SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-67624; File No. SR-CBOE-2012-040)

August 8, 2012

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Granting Approval of Proposed Rule Change Related to Permanent Approval of its Pilot on FLEX Minimum Value Sizes

I. Introduction

On April 25, 2012, 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 relating to permanent approval of its pilot program eliminating Flexible Exchange Option ("FLEX Option") minimum value sizes. The proposed rule change was published for comment in the Federal Register on May 11, 2012.[3] The Commission received no comments on the proposal. The Exchange consented to an extension of the time period for the Commission to approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether the proposed rule change should be disapproved, to August 9, 2012. CBOE filed Amendment No. 1 to the proposed rule change, in order to transmit a pilot report, on August 6, 2012.[4] This order approves the proposed rule change.

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

2 17 CFR 240.19b-4.

3 See Securities Exchange Act Release No. 66934 (May 7, 2012), 77 FR 27822 (May 11, 2012) ("Notice").

4 In Amendment No. 1, CBOE submitted as Exhibit 3 to its proposal an annual report summarizing pilot data collected for the year 2011, the most recent complete year of the pilot program ("Pilot Report"). Specifically, the Pilot Report summarizes the open interest and trading volume in FLEX Option transactions opened during the year 2011 with a size below the minimum value thresholds in force before the pilot, as well as the types of customers initiating such transactions.

II. Description of the Proposal

FLEX Options, unlike traditional standardized options, allow investors to customize basic option terms, including size, expiration date, exercise style, and certain exercise style prices within certain parameters as set forth in CBOE's rules.[5] CBOE currently has in place a pilot program under which there is no minimum value size requirement for FLEX Option transactions ("Pilot Program") which, practically, allows FLEX Option trades to be initiated at levels as low as one contract.[6] CBOE is proposing to make the Pilot Program permanent.

Prior to the Pilot Program, the minimum value size for an opening transaction in any FLEX series without open interest was: (1) for FLEX Equity Options,[7] the lesser of 250 contracts or the number of contracts overlying $1 million in the underlying securities;[8] and (2) for FLEX Index Options,[9] $10 million Underlying Equivalent Value.[10] Additionally, the

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5 See Notice, supra note 3; see also CBOE Rules 24A.1(d) and 24B.1(d).

6 See CBOE Rules 24A.4.01(b), 24B.4.01(b); Securities Exchange Act Release Nos. 61439 (January 28, 2010), 75 FR 5831 (February 4, 2010) (SR-CBOE-2009-087) (approving establishment of pilot program); 61676 (March 9, 2010), 75 FR 13191 (March 18, 2010) (SR-CBOE-2010-026) (technical rule change to include original pilots' conclusion date of March 28, 2011 in the rule text); 64110 (March 24, 2011), 76 FR 17463 (March 29, 2011) (SR-CBOE-2011-024) (extending the pilots through March 30, 2012); and 66701 (March 30, 2012), 77 FR 20673 (April 5, 2012) (SR-CBOE-2012-027) (extending the pilots through the earlier of November 2, 2012 or the date on which the respective pilot program is approved on a permanent basis). There is also a CBOE pilot program currently in place that eliminates certain restrictions on the exercise settlement values for FLEX index options. Although that exercise settlement value pilot was originally approved along with the Pilot Program, it is not part of this proposal.

7 See CBOE Rules 24A.1(e) and 24B.1(f) (defining "FLEX Equity Option").

8 Under a different pilot program, superseded by the pilot that CBOE now seeks to make permanent, the 250-contract minimum for Flex Equity Options was reduced to 150 contracts. See Securities Exchange Act Release No. 57429 (March 4, 2008), 73 FR 13058 (March 11, 2008) (order approving SR-CBOE-2006-36).

9 See CBOE Rules 24A.1(f) and 24B.1(g) (defining "FLEX Index Option").

10 See CBOE Rules 24A.4(a)(4)(ii) and 24B.4(a)(5)(ii); see also CBOE Rules 24A.1(q) and 24B.1(z) (defining "Underlying Equivalent Value").

minimum value size for a transaction in any currently-opened FLEX series was: (1) for FLEX Equity Options, the lesser of 100 contracts or the number of contracts overlying $1 million in the underlying securities, and 25 contracts in the case of closing transactions; (2) for FLEX Index Options, $1 million Underlying Equivalent Value in the case of both opening and closing transactions; or (3) in either case, the remaining underlying size or Underlying Equivalent Value on a closing transaction, whichever is less.[11] There were also, prior to the Pilot Program, minimum value size requirements applicable to FLEX Quotes[12] responsive to a Request for Quotes,[13] including certain minimum value size requirements that specifically applied to FLEX Appointed Market Makers and FLEX Index Appointed Market Makers.[14]

