SECURITIES AND EXCHANGE COMMISSION
(Release No. 51497; File No. SR-CBOE-2004-54)

April 6, 2005

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Partial Amendment No. 1 thereto by the Chicago Board Options Exchange, Incorporated to Amend Rules Relating Margin Treatment on Stock Transactions Effected by an Options Market Maker to Hedge Options Positions

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4[2] thereunder, notice is hereby given that on July 30, 2004, the Chicago Board Options Exchange, Incorporated ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("Commission" or "SEC") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. On February 22, 2005, the CBOE filed a partial amendment to its 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 Chicago Board Options Exchange, Incorporated (the “CBOE” or “Exchange”) is proposing to eliminate a rule that essentially disallows favorable margin treatment on stock transactions initiated by options market makers to hedge an option position if the exercise price of the option is more than two standard exercise price intervals above the price of the stock in the case of a call option, or below in the case of a put option. The text

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

2 17 CFR 240.19b-4.

3 SR-CBOE-2004-54: Amendment No. 1. Under the partial amendment, the options market maker must be able to demonstrate that it effected its permitted offset transactions for market-making purposes.

of the proposed rule change is available on CBOE's website (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

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

1. Purpose

When options market makers hedge their option positions by taking a long or short position in the underlying security, the underlying security is allowed "good faith" margin treatment,[4] provided the underlying security meets the definition of a "permitted offset."[5] To qualify as a permitted offset, CBOE Rule 12.3(f)(3) requires, among other things, that the transaction price of the underlying security be not more than two standard exercise price intervals below the exercise price of the option being hedged in the case of a call option, or above in the case of a put option. The term "in-or-at-the-money" is used in CBOE Rule 12.3(f)(3) to refer to the two standard strike price interval requirement. Stated another way, "in-or-at-the-money" means the option being hedged cannot be "out-of-the-money" by more than two standard exercise price intervals.[6]

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[4] Good faith margin is defined in Regulation T of the Board of Governors of the Federal Reserve System ("Regulation T"), the margin setting authority for the securities industry, as the amount of margin a creditor would require in exercising sound credit judgment.

[5] A "permitted offset" is defined in CBOE Rule 12.3(f)(3).

[6] An option is "out-of-the-money" when, based on comparison of the exercise price to the current market price of the underlying security, it makes no economic sense to exercise the option. For example, a call option with the right to purchase the underlying security at $50 per share would not be exercised if the underlying security were trading in the market for $46 per share.

The intent of this requirement was to confine good faith margining of transactions in the underlying security to those that constituted meaningful hedges of an option position. The need to hedge with 100 shares or units of the underlying security diminishes the more the exercise price of a call option is above the price of the underlying security, and the more the exercise price of a put option is below. If these inexpensive, "out-of-the-money" options are offset with a position in the underlying security equivalent in size (that is, units or shares) to that represented by the option, the risk of the combined positions is nearly the same as the underlying security position without the option. The option has very little effect. To prevent inexpensive, "out-of-the-money" options from being used as a means to gain good faith margin for trading in the underlying security, the two standard strike price interval limitation was imposed.

The Exchange is proposing to remove the "in-or-at-the-money" requirement.[7] The Exchange believes that a hedging transaction in the underlying security by an options market-maker can constitute a reasonable hedge, and is deserving of good faith margin, even if the exercise price of the option is out-of-the-money by more than two standard exercise price intervals. The listing of option series is not limited to options that meet the "in-or-at-the-money" requirement and options market-makers are obligated to provide liquidity in such "out-of-the money" options. In today's listed options market, there can be numerous options series that are out-of-the-money, more so than when the idea of an "in-or-at-the-money" requirement was first conceived. Moreover, in today's listed

[7] The New York Stock Exchange ("NYSE") also has filed a proposed rule change to remove the "in-or-at-the-money" language from its rules on permitted offsets. Although the language of the NYSE's proposed rule change differs from the language of the CBOE's proposed rule change, the proposed changes from the two exchanges are substantively identical. The Commission is publishing a notice to solicit comments on the NYSE's proposed rule change.

options market, smaller standard exercise price intervals have been introduced in some options (for example, 1 point and 2½ points), in contrast to the earlier days of the listed options market when the only standard was a five-point interval.

