

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51244; File No. SR-CBOE-2003-30)

February 23, 2005

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing and Order Granting Accelerated Approval to a Proposed Rule Change and Amendment Nos. 1, 2, 3, and 4 Thereto Relating to Position Limits and Exercise Limits

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 July 9, 2003, 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 and II below, which Items have been prepared by the Exchange. On January 8, 2004, the CBOE filed Amendment No. 1 to the proposed rule change.³ On October 29, 2004, the CBOE filed Amendment No. 2 to the proposed rule change.⁴ On February 10, 2005, the CBOE filed Amendment No. 3 to the proposed rule change.⁵ On February 15, 2005, the CBOE filed Amendment No. 4 to the proposed rule change.⁶ The Commission is publishing this notice to

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See letter from James M. Flynn, Attorney II, Legal Division, CBOE, to Sharon Lawson, Senior Special Counsel, Division of Market Regulation (“Division”), Commission, dated January 7, 2004 (“Amendment No. 1”).

⁴ See letter from Edward J. Joyce, President and Chief Operating Officer, CBOE, to Nancy Sanow, Assistant Director, Division, Commission, dated October 28, 2004 (“Amendment No. 2”).

⁵ Amendment No. 3, which replaced and superseded the original filing and the first and second amendments in their entireties, eliminated, among other things, certain hedge exemptions that were proposed in the original filing, requested that the increases to the standard position and exercise limits proposed in the filing be adopted as a six-month pilot program, and requested accelerated approval of the proposed rule change.

⁶ Amendment No. 4, which replaced and superseded the original filing and the previous amendments in their entireties, retained the changes made by Amendment No. 3 and made technical corrections to the filing.

solicit comments on the proposed rule change, as amended, from interested persons and is accelerating approval of the proposed rule change, as amended, on a pilot basis.

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

The CBOE proposes to amend Exchange Rule 4.11 and Exchange Rule 4.12 to increase the standard position limits and exercise limits for equity option contracts and options on the Nasdaq-100 Index Tracking Stock (“QQQQ”). The text of the proposed rule change is available on the CBOE's Web site (<http://www.cboe.com>), at the CBOE's Office of the Secretary, and at the Commission's Public Reference Room.

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

In its filing with the Commission, the CBOE included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item III below. The 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 CBOE is proposing several changes to Exchange Rule 4.11 (Position Limits) and, accordingly, to Exchange Rule 4.12 (Exercise Limits). Exchange Rule 4.11 subjects equity options to one of five different position limits depending on the trading volume and outstanding shares of the underlying security. Exchange Rule 4.12 establishes exercise limits for the

corresponding options at the same levels as the corresponding security's position limits.⁷

Standard Position and Exercise Limits

The Exchange is proposing to adopt a pilot program for a period of six months during which the standard position and exercise limits for options on the QQQQ and for equity option classes traded on the Exchange would be increased to the following levels:

Current Equity Option Contract Limit	Proposed Equity Option Contract Limit
13,500 contracts	25,000 contracts
22,500 contracts	50,000 contracts
31,500 contracts	75,000 contracts
60,000 contracts	200,000 contracts
75,000 contracts	250,000 contracts
Current QQQQ Option Contract Limit	Proposed QQQQ Option Contract Limit
300,000 contracts	900,000 contracts

The standard position limits were last increased on December 31, 1998.⁸ Since that time there has been a steady increase in the number of accounts that, (a) approach the position limit; (b) exceed the position limit; and (c) are granted an exemption to the standard limit. Several

⁷ Exchange Rule 4.12 states “. . . no member shall exercise, for any account in which it has an interest or for the account of any customer, a long position in any options contract where such member or customer, acting alone or in concert with others, directly or indirectly . . . has or will have exercised within any five consecutive business days aggregate long positions in any class of options dealt in on the Exchange in excess of [the established limits set by the Exchange]. . . .”

⁸ See Securities Exchange Act Release No. 40875 (December 31, 1998), 64 FR 1842 (January 12, 1999) (SR-CBOE-98-25) (approval of increase in position limits and exercise limits).

member firms have petitioned the Exchange to either eliminate position limits, or in lieu of total elimination, increase the current levels and expand the available hedge exemptions. A review of available data indicates that the majority of accounts that maintain sizable positions are in those option classes subject to the 60,000 and 75,000 tier limits. There also has been an increase in the number of accounts that maintain sizable positions in the lower three tiers. In addition, overall volume in the options market has continually increased over the past five years. The Exchange believes that the increase in options volume and lack of evidence of market manipulation occurrences over the past twenty years justifies the proposed increases in the position and exercise limits.

