

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-68086; File No. SR-CBOE-2012-066)

October 23, 2012

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Granting Approval of a Proposed Rule Change, as Modified by Amendment No. 1 Thereto, to Increase Position and Exercise Limits for EEM Options

I. Introduction

On July 9, 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 to increase the position and exercise limits for options on the iShares MSCI Emerging Markets Index Fund (“EEM”) to 500,000 contracts. The proposed rule change was published for comment in the Federal Register on July 26, 2012.³ On September 6, 2012, the Commission extended the time period for Commission action to October 24, 2012.⁴ On October 18, 2012, the Exchange filed Amendment No. 1 to the proposed rule change.⁵ The Commission received no comment letters on the proposed rule change. This order approves the proposed rule change, as modified by Amendment No. 1 thereto.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 67478 (July 20, 2012), 77 FR 43897 (“Notice”).

⁴ See Securities Exchange Act Release No. 67790 (September 6, 2012), 77 FR 56243 (September 12, 2012).

⁵ Amendment No. 1 provides a description of EEM and the MSCI Emerging Markets Index, as well as additional justification for the proposed rule change. See, e.g., infra notes 6, 12, 14, and 24. Amendment No. 1 is not subject to notice and comment because it does not materially alter the substance of the proposed rule change or raise any novel regulatory issues.

II. Description of Proposed Rule Change

Currently, position limits for exchange-traded fund (“ETF”) options, such as EEM options,⁶ are determined pursuant to Exchange Rule 4.11 and vary according to the number of outstanding shares and past six-month trading volume of the underlying security. The current position limit for EEM options is 250,000 contracts. The purpose of the proposed rule change is to amend Exchange Rule 4.11, Interpretation and Policy .07 to increase the position and exercise limits for EEM options to 500,000 contracts.⁷ The Exchange states its belief that increasing position limits for EEM options will lead to a more liquid and competitive market environment for EEM options that will benefit customers interested in this product.⁸

In its filing, the Exchange states that there is precedent for establishing higher position limits for options on actively-traded ETFs.⁹ Specifically, options on the DIAMONDS Trust (DIA) have a position limit of 300,000 contracts, options on the Standard and Poor’s Depository Receipts Trust (SPY) have no position limits,¹⁰ options on the iShares Russell 2000 Index Fund

⁶ In Amendment No. 1, the Exchange states that EEM tracks the performance of the MSCI Emerging Markets Index, which has approximately 800 components. The Exchange also states that the MSCI Emerging Markets Index “is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.” According to the Exchange, the MSCI Emerging Markets Index “consists of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.”

⁷ Pursuant to Exchange Rule 4.12, Interpretation and Policy .02, which is not being amended by the proposed rule change, the exercise limit for EEM options would be similarly increased.

⁸ See Notice, supra note 3, at 43898.

⁹ See id., at 43897.

¹⁰ See Securities Exchange Act Release No. 67937 (September 27, 2012), 77 FR 60489 (October 3, 2012) (SR-CBOE-2012-091) (eliminating position and exercise limits for SPY options on a pilot basis).

(IWM) have a position limit of 500,000 contracts, and options on the PowerShares QQQ Trust (QQQQ) have a position limit of 900,000 contracts.¹¹

In addition, in its filing, the Exchange states that the average daily volume in 2011 for EEM was 65 million shares,¹² as compared to 64.1 million shares for IWM and 213 million shares for SPY.¹³ In 2011, the average daily volume for options contracts overlying EEM was 280,000 contracts,¹⁴ as compared to 662,500 contracts for options overlying IWM and 2,892,000 contracts for options overlying SPY.¹⁵ The total shares outstanding for EEM was 922.9 million, as compared to 192.6 million shares for IWM and 716.1 million shares for SPY.¹⁶ Further, the fund market cap for EEM was \$41.1 billion, as compared to \$15.5 billion for IWM and \$98.3 billion for SPY.¹⁷

The Exchange notes that the options reporting requirements of Exchange Rule 4.13 would continue to be applicable to EEM options.¹⁸ As set forth in Exchange Rule 4.13(a), each Trading Permit Holder (“TPH”) must report to the Exchange certain information in relation to any customer who, acting alone, or in concert with others, on the previous business day maintained aggregate long or short positions on the same side of the market of 200 or more

¹¹ See Exchange Rule 4.11, Interpretation and Policy .07.

