

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-56378; File No. SR-CBOE-2006-90)

September 10, 2007

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of a Proposed Rule Change and Amendment No. 1 Thereto to Trade Delayed Start Option Series

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ and Rule 19b-4 thereunder,² notice is hereby given that on November 7, 2006, the Chicago Board Options Exchange, Incorporated (“CBOE” or “Exchange”), filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been substantially prepared by CBOE. On September 5, 2007, the Exchange filed Amendment No. 1 to the proposed rule change.³ The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

The Exchange proposes to introduce for trading a new type of option, called Delayed Start Option SeriesTM (“DSO”). CBOE proposes to be able to list a DSOTM on any security index option that is already approved for trading on the Exchange. The text of the proposed rule change is available on the Exchange’s Web site (<http://www.cboe.com>), at the Office of the Secretary, CBOE and at the Commission.

II. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, CBOE included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 1 replaces the original filing in its entirety.

rule change. The text of these statements may be examined at the places specified in Item IV below. CBOE 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

The Exchange currently lists and trades standardized options. Options are standardized in that at the inception of trading, the terms of the option contracts are typically uniform and fixed, such as the expiration date, the exercise style (American or European), strike price, settlement feature (cash vs. physical), etc.⁴ The Exchange proposes to introduce for trading a new type of security index option product called Delayed Start Option Series (“DSOs”). DSOs will possess all of the characteristics of existing index options with one variation: at the commencement of trading of a particular DSO, and until a predetermined date (the “strike setting date”), there will be no set exercise price. Instead, prior to the opening of the particular DSO series, a pre-established methodology will be applied to determine the strike price of the DSO. In addition, prior to the opening of the particular DSO series, the Exchange will fix the expiration date of the DSO and the date on which the exercise price will be established (the strike setting date). The methodology, as well as the purpose of DSOs, is described in greater detail below.

Volatility

The DSO is designed primarily to allow customers to manage risk associated with the volatility of a particular security index. Volatility is one of the most important determinants of an option's price, because any change in the volatility of a security will consequently change the

⁴ Cf. Flex Options, which allow parties to designate certain terms of the transaction.

price of a standard index option contract. Consequently, any time an investor takes a position in a standard index option contract, that investor will necessarily be exposed to the volatility of the level (or calculated value) of the underlying security or security index.

The effect of a change in volatility on the price of an option contract is quantified by what is referred to as an option's vega (or volatility exposure). Vega is derived from the formula used to price options and is itself dependent on factors that contribute to an option's price. The two major determinants of an index option's vega are the relationship between an option's strike price and the level of the underlying index and the amount of time left until the option matures.

DSOs have been designed to address the dependence of an index option's vega on the relationship between the option's strike price and the underlying index level. Generally, an at-the-money option has the highest vega because an at-the-money option has the greatest uncertainty as to whether it will expire in- or out-of-the-money. DSOs will be useful tools to manage volatility risk because prior to the strike setting date, the DSO's price will be most sensitive to changes in implied volatility, and changes in the index level will have less impact on a DSO's price. The introduction of DSOs will provide members and investors with an exchange-traded product to assist them in managing the risks associated with changes in volatility. CBOE believes that providing a standardized contract with transparent markets and the guarantee of a clearinghouse (i.e., The Options Clearing Corporation ("OCC")) will benefit investors.

Product Description

DSOs will be identical to other options series that currently trade except that instead of specifying a specific index value number for the exercise price, the exercise price will be specified in terms of a specific method for fixing such a number. This method will provide that the strike price is fixed based on the closing value of the underlying index on a predetermined

strike setting date prior to expiration. The particular strike setting date will be specified at the time the DSO is initially opened for trading and will be no sooner than one month, and no later than twelve months, after the series' opening. The particular expiration date will also be specified at the time the DSO is initially opened for trading and will be no later than what is currently permitted under CBOE rules.⁵

Initially, CBOE will establish the strike setting dates for all series of DSOs at three months prior to the option's expiration date. Each DSO series that is issued as such will trade without an exercise price until three months prior to expiration, at which point the option's exercise price will be fixed based on the underlying index's closing price. After the strike setting date, and up until the expiration date, the DSO will trade the same as any other option in the same index class.