The Exchange also proposes the adoption of a new equity hedge exemption to the existing exemptions currently provided under Interpretation and Policy .04 to Exchange Rule 4.11. Specifically, new Interpretation and Policy .04(a)(5) to Exchange Rule 4.11 would allow for a “reverse collar” hedge exemption to apply when a long call position is accompanied by a short put position, and the long call expires with the short put. In addition, the strike price of the long call must equal or exceed the short put, and each long call and short put position must be hedged with 100 shares of the underlying security (or other adjusted number of shares). Neither side of the long call short put can be in-the-money at the time the position is established. The Exchange believes this is consistent with the existing Interpretation and Policy .04(a)(4) to Exchange Rule 4.11, which provides for an exemption for a “collar,” and Interpretation and Policy .04(a)(2) and (3) to Exchange Rule 4.11, which provide for a hedge exemption for reverse conversions and conversions, respectively.

Manipulation

The CBOE believes that position and exercise limits, at their current levels, no longer serve their stated purpose. The Commission has previously stated that:

Since the inception of standardized options trading, the options exchanges have had rules imposing limits on the aggregate number of options contracts that a member or customer could hold or exercise. These rules are intended to prevent the establishment of options positions that can be used or might create incentives to manipulate or disrupt the underlying market so as to benefit the options position. In particular, position and exercise limits are designed to minimize the potential for mini-manipulations and for corners or squeezes of the underlying market. In addition such limits serve to reduce the possibility for disruption of the options market itself, especially in illiquid options classes.⁹

As the anniversary of listed options trading approaches its thirty-second year, the Exchange believes that the existing surveillance procedures and reporting requirements at the CBOE, other options exchanges, and at the several clearing firms are capable of properly identifying unusual and/or illegal trading activity. In addition, routine oversight inspections of CBOE's regulatory programs by the Commission have not uncovered any material inconsistencies or shortcomings in the manner in which the Exchange's market surveillance is conducted. These procedures utilize daily monitoring of market movements via automated surveillance techniques to identify unusual activity in both options and in underlying stocks.

⁹ See Securities Exchange Act Release No. 39489 (December 24, 1997), 63 FR 276 (January 5, 1998) (SR-CBOE-97-11) (approval of increase in position limits and exercise limits for OEX index options).

Furthermore, the significant increases in unhedged options capital charges resulting from the September 1997 adoption of risk-based haircuts in combination with the Exchange margin requirements applicable to these products under Exchange rules, serve as a more effective protection than do position limits.¹⁰

Furthermore, large stock holdings must be disclosed to the Commission by way of Schedules 13D or 13G.¹¹ Options positions are part of any reportable positions and, thus, cannot be legally hidden. In addition, Exchange Rule 4.13, which requires members to file reports with the Exchange for any customer or member who held aggregate long or short positions of 200 or more option contracts of any single class for the previous day, will remain unchanged and will continue to serve as an important part of the Exchange's surveillance efforts.

The Exchange believes that restrictive equity position limits prevent large customers, such as mutual funds and pension funds, from using options to gain meaningful exposure to individual stocks. This can result in lost liquidity in both the options market and the stock market. In addition, the Exchange has found that restrictive limits and narrow hedge exemption relief restrict member firms from adequately facilitating customer order flow and offsetting the risks of such facilitations in the listed options market. The fact that position limits are calculated on a gross rather than a delta basis also is an impediment.

Financial Requirements

The Exchange believes that the current financial requirements imposed by the Exchange and by the Commission adequately address concerns that a member or its customer may try to

¹⁰ See Securities Exchange Act Release No. 38248 (February 6, 1997), 62 FR 6474 (February 12, 1997) (File No. S7-7-94) (adopting risk-based haircuts); and CBOE Rule 12.3 (Margins).

¹¹ 17 CFR 240.13d-1.

maintain an inordinately large unhedged position in an equity option. Current margin and risk-based haircut methodologies serve to limit the size of positions maintained by any one account by increasing the margin and/or capital that a member must maintain for a large position held by itself or by its customer. It also should be noted that the Exchange has the authority under Exchange Rule 12.3(h) and Exchange Rule 12.10 to impose higher margin requirements upon a member or member organization when the Exchange determines that higher requirements are warranted. Also, the Commission's net capital rule, Rule 15c3-1 under the Act,¹² imposes a capital charge on members to the extent of any margin deficiency resulting from the higher margin requirement.

