta calculation.

14 The terms "delta neutral," "permitted pricing model," and "options contract equivalent of the net delta" would be defined for the Index Exemption similar to the way these terms are defined for the Equity Exemption; with appropriate adjustments. See id. and infra note 15.

15 For purposes of the Index Exemption, the term "options contract equivalent of the net delta" would be defined as the net delta divided by "units of trade that equate to one option contract on a delta basis," and the term "net delta" would be defined as, at any time, the number of shares "and/or other units of trade (either long or short)" required to offset the risk that the value of an index option position will change with incremental

A member that intends to employ, or whose non-member affiliate or customer intends to employ, the Index Exemption would be required to provide a written certification to CBOE stating that the member, its affiliate, and/or its customer will use a permitted pricing model.[17] In addition, members that carry an account that includes an index option position for a non-member affiliate would be required to obtain and provide to the Exchange a written statement from the non-member affiliate confirming that the affiliate: (1) is relying on this exemption; (2) will use only a permitted pricing model for purposes of calculating the net delta of its option positions for purposes of this exemption; (3) will promptly notify the member if it ceases to rely on this exemption; (4) authorizes the member, upon request, to provide to the Exchange or the Options Clearing Corporation such information regarding positions of the non-member affiliate as part of the Exchange's confirmation or verification of the accuracy of the net delta calculation under this exemption; and (5) if the non-member affiliate is using the OCC Model, has duly executed and delivered to the member such documents as the Exchange may require as a condition to reliance

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changes in the value of the underlying index, as determined in accordance with a permitted pricing model.

[16] See proposed Rule 24.4.05(B). The Commission notes that Rule 24.4 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 Index Exemption, such position cannot be used to take advantage of another exemption from position limit requirements.

[17] See proposed Rule 24.4.05(E)(1)(i), (3)(i), and (4)(i). The Commission notes that customers relying on the Index Exemption would be permitted to hedge their positions only in accordance with the OCC Model. See proposed Rule 24.4.05(A). In addition, the Commission notes that, consistent with the Equity Exemption, the Exchange will not make the Index Exemption available to customers until the Exchange provides a representation to the Commission's Office of Compliance Inspections and Examinations that it can adequately surveil for such a customer exemption. Telephone conversation between Andrew Spiwak, Director Legal Division and Chief Enforcement Attorney, CBOE, and Theodore S. Venuti, Special Counsel, Division of Trading and Markets, Commission, on May 27, 2010. See also supra note 7.

on this exemption.[18] Members that carry an account that includes an index option position for a customer would be required to obtain and provide to the Exchange a written statement from the customer confirming that the customer: (1) is relying on this exemption; (2) will use only the OCC Model for purposes of calculating the net delta of the customer's options positions for purposes of this exemption; (3) will promptly notify the member if the customer ceases to rely on this exemption; and (4) in connection with using the OCC Model, has duly executed and delivered to the member such documents as the Exchange may require as a condition to reliance on this exemption.[19]

Furthermore, any member would be required to report, in accordance with Rule 4.13, all index options positions (including those that are delta neutral) that are reportable under that rule, and also would be required to report on its own behalf or on behalf of a designated aggregation unit[20] the net delta and options contract equivalent of the net delta of such positions for a each account that holds an index option position subject to the delta hedging exemption in excess of the levels specified in 24.4 (and Rule 24.4A, in the case of industry index options).[21] Each member relying on the exemption would be required to retain, and undertake reasonable efforts to ensure that its non-member affiliates or customers relying on the exemption retain, a list of the options, securities, and other instruments underlying each option position net delta calculation

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18 See proposed Rule 24.4.05(E)(3)(ii).

19 See proposed Rule 24.4.05(E)(4)(ii).

20 See proposed Rule 24.4.05(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 correlated instruments 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.

21 See proposed Rule 24.4.05(F). See also supra note 12.

reported to the Exchange; and to produce such information to the Exchange upon request.[22] In addition, the options positions of a non-member relying on the exemption would be required to be carried by a member with which it is affiliated.[23]

The Exchange will announce the operative date of the proposed rule change in a regulatory circular to be published no later than 60 days after Commission approval. The operative date shall be no later than 30 days after publication of the regulatory circular.

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.[24] In particular, the Commission believes that the proposed rule change is consistent with Section 6(b)(5) of the Act,[25] 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 Equity 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.[26] The Commission believes that it is appropriate and consistent with the Act to expand the Equity Exemption to allow the use of correlated instruments in determining whether an ETF options position is delta neutral. The Commission further believes that it is

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[22] See proposed Rule 24.4.05(G).

[23] See proposed Rule 24.4.05(E)(2).

[24] 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).

[25] 15 U.S.C. 78f(b)(5).

[26] 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.

appropriate and consistent with the Act to establish a delta based index options hedge exemption from position limits. Finally, the Commission believes that it is reasonable for CBOE to exempt Exchange Market-Makers and DPMs using the OCC Model from the reporting requirements of the Equity Exemption, and not to include them as subject to the reporting requirements of the Index Exemption, because the Exchange can access the information through the Exchange's market surveillance systems.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[27] that the proposed rule change (SR-CBOE-2010-021), 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.[28]

Florence E. Harmon
Deputy Secretary

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27 15 U.S.C. 78s(b)(2).

28 17 CFR 200.30-3(a)(12).