

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-60126; File No. SR-CBOE-2008-55)

June 17, 2009

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Granting Approval to a Proposed Rule Change, as Modified by Amendment No. 1, Relating to Margin Requirements

I. Introduction

On June 2, 2008, 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> the Chicago Board Options Exchange, Incorporated (the “Exchange” or “CBOE”) filed with the Securities and Exchange Commission (the “Commission”) a proposed rule change to modify its margin requirements to facilitate, under certain circumstances, the ability of account holders to use vested and currently exercisable compensatory employee stock options (“Vested Employee Options”) issued by publicly traded companies as collateral for writing call options that have the same underlying security as the Vested Employee Options. On May 3, 2009, CBOE filed Amendment No. 1. The proposed rule change was published for comment in the Federal Register on May 13, 2009.<sup>3</sup> The Commission received one comment letter on the proposed rule change.<sup>4</sup>

II. Description

The Exchange proposes to amend its margin requirements to facilitate, under certain circumstances, the ability of account holders to use Vested Employee Options issued by publicly traded companies (“Issuers”) as collateral for writing call options that have the same underlying

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

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

<sup>3</sup> See Securities Exchange Act Release No. 59876 (May 6, 2009), 74 FR 22613 (May 13, 2009) (“Notice”).

<sup>4</sup> See letter from Kandy Rathinasamy, dated May 15, 2009 (“Rathinasamy Letter”).

security as the Vested Employee Options. Specifically, the proposal would allow account holders to sell, as a hedge, listed equity call options on the same underlying security as the account holder's Vested Employee Options without the requirement of margin (the "Transactions"). The proposal would permit account holders to engage in the Transactions using their Vested Employee Options as collateral. Currently, such Transactions would be deemed "naked" for purposes of margin rules and subject to a deposit of cash margin, effectively making the strategies cost prohibitive and impractical. The Exchange believes that enabling employees who hold Vested Employee Options to generate income and liquidity on their otherwise illiquid asset through the listed options markets will benefit investors by providing greater transparency and liquidity.

Under Section 220.12(f)(1) of Regulation T,<sup>5</sup> the Exchange, as a registered national securities exchange, is permitted to recognize the type of transactions described below as eligible for margin treatment subject to the approval of the Commission.

The proposal would permit account holders to sell listed call options on the same security that underlies their Vested Employee Options without the requirement of margin. Given the uncertificated nature of employee stock options, in order to secure the account holder's obligations under the Transactions, the proposal would require:

1. The account holder to (A) pledge the Vested Employee Options to the broker-dealer and (B) provide the broker-dealer with an irrevocable power-of-attorney authorizing the broker-dealer to exercise the Vested Employee Options on the account holder's behalf if the listed call options are assigned or if the broker-dealer determines it is necessary. The irrevocable

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<sup>5</sup> Section 220.12(f)(1) of Regulation T (12 CFR 220), Supplement: Margin Requirements, grants authority to registered national securities exchanges to promulgate rules relating to call and put margin requirements.

power-of-attorney may also be used in the event the account holder wishes to close the listed option position prior to its expiration and instructs the broker-dealer to exercise that number of Vested Employee Options necessary to cover the cost of the closing purchase (the account holder will also have the option of depositing additional cash in the account holder's account to cover the cost of the closing purchase).

2. In the event the Vested Employee Options are exercised between the date of the Transaction in the listed call options (the "Commencement Date") and the date the Transaction is closed (the "Closing Date"), the shares issued upon exercise will be pledged to the broker-dealer (thereby replacing the Vested Employee Options that had been pledged prior to exercise). For example, during the time a Transaction is pending, the account holder may resign from the account holder's employment with the Issuer and may be required to exercise the Vested Employee Options within a certain timeframe following the account holder's departure. In such a scenario, the account holder would ask the broker dealer to exercise the Vested Employee Options and the stock issued pursuant to the exercise would be pledged to the broker-dealer.