Finally, equity position limits have been gradually expanded from 1,000 contracts in 1973 to the current level of 75,000 contracts for options on the largest and most active underlying securities. To date, the Exchange believes that there have been no adverse affects on the market as a result of these past increases in the limits for equity option contracts.

Housekeeping Changes

The Exchange is proposing to amend Exchange Rule 4.11 by deleting the requirement that notice of position limit information be manually posted on the Exchange Bulletin Board. With the advance of technologies, position limits are now communicated to the membership largely through electronic media. Currently, applicable position limits are posted on the CBOE Internet site and on the Options Clearing Corporation Internet site and are sent electronically via e-mail to those member firms that have requested this type of notification. Paper copies of the position limits also are available to the trading floor community upon request. Posting a paper

¹² 17 CFR 240.15c3-1.

list, which is quite long and consumes a large amount of space, on the Exchange Bulletin Board is an outdated requirement that no longer serves a purpose. Therefore, the Exchange proposes to amend the language to state that position limit information must be posted publicly.

The Exchange also proposes a minor change to Interpretation and Policy .06 to Exchange Rule 4.11 to correct the “Example” pertaining to the equity hedge exemption. The current Example inaccurately refers to the equity hedge exemption being limited to two times the standard limit. This limitation was removed in a previous rule filing,¹³ and is thus no longer relevant. Currently, there is no position limit restriction for qualified hedge strategies under the equity hedge exemption policy.

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with and furthers the objectives of Section 6(b)(5) of the Act,¹⁴ in that it is designed to perfect the mechanisms of a free and open market and to protect investors and the public interest.

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

The Exchange does not believe that the proposed rule change would impose any burden on competition.

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.

¹³ See Securities Exchange Act Release No. 40875 (December 31, 1998), 64 FR 1842 (January 12, 1999) (SR-CBOE-98-25) (approval of increase in position limits and exercise limits).

¹⁴ 15 U.S.C. 78f(b)(5).

III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, 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-2003-30 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-CBOE-2003-30. 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 Section, 450 Fifth Street, NW, Washington, DC 20549. 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 publicly available. All submissions should refer to File Number SR-CBOE-2003-30 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

IV. Commission's Findings and Order Granting Accelerated Approval of Proposed Rule Change

After careful consideration, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder, applicable to a national securities exchange.¹⁵ In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,¹⁶ 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 mechanisms of a free and open market and to protect investors and the public interest.

The Commission notes that standard position and exercise limits have not been increased in six years, during which time overall options market volume has continually increased, and the number of accounts that approach the current limits, exceed them, and are granted exemptions from the limits has also increased. The CBOE believes, among other things, that restrictive position limits result in lost liquidity by preventing large customers from using options to gain meaningful exposure to individual stocks. In view of the Exchange's representations concerning its surveillance procedures and capabilities of identifying unusual or illegal trading activity, as

¹⁵ In approving this proposal, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹⁶ 15 U.S.C. 78f(b)(4).

well as other protections against market manipulation noted in the proposal, the Commission believes that it is appropriate at this time to approve the proposed increases in position and exercise limits for a pilot program of six months.

The Commission also believes that the proposal to implement the “reverse collar” hedge exemption is consistent with the existing hedge exemption relating to the “collar” strategy, which has already been approved by the Commission. The additional amendments appropriately adjust the requirement that the Exchange post reasonable notice of new position limits to reflect current technology, and eliminate an inaccuracy in the Exchange rules.

The CBOE has requested that the Commission find good cause for approving the proposed rule change prior to the thirtieth day after publication of notice thereof in the Federal Register. The Commission believes that it is appropriate to accelerate approval of the proposed rule change so that the pilot program, intended to ease restrictions that inhibit liquidity in the options market, consistent with the protection of investors, may begin without delay. Accordingly, the Commission finds good cause, pursuant to Section 19(b)(2) of the Act,¹⁷ for approving the proposed rule change, as amended, prior to the thirtieth day after the date of publication of notice thereof in the Federal Register.

¹⁷ 15 U.S.C. 78s(b)(2).

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁸ that the proposed rule change (SR-CBOE-2003-30), as amended, is hereby approved on an accelerated basis for a pilot period to expire on August 23, 2005.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁹

Margaret H. McFarland
Deputy Secretary

¹⁸ 15 U.S.C. 78s(b)(2).

¹⁹ 17 CFR 200.30-3(a)(12).