CBOE's proposal will make permanent the Pilot Program eliminating these minimum value sizes by deleting CBOE Rules 24A.4(a)(4), 24A.4.01(b), 24B.4(a)(5), and 24B.4.01(b), as well as by deleting cross-references in Rules 24A.9(b) and 24B.9(c) that applied the minimum value size requirements in Rules 24A.4(a)(4)(iv) and 24B.4(a)(5)(iv) to FLEX Quotes entered by FLEX Appointed Market Makers or FLEX Qualified Market Makers.[15]

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11 See CBOE Rules 24A.4(a)(4)(iii) and 24B.4(a)(5)(iii).

12 See CBOE Rules 24A.1(h) and 24B.1(k) (defining "FLEX Quote").

13 See CBOE Rules 24A.1(n) and 24B.1(r) (defining "Request for Quotes").

14 See CBOE Rules 24A.4(a)(4)(iv) and 24B.4(a)(5)(iv); see also CBOE Rules 24A.9 and 24B.9 (defining and describing FLEX Qualified Market Makers and FLEX Appointed Market Makers).

15 As a technical change, CBOE also proposes to relocate certain language from the provisions that would be deleted by its proposal. Specifically, CBOE proposes to move from Rules 24A.4(a)(4)(i) and 24B.4(a)(5)(i) to Rules 24A.4(a)(2)(iv) and 24B.4(a)(2)(iv), respectively, language setting an expiration date maximum term of fifteen years for FLEX Requests for Quotes, FLEX Orders and FLEX Option contracts. CBOE also proposes to move from Rule 24B.4(a)(5)(iv) to Rule 24B.9(c) language regarding the minimum percentage of Requests for Quotes in response to which FLEX Appointed Market Makers must provide a FLEX Quote.

III. Discussion and Commission Findings

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.[16] In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,[17] which requires, among other things, that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, 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; and not be designed to permit unfair discrimination between customers, issuers, brokers or dealers.

FLEX Options were originally designed for use by institutional and high net worth customers, rather than retail investors.[18] In approving the Pilot Program, while the Commission noted that it had received several comment letters stating that the proposal would assist institutional customers, it also noted that the elimination of the minimum value size requirements

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

17 15 U.S.C. 78f(b)(5).

18 See Securities Exchange Act Release Nos. 31920 (February 24, 1993), 58 FR 12280 (March 3, 1993) (order approving SR-CBOE-92-17); 57429 (March 4, 2008), 73 FR 13058 (March 11, 2008) (order approving SR-CBOE-2006-36). As noted in the Options Disclosure Document ("ODD"), which explains the characteristics and risks of exchange-traded options, flexibly structured options may be useful to sophisticated investors seeking to manage particular portfolio and trading risks. Rule 9b-1 under the Act requires that broker-dealers furnish the ODD to a customer before accepting an order from the customer to purchase or sell an option contract relating to an options class that is the subject of the ODD, or approving the customer's account for the trading of such option. See 17 CFR 240.9b-1(d).

raised the possibility that retail customers would access the FLEX Options market.[19] One of the risks to retail investors outlined in the ODD[20] is that, because of the customized nature of FLEX Options and lack of continuous quotes, trading in FLEX Options is often less deep and liquid than trading in standardized options on the same underlying interest.[21] Additionally, the Commission observed, in approving the Pilot Program, that reducing the minimum value size for opening FLEX Option transactions increases the potential for the FLEX Options market to act as a surrogate for the standardized options market, and expressed its concern in this regard because the standardized market contains certain protections for investors not present in the FLEX Options market.[22] The Commission stated that, in the event the Exchange proposed making the Pilot Program permanent, information regarding the types of customers initiating opening FLEX Options transactions during the Pilot Program, to be compiled and submitted to the Commission by CBOE as part of its monitoring of the Pilot Program, would enable the Commission to evaluate how market participants have responded to the Pilot Program and what types of customers are using the FLEX Options market.[23]

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19 See Securities Exchange Act Release No. 61439 (January 28, 2010), 75 FR 5831 (February 4, 2010) (SR-CBOE-2009-087) ("Pilot Approval Order").