The Exchange may determine to issue series of DSOs with more or less time than three months between the strike setting date and expiration date. As indicated above, the particular strike setting date and the expiration date, and thus the corresponding length of the interval between the strike setting date and expiration, will be set prior to issuance of each particular series. No changes to any terms of existing DSO series will be made once the series commences trading.

There are two primary reasons for varying the length of time between the strike setting date and expiration. First, the volatility implied by an option's price varies mainly with strike price and time to expiration. The volatility implied by an option with four months to expiration can be different than that implied by an option with three months to expiration. Second, not

⁵ Presently, the longest term for an option series expiration is thirty-nine months from the listing date. See Rule 5.8(a) and proposed Rule 24.9(d)(2).

only does the implied volatility vary with strike price and time to expiration but changes in the level of implied volatility also vary with strike price and time to expiration. For example, the implied volatility of a one-month at-the-money call option could change without a corresponding change in the implied volatility of a three-month at-the-money call option. This has implications for the usefulness of DSOs in hedging the risk of changes in implied volatility.

To illustrate, if an investor has a long position in three-month, non-DSO, at-the-money options and wishes to hedge against changes in implied volatility, a DSO with one-month between the strike setting date and the expiration date would not always provide a useful hedge. A DSO with three months between the strike setting and expiration dates, would primarily be sensitive to changes in the implied volatility of a three-month option, however, which allows the investor to more precisely achieve the desired hedge.

Establishment of Strike Price

On the strike setting date, the DSO is assigned an at-the-money, in-the-money or out-of-the-money strike price. A DSO's exercise price will be fixed based on the closing value of the underlying index on the strike setting date, rounded to the nearest one-eighth (.125) value, or such smaller value as the Exchange may designate at the time the DSO is listed, provided that the value cannot be smaller than 0.01.⁶ For example, using a one-eighth interval, if the SPX closes at 1004.12 on the strike setting date, the DSO would be assigned a strike price of 1004.125. After the strike setting date, the DSO will trade the same as other options until expiration. As discussed above, at-the-money options generally have the greatest sensitivity to changes in

⁶ Because of system limitations, the Exchange currently plans to round DSO exercise prices to the nearest .125. However, should the system functionality permit it in the future, the Exchange wants the flexibility to be able to determine to round DSO exercise prices to a smaller value, provided that the particular increment would be designated at the time the DSO is listed and that it would not be any smaller than 0.01.

implied volatility. DSOs will be useful to manage volatility risk because, prior to the strike setting date, the DSO's price will be most sensitive to changes in implied volatility. Because these DSOs are always "at-the-money" prior to the strike setting date, changes in the index level will have less impact on an at-the-money DSO's price.

The Exchange also plans to list in- or out-of-the money DSOs. These types of DSOs would trade in the exact same manner as at-the-money DSOs, except that the strike price would be set to a predetermined level either in- or out-of-the-money on the strike setting date (e.g., 5% in-the-money, 5% out-of-the-money). For example, if the Exchange determines to list a 5% out-of-the-money DSO on the S&P 500® Index ("SPX") and the SPX closes at 1000 on the strike setting date, the strike price would be established at 1050. The amount by which the strike price of an in- or-out-of-the money DSO series will be set in- or out-of-the-money on the strike setting date will be announced prior to the inception of trading of that particular series and will not change thereafter.

There are two purposes for listing strike prices that are in- or out-of-the-money. First, DSOs may be useful to investment managers who follow covered call writing programs. These managers typically sell out-of-the-money call options. Therefore, out-of-the-money DSOs would be of more interest to them. Second, implied volatility and changes in implied volatility vary by strike price. Therefore, market participants may desire the ability to trade the volatility exposure of an index option that is not at-the-money because it may better match these participants' volatility exposure.