¹² In Amendment No. 1, the Exchange states that, through October 17, 2012, the year-to-date average daily trading volume for EEM across all exchanges was 49.3 million shares.

¹³ See Notice, supra note 3, at 43898.

¹⁴ In Amendment No. 1, the Exchange states that, through October 17, 2012, the year-to-date average daily trading volume for EEM options across all exchanges was 250,304 contracts.

¹⁵ See Notice, supra note 3, at 43898.

¹⁶ See id.

¹⁷ See id.

¹⁸ See id.

contracts in any single class of option contracts dealt in on the Exchange.¹⁹ Further, Exchange Rule 4.13(b) requires each TPH (other than an Exchange market-maker or Designated Primary Market-Maker)²⁰ that maintains a position in excess of 10,000 non-FLEX equity option contracts on the same side of the market, on behalf of its own account or for the account of a customer, to report to the Exchange information as to whether such positions are hedged, and provide documentation as to how such contracts are hedged.²¹

The Exchange believes that the existing surveillance procedures and reporting requirements at CBOE, other options exchanges, and at the several clearing firms are capable of properly identifying unusual and/or illegal trading activity.²² According to the Exchange, its surveillance procedures utilize daily monitoring of market movements via automated surveillance techniques to identify unusual activity in both options and underlying stocks.²³ In addition, the Exchange states that its surveillance procedures have been effective for the surveillance of trading in EEM options, and will continue to be employed.²⁴

¹⁹ The report must include, for each such class of options, the number of option contracts comprising each such position and, in the case of short positions, whether covered or uncovered. See Exchange Rule 4.13(a).

²⁰ According to the Exchange, market-makers (including Designated Primary Market-Makers) are exempt from the referenced reporting requirement because market-maker information can be accessed through the Exchange's market surveillance systems. See Notice, supra note 3, at 43898.

²¹ According to the Exchange, this information would include, but would not be limited to, the option position, whether such position is hedged and, if so, a description of the hedge, and the collateral used to carry the position, if applicable. See id.

²² See id.

²³ See id.

²⁴ See id., at n. 5. In Amendment No. 1, the Exchange represents that more than 50% of the weight of the securities held by EEM are now subject to a comprehensive surveillance agreement ("CSA"). Additionally, the Exchange states that the component securities of the MSCI Emerging Markets Index on which EEM is based for which the primary market is in any one country that is not subject to a CSA do not represent 20% or more of the

The Exchange further states its belief that the current financial requirements imposed by the Exchange and by the Commission adequately address concerns that a TPH or its customer may try to maintain an inordinately large unhedged position in an option, particularly on EEM.²⁵ Current margin and risk-based haircut methodologies, the Exchange states, serve to limit the size of positions maintained by any one account by increasing the margin and/or capital that a TPH must maintain for a large position held by itself or by its customer.²⁶ In addition, the Exchange notes that the Commission's net capital rule, Rule 15c3-1 under the Act,²⁷ imposes a capital charge on TPHs to the extent of any margin deficiency resulting from the higher margin requirement.²⁸

III. Discussion and Commission Findings

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.²⁹ In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,³⁰ 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 remove impediments to and perfect the mechanism of a free

weight of the MSCI Emerging Markets Index. Further, the Exchange states that the component securities of the MSCI Emerging Markets Index on which EEM is based for which the primary market is in any two countries that are not subject to CSAs do not represent 33% or more of the weight of the MSCI Emerging Markets Index.

²⁵ See Notice, supra note 3, at 43898.

²⁶ See id.

²⁷ 17 CFR 240.15c3-1.

²⁸ See Notice, supra note 3, at 43898.

²⁹ 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).

³⁰ 15 U.S.C. 78f(b)(5).

and open market and a national market system and, in general, to protect investors and the public interest.

Position and exercise limits serve as a regulatory tool designed to address manipulative schemes and adverse market impact surrounding the use of options. Since the inception of standardized options trading, the options exchanges have had rules limiting the aggregate number of options contracts that a member or customer may hold or exercise.³¹ These position and exercise limits are intended to prevent the establishment of options positions that can be used or might create incentives to manipulate the underlying market so as to benefit the options positions.³² In particular, position and exercise limits are designed to minimize the potential for mini-manipulations and for corners or squeezes of the underlying market.³³ In addition, such limits serve to reduce the possibility for disruption of the options market itself, especially in illiquid classes.³⁴

Over the years, the Commission has taken a gradual, evolutionary approach toward expansion of position and exercise limits for option products overlying certain ETFs where there is considerable liquidity in both the underlying cash markets and the options markets, and, in the case of certain broad-based index options, toward elimination of such limits altogether.³⁵ The

³¹ See, e.g., Securities Exchange Act Release No. 45236 (January 4, 2002), 67 FR 1378 (January 10, 2002) (SR-Amex-2001-42).