20 See supra note 18.

21 In particular, the ODD states that because many of the terms of FLEX Options are not standardized, it is less likely that there will be an active secondary market in which holders and writers of such options will be able to close out their positions by offsetting sales and purchases. Also, the ODD states that certain margin requirements for positions in flexibly structured options may be significantly greater than the margin requirements applicable to similar positions in other options on the same underlying interest.

22 See Pilot Approval Order, supra note 19. In particular, the Commission noted that continuous quotes may not always be available in the FLEX Options market and that FLEX Options do not have trading rotations at either the opening or closing of trading. Id.

23 Id. CBOE has submitted the Pilot Report as well as other, confidential reports of data collected during the Pilot Program. See Notice, supra note 3; see also Amendment No. 1, supra note 4.

Based on the Pilot Report that CBOE provided to the Commission, the significant majority of FLEX Option transactions with small value sizes have been initiated by institutional customers, while, at the same time, retail investor participation in such transactions has remained extremely low.[24] For example, the Pilot Report states that of the 551 FLEX Option transactions for non-broker-dealer customers that were initiated below the pre-pilot minimum value size requirement, 550 were initiated for the accounts of institutional customers.[25] Based on this usage, CBOE has stated that it believes that there is sufficient investor interest and demand to make the Pilot Program permanent.[26]

On balance, the Commission believes that it is consistent with the Act to make the Pilot Program permanent. Given the current level of retail usage, the potential concerns regarding exposing less sophisticated investors to the FLEX Options market are minimized. The protections noted below, including heightened options suitability requirements, should help to address any concerns about the potential for increased retail participation in the FLEX Options market. Moreover, the Commission is not aware of data or analysis suggesting that the trading of FLEX Options has acted as a surrogate for the trading of standardized options on CBOE as a result of the Pilot Program.

Existing safeguards – such as position reporting requirements and margin requirements – will continue to apply to FLEX Options.[27] Further, as noted above, under Rule 9b-1 under the

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24 See Pilot Report, supra note 4.

25 Id.

26 Id.

27 Certain FLEX Options such as, for example, narrow-based index FLEX options, have exercise and position limits, but other FLEX Options do not. See CBOE Rules 24A.7, 24A.8, 24B.7 and 24B.8.

Act,[28] all customers of a broker-dealer with options accounts approved to trade FLEX Options must receive the ODD, which contains specific disclosures about the characteristics and special risks of trading FLEX Options.[29] In addition, similar to other options, FLEX Options are subject to Trading Permit Holder supervision and suitability requirements, such as in CBOE Rules 9.8 and 9.9.[30] The Commission believes that these safeguards are reasonably designed to help mitigate potential risks for retail and other investors of investing in FLEX Options.

CBOE also believes that permanently removing the minimum value size requirements for FLEX Options will give investors a more viable, exchange-traded alternative to customized options in the OTC market, which are not subject to minimum value size requirements.[31] Furthermore, CBOE has represented that broker-dealers have indicated to CBOE that the minimum value size requirements have prevented them from bringing transactions on the Exchange that are already taking place in the OTC market.[32] Therefore, it appears possible that permanent approval of the Pilot Program could further incent trading interest in customized options to move from the OTC market to CBOE. To the extent investors choose to trade FLEX Options on CBOE in lieu of the OTC market as a result of the permanent removal of the minimum value size requirements, such action should benefit investors. As the Commission has previously noted, there are certain benefits to trading on an exchange, such as enhanced efficiency in initiating and closing out positions, increased market transparency, and heightened

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28 17 CFR 240.9b-1.

29 See supra note 18.

30 See Notice, supra note 3.

31 Id.

32 Id.

contra-party creditworthiness due to the role of the Options Clearing Corporation as issuer and guarantor of FLEX Options.[33]

IV. Conclusion

In summary, the Commission believes, for the reasons noted above, that the proposed rule change to permanently approve the Pilot Program is consistent with the Act and Section 6(b)(5) thereunder in particular, and should be approved. The Commission expects CBOE to continue to monitor the usage of FLEX Options and review whether changes need to be made to its rules or the ODD to address any changes in retail FLEX Option participation or any other issues that may occur as a result of the elimination of the minimum value sizes on a permanent basis.

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33 See Securities Exchange Act Release No. 57429 (March 4, 2008), 73 FR 13058 (March 11, 2008) (order approving SR-CBOE-2006-36).

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[34] that the proposed rule change (SR-CBOE-2012-040) be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[35]

Kevin M. O'Neill
Deputy Secretary

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34 15 U.S.C. 78s(b)(2).

35 17 CFR 200.30-3(a)(12).