3. The Issuer will promptly deliver the stock upon payment or receipt of the exercise notice from the broker-dealer.<sup>6</sup> The Issuer will also agree prior to the Commencement Date to waive any forfeiture conditions that otherwise might apply to the Vested Employee Options (e.g., upon a termination of the account holder's employment with the Issuer) as well as any transfer restrictions that would preclude pledge of the Vested Employee Options to the broker-dealer. In addition, the Issuer will represent that the Vested Employee Options are

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<sup>6</sup> The Exchange will proscribe a set delivery period, which is expected to be no later than three business days following assignment of the listed options.

covered by an effective registration statement on Form S-8. If the registration statement becomes ineffective the Issuer will notify the broker-dealer immediately.

4. Because it is essential that the account holder, broker-dealer and Issuer cooperate and are each fully informed, agree to and acknowledge their own and each other's responsibilities, all Transactions will be governed by an agreement (the "Agreement") entered into by the account holder, broker-dealer and Issuer prior to the Commencement Date of the first transaction. The Agreement would generally set forth each party's obligations, representations and acknowledgements and the terms and conditions governing the Transactions and must be in a form acceptable to the Exchange.<sup>7</sup>

5. Such other terms and conditions prescribed by the Exchange in accordance with such form, formats and procedures as may be established by the Exchange from time to time would also apply. In this regard, upon approval of the proposed rule change and for a period of one year, the Exchange will require that, prior to the Commencement Date, a legal opinion with respect to the account holder's and Issuer's legal right to enter into the Transactions under the terms of the Issuer's employee stock option plan and related documents (the "Legal Opinion") be obtained in a form acceptable to the Exchange. During the one-year time period, the Exchange may determine that such Legal Opinion is no longer necessary and will revise its established forms, formats and procedures accordingly.

### III. Discussion and Commission's Findings

After careful review of the proposed rule change, the comment letter and CBOE's response, the Commission finds that the proposed rule change is consistent with the requirements

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<sup>7</sup> In this regard, the Exchange currently intends to recognize the Master Vested Stock Option Monetization Agreement, created by iOptions Group, LLC, as one acceptable agreement.

of the Act and the rules and regulations thereunder applicable to a national securities association.<sup>8</sup>

In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5),<sup>9</sup> in that the proposed rule change is designed to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, remove impediments to and perfect the mechanisms of a free and open market and a national market system, and, in general, to protect investors and the public interest. The proposed rule change will offer market participants new trading opportunities and will enhance the Exchange's competitive position.

The Commission received one comment letter, in support of the proposal, stating that the proposed rule change is "a great idea, allowing employees to monetize the time value of their options."<sup>10</sup>

The Commission believes that the proposed rule change to amend the Exchange's margin rule should be allowed. However, the Commission does have significant concerns with the amount of control each broker-dealer has over the Vested Employee Options. One purpose of the margin rules is to protect broker-dealers in the event of market turmoil. The broker-dealer must have enough control over the cash or securities it is holding as margin on behalf of investors to be able to act unilaterally to protect itself. With Vested Employee Options, the broker-dealer cannot act unilaterally to use the margin deposited by the customer (*i.e.*, the Vested Employee Options); instead, the broker-dealer must rely on another person (*i.e.*, the issuer) to promptly deliver the required shares. For example, if an issuer notifies the broker-dealer that there is an ineffective registration statement, it could prevent the broker-dealer from exercising

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<sup>8</sup> In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>9</sup> 15 U.S.C. 78f(b)(5).

<sup>10</sup> See Rathinasamy Letter, supra note 4.

the options and receiving publicly tradable shares, a prospect that could cause financial harm to the broker-dealer.

The Commission raised these concerns in the Notice by noting in a footnote that absent relief from the Commission, broker-dealers would need to take a capital charge for any unsecured margin debt and by asking questions about how the broker-dealer's legal authority to exercise the Vested Employee Options could be enhanced and how to limit the liquidity and operational risks arising from the Transactions. The Commission received no comments on this footnote or these questions. Thus, for purposes of determining whether an account is unsecured or partly secured pursuant to the net capital rule,<sup>11</sup> including an account containing a Transaction, a broker-dealer may not include the value of a Vested Employee Option.

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<sup>11</sup> 17 CFR 240.15c3-1.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>12</sup> that the proposed rule change (SR-CBOE-2008-55), as modified by Amendment No. 1, be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>13</sup>

Florence E. Harmon  
Deputy Secretary

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<sup>12</sup> 15 U.S.C. 78s(b)(2).

<sup>13</sup> 17 CFR 200.30-3(a)(12).