³² See, e.g., Securities Exchange Act Release No. 47346 (February 11, 2003), 68 FR 8316 (February 20, 2003) (SR-CBOE-2002-26).

³³ See id.

³⁴ See id.

³⁵ The Commission's incremental approach to approving changes in position and exercise limits for option products overlying certain ETFs is well-established. See, e.g., Securities Exchange Act Release No. 67672 (August 15, 2012), 77 FR 50750, n. 42 and accompanying text (August 22, 2012) (SR-NYSEAmex-2012-29) (approving proposed rule change to eliminate position limits for SPY options on a pilot basis); Securities Exchange Act Release No. 64695 (June 17, 2011), 76 FR 36942, n. 19 and accompanying

Commission has been careful to balance two competing concerns when considering proposals by self-regulatory organizations to change position and exercise limits. The Commission has recognized that the limits can be useful to prevent investors from disrupting the market in securities underlying the options.³⁶ At the same time, the Commission has determined that limits should not be established in a manner that will unnecessarily discourage participation in the options market by institutions and other investors with substantial hedging needs or to prevent specialists and market makers from adequately meeting their obligations to maintain a fair and orderly market.³⁷

The Commission believes that it is reasonable for the Exchange to increase the position and exercise limits for options on EEM to 500,000 contracts. As noted above, the markets for standardized options on EEM and for EEM itself have substantial trading volume and liquidity. The Commission believes that this liquidity would lessen the opportunity for manipulation of this product and disruption in the underlying market that a lower position limit may protect against. Specifically, the Exchange notes that, in 2011, the average daily trading volumes for EEM and options on EEM were 65 million shares and 280,000 contracts, respectively.³⁸ In Amendment No. 1, the Exchange notes that, through October 17, 2012, the year-to-date average daily trading volume for EEM across all exchanges was 49.3 million shares, and the year-to-date average daily trading volume for EEM options across all exchanges was 250,304 contracts.³⁹

text (June 23, 2011) (SR-Phlx-2011-58) (approving increase of SPY options position limit to 900,000 contracts).

³⁶ See Securities Exchange Act Release No. 39489 (December 24, 1997), 63 FR 276 (January 5, 1998) (SR-CBOE-97-11).

³⁷ See id.

³⁸ See Notice, supra note 3, at 43898.

³⁹ See supra notes 12 and 14 and accompanying text.

The Exchange also notes that there were 922.9 million shares of EEM outstanding, with a market cap of \$41.1 billion.⁴⁰

As noted above, the Exchange also believes that current margin and net capital requirements serve to limit the size of positions maintained by any one account.⁴¹ The Commission agrees that these financial requirements should help to address concerns that a member or its customer may try to maintain an inordinately large unhedged position in EEM options and will help to reduce risks if such a position is established.

The Commission further agrees with the Exchange that the reporting requirements imposed by Exchange Rule 4.13,⁴² as well as the Exchange's surveillance procedures, together with those of other exchanges and clearing firms,⁴³ should help protect against potential manipulation. The Commission expects that the Exchange will continue to monitor trading in the EEM options for the purpose of discovering and sanctioning manipulative acts and practices, and to reassess the position and exercise limits, if and when appropriate, in light of its findings.

In sum, given the measure of liquidity for EEM and options on EEM, the broad range of component securities that make up the MSCI Emerging Markets Index, the margin and capital requirements cited above, the Exchange's options reporting requirements, and the Exchange's surveillance procedures and agreements with other markets, the Commission believes that increasing the position and exercise limits for the EEM options to 500,000 contracts is consistent with the Act.

⁴⁰ See Notice, supra note 3, at 43898.

⁴¹ See supra notes 25-28 and accompanying text.

⁴² See supra notes 18-21 and accompanying text.

⁴³ See supra notes 22-24 and accompanying text.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,⁴⁴ that the proposed rule change (SR-CBOE-2012-066), as modified by Amendment No. 1 thereto, be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁴⁵

Kevin M. O'Neill
Deputy Secretary

⁴⁴ 15 U.S.C. 78s(b)(2).

⁴⁵ 17 CFR 200.30-3(a)(12).