Exercise Style

All DSOs will feature European-exercise style until the strike setting date (i.e., the option contract cannot be exercised during this period). After the strike setting date, the DSO will be subject to the exercise style (e.g., American or European) of the particular index option class. Most index options, including the SPX, DJX, XEO, and NDX,⁷ already feature European-style exercise. OEX options feature American-style exercise.⁸ Accordingly, on the strike setting date, DSOs on the OEX will be subject to an American-style exercise. This is reflected in newly proposed Rule 24.9(d)(1). The period during which exercise is restricted will depend upon the particular DSO's strike setting date, expiration date and expiration style. For instance, if a DSO that is subject to an American-style exercise is issued with a nine-month expiration and a strike setting date fixed at three-months prior to expiration, the period of non-exercise will be six months.⁹

Trading Increments, Margin, and Trading Symbols

The Exchange proposes to list DSO puts to correspond with each DSO call in a particular index option class. As with all other options, the premium quotation would be stated in

⁷ The following are the correlating underlying indexes for each listed option class: (1) Standard and Poor's 100 Stock Index ("XEO") (European-style exercise); (2) Standard and Poor's 500 Stock Index ("SPX"); (3) Nasdaq 100 Stock Index ("NDX"); and (4) Dow Jones Industrial Average Index ("DJX").

⁸ CBOE lists both European-and American-style exercise options on the Standard & Poor's 100 Stock Index. European-style index options trade under the symbol XEO while American-style options trade under the symbol OEX. Except as noted otherwise, references in this filing to "OEX" include the XEO series.

⁹ Similarly, a DSO that is subject to European-style exercise with a nine-month expiration and a strike setting date fixed at three months prior to expiration would have a nine-month period of non-exercisability. The strike setting interval would be made and publicly announced prior to inception of trading of that particular DSO series. No changes to any terms of existing DSO series will be made once the series trades (with the exception of the establishment of the exercise price).

decimals, and one point would equal \$100. The minimum tick for options trading below \$3.00 would be 0.05 (\$5.00) and for all other series, 0.10 (\$10.00).

DSOs in any particular index option class will be treated the same as any other options on the same index for the purpose of determining customer margin.¹⁰ Therefore, a buyer of DSOs would have to pay the premium in full, while a seller will have to put up the entire premium, plus 15% of the underlying value for a broad-based index option, or the premium plus 20% for a narrow-based or micro narrow-based index option. Thus, for example, since an at-the-money DSO will always be at-the-money prior to the strike setting date, customer margin for the short will always be the premium plus 15% (20%) of the underlying value. Following the strike setting date, customer margin may be less than 15% (20%) of the underlying value based on the amount the option is out-of-the-money at that time.

Prior to the strike setting date, margin on any DSO will be based on the then-current level of the underlying index. For example, a DSO whose strike price will be set to be at-the-money will be margined as an at-the-money option in the same index option class prior to the strike setting date, because prior to the strike setting date the DSO's price will be directly related to the price of an at-the-money option. Prior to the strike setting date, in- and out-of-the-money DSOs will be margined the same as any other in- and out-of-the-money options in the same index option class.

Prior to the strike setting date, DSOs will be distinguished from existing options by a unique root symbol and a special strike price code designating an at-the-money, in-the-money or

¹⁰ See Rule 12.3. However, the Exchange does not initially plan to permit spread margining between DSO and non-DSO options for the time period between the initial listing of a DSO and its strike setting date. The Exchange intends to consider what spread margin would be appropriate and address the subject under a separate rule filing.

out-of-the-money option. The Exchange presently intends to trade the DSO series under separate symbols from other option series on the same index option class. The Exchange notes that this is identical to how options on the SPX traded when the Exchange began listing both A.M. and P.M.-settled SPX option series.¹¹ The exact exercise price, and a unique DSO strike price code, will be fixed on the strike setting date pursuant to the method established at the time the option series was originally opened for trading. The strike price code will specify the exact strike price of the particular DSO option series (rounded to the nearest eighth or smaller increment, if applicable).

Position and Exercise Limits

Positions in any DSO will be subject to the same rules governing position and exercise limits upon other options in the same index option class and, for the purposes of determining position limits, DSO positions will be aggregated with positions in other series of the same option class.¹² Similarly, members and member organizations trading in DSOs will continue to be subject to the same reporting requirements and margin and clearing firm requirements as provided under Interpretation and Policy .03 and .04 to Rule 24.4.

¹¹ See Securities Exchange Act Release No. 30944 (July 21, 1992), 57 FR 33376 (July 28, 1992)(order approving SR-CBOE-92-09).

¹² See CBOE Rules 4.11, 4.12, 24.4, 24.4A, and 24.4B. In addition, the Exchange is proposing to clarify in Rule 24.4B, Position Limits for Options on Micro Narrow-Based Indexes as Defined Under Rule 24.2(d), that position in Short Term Option Series and Quarterly Options, together with DSO positions, shall be aggregated with positions in options contracts in the same class.

Pricing of a DSO

Similar to other index options, the pricing of an at-the-money DSO reflects the price of the underlying index, implied volatility, interest rates, time to expiration, and strike price. Variations of the same pricing formulas apply to the pricing of in- and out-of-the money DSOs. Pricing formulas, which have been available for over a decade, reflect this methodology. In fact, the relevant pricing formulas that we anticipate market participants will use to assist in their trading generally are derived from the original Black-Scholes pricing formula to account for the time between the start of the contract and when the strike price is set.¹³

Therefore, the price for a DSO will generally approximate the concurrent price for a similar option, with one significant deviation: whereas other options are priced based on current levels of implied volatility, a DSO is priced using an expectation of implied volatility levels at the time the strike price is set, which is generally derived from the current level of implied volatility. The dependence of a particular DSO's price on expected implied volatility is what makes a DSO useful to market participants that are interested in volatility trading.

Customer Suitability

Although DSOs may be suitable for all types of investors, the Exchange is adopting a rule that limits the trading of DSOs to investors with prior options trading experience. Also, prior to the commencement of trading of DSOs, the Exchange will make available on its website all information necessary to inform members and customers of the addition of new DSO series to a particular option class. This information will highlight the differences in exercise methodology of DSOs, identify the new symbols for the DSO series, indicate the investor restrictions, identify the initial expiration months and strike prices available for trading, and reference the particular

¹³ A derivation of the formula for valuing similar contracts appeared in RISK, February 1991. See Rubinstein, Mark, "Pay Now, Choose Later," RISK, February 1991.

CBOE Rules that govern DSO trading. The Exchange also will make available on its website the DSO product specifications, trading characteristics, and any other information that will describe the operation of DSO products.

Applicability of Rule 9b-1

The Exchange asks the Commission to clarify that DSOs are standardized options under Rule 9b-1 of the Act. Subsection (a)(4) of Rule 9b-1 defines “standardized options” as “options contracts trading on a national securities exchange, an automated quotations system of a registered securities association, or a foreign securities exchange which relate to options classes the terms of which are limited to specific expiration dates and exercise prices, or such other securities as the Commission may, by order, designate.” DSOs are like existing options trading on CBOE in every respect except for the determination of the exercise price. DSOs (1) trade on a national securities exchange, (2) have a specific exercise date, (3) have fixed terms, (4) have specific exercise style, and (5) will be issued and cleared by OCC. All of these are attributes of “standardized options” as defined in Rule 9b-1. The one respect with which DSOs differ from existing options is that the existing options have a fixed exercise price at the commencement of trading while DSOs have a formula set at the commencement of trading for fixing the exercise price. A DSO has a specific exercise price because the exercise price is established at the commencement of trading according to a formula that is publicly known and announced, objectively determined, and unalterable. A party entering into a DSO knows exactly the option’s exercise price formula, which is the value of the underlying index as of the close on the strike setting date.

Furthermore, the DSO is a single option contract. To illustrate, a DSO listed with six months to expiration and three months until the strike setting date is simply a single option

contract with six months to expiration, for which the strike price is allowed to float for the first three months. There is no contract settlement on the strike setting date. As a result, a market participant with a short position in a DSO series is not obligated to make delivery of any underlying security or cash on the strike setting date. The strike setting date is only relevant to the contract as the date on which the pre-determined formula is applied to determine the strike price of the existing DSO series.

If the Commission cannot determine that DSOs are, by their terms, standardized options, then the Exchange requests that the Commission use its authority under Rule 9b-1(a)(4) to otherwise designate DSOs as standardized options. The Commission used this authority in 1993 to designate “Flex Options” as standardized options.¹⁴ In making this designation, the Commission found that, “[a]part from the flexibility with respect to strike prices, settlement, expiration dates, and exercise style, all of the other terms of Flex Options are standardized.” The Commission observed that standardized terms include matters such as “exercise procedures, contract adjustments, time of issuance, effect of closing transactions, restrictions on exercise under OCC rules [and] margin requirements....” The Commission also emphasized that Flex Options could be written in a way that would make them fully fungible with other options issued by OCC that fell within the framework of Rule 9b-1. DSOs share all of these characteristics and, in fact, are more standardized than Flex Options in that strike price, settlement, expiration dates,

¹⁴ See Securities Exchange Act Release No. 31910 (February 23, 1993), 58 FR 12056 (March 2, 1993).

and exercise style are fixed by the Exchange for each DSO series.¹⁵ The strike price is simply specified by the Exchange in terms of a pre-established formula for fixing a set strike price on a pre-determined date. No changes to any terms of existing DSO series will be made once the series begins trading.

Advantages of Exchange Trading vs. OTC Market

It is the Exchange's understanding that products similar to DSOs currently trade in the OTC market. Most options pricing software available commercially and through derivatives websites include a pricing model for DSOs. The Exchange believes that exchange-listed DSOs will have three important advantages over the contracts that are traded in the OTC market. First, as a result of greater standardization of contract terms and the support of a DPM, the trading crowd, or a CBOE Lead Market Maker ("LMM"), Exchange-listed contracts could develop substantial liquidity. Second, counter-party credit risk is mitigated by the fact that the contracts are issued and guaranteed by OCC. Finally, the price discovery and dissemination provided by the CBOE and its members will lead to more transparent markets. CBOE's ability to offer DSOs would aid it in competing with the OTC market and at the same time expand the universe of listed products available to interested market participants.

¹⁵ The Commission has consistently cited the criteria outlined above when making Rule 9b-1 standardization determinations. See, e.g., Securities Exchange Act Release Nos. 39549 (January 14, 1998), 63 FR 3601 (January 23, 1998)(Phlx Flexible Exchange Traded Equity and Index Options); 37336 (June 19, 1996), 61 FR 33558 (June 27, 1996)(Amex Flexible Exchange Options on Specified Equity Securities); 36841 (February 14, 1996), 61 FR 6666 (February 21, 1996)(CBOE and PCX Flexible Exchange Traded Equity and Index Options); and 34203 (June 13, 1994), 59 FR 31658 (June 20, 1004)(CBOE Foreign Currency Flex Options, which incorporates by reference the findings of Securities Exchange Act Release No. 31920 (February 24, 1993), 58 FR 12280 (March 3, 1993)).

The Exchange represents that it will have surveillance procedures that are adequate to monitor trading activity in DSOs. In this respect, the Exchange intends to monitor trading activity in DSOs like any other option series listed in that same index option class.

2. Statutory Basis

The Exchange believes that the introduction of the new DSO series provides investors with a valuable hedging tool that will be traded on a listed exchange. For these reasons, the Exchange believes that the proposed rule change is consistent with Section 6 of the Act¹⁶ in general and, in particular, with Section 6(b)(5)¹⁷ in that it is designed to promote just and equitable principles of trade as well as to protect investors and the public interest.

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

CBOE does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

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

No written comments were solicited or received with respect to the proposed rule change.

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

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding, or (ii) as to which CBOE consents, the Commission will:

- (A) by order approve such proposed rule change, or

¹⁶ 15 U.S.C. 78(f).

¹⁷ 15 U.S.C. 78(f)(b)(5).

- (B) institute proceedings to determine whether the proposed rule change should be 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 e-mail to rule-comments@sec.gov. Please include File Number SR-CBOE-2006-90 on the subject line.

Paper comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-CBOE-2006-90. This file number should be included on the subject line if e-mail 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 inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00

pm. Copies of such filing also will be available for inspection and copying at the principal office of the CBOE. 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-CBOE-2006-90 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁸

Florence E. Harmon
Deputy Secretary

¹⁸ 17 CFR 200.30-3(a)(12).