The need for relief from the "in-or-at-the-money" constraint has been addressed before. Prior to June 1, 1997, "in-or-at-the-money" was defined in Regulation T to mean the price of the underlying security is not more than one standard exercise price interval below the exercise price of the option being hedged in the case of a call option, or above in the case of a put option. Provisions pertaining to market-makers and specialists were removed from Regulation T effective June 1, 1997, due to an exemption for market-makers and specialists that resulted from passage of the National Securities Markets Improvement Act of 1996. The Exchange, as well as the New York Stock Exchange, adopted the provisions of Regulation T applicable to market-makers and implemented them as exchange rules effective June 1, 1997, except for the definition of "in-or-at-the-money." The current definition of "in-or-at-the-money," requiring two standard exercise price intervals, was proposed by the exchanges and approved by the Commission at that time.[8] This was done based upon the recommendation of an industry committee organized by the New York Stock Exchange to review its margin rules. That committee did consider relief in the form of eliminating the "in-or-at-the-money" requirement altogether, but a majority in favor of elimination was not attained at that time.

The Exchange also believes that the "in-or-at-the-money" requirement is not in tune with current options market-maker hedging technique. Options market-makers generally seek to create a risk-neutral hedge when they offset an option with a position in

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[8] See Securities Exchange Act Release No. 34-38709 (June 2, 1997), 62 FR 31643 (approving SR-CBOE-97-17).

the underlying security. In the case of an “out-of-the-money” option, they cannot create a risk-neutral hedge if they take a full 100 share position per option in the underlying security, because any gain/loss on the option being hedged would be outweighed by the loss/gain in the underlying security position. Therefore, losses on the underlying security position are not equally hedged and pose a risk. Instead, options market-makers will take a less than 100 share position in the underlying security per option being hedged so that any gain/loss on that position in dollar terms closely tracks that of the dollar gain/loss on the option position. When options market-makers hedge in this manner, known as “delta neutral hedging,” they cannot benefit from any gain on a position in the underlying security because it is equally offset by a loss in the option being hedged. Therefore, there is no need for a rule provision that was originally intended to guard against options market-makers obtaining good faith credit for trading in the underlying security that is unrelated to the options market-making business.

It should be noted that internal risk control systems at all of the broker-dealers that clear and carry the accounts of options market-makers impose a delta neutral trading standard on options market-makers, monitor options marker-makers’ compliance with the clearing firm’s risk limits, and intervene as necessary to counter any deviation from acceptable risk levels. The internal risk control systems employed by the clearing firms thus provide as good a deterrent against unrelated trading in the underlying security or instrument as the current “in-or-at-the-money” requirement.

Another reason why the Exchange deems the “in-or-at-the-money” requirement unnecessary is the fact that, when a clearing firm extends good faith margin on a security underlying an option, it must reduce its net capital by any amount by which the deduction

required by Rule 15c3-1 under the Securities Exchange Act of 1934 (the "haircut") exceeds the amount of equity in the options market maker's account. Thus, the market-maker must post enough margin to cover the haircut requirement or the clearing firm must, in effect, post the margin, or any portion not on deposit in the market-maker's account, by setting aside its capital. In this way there is a safety cushion to cover the credit risk when good faith margin is extended and the good faith requirement is less than the haircut requirement. Thus, when good faith margin is extended, the haircut requirement is a de facto minimum margin requirement.

In further support of eliminating the "in-or-at-the-money" requirement is the fact that, according to each of the options market maker clearing firms, a violation of the "in-or-at-the-money" requirement is very rare. The clearing firms also point out that when the price of an underlying security established for hedging purposes changes in a manner so as to exceed the two standard exercise price interval, the underlying security maintains its permitted offset status, and it becomes impractical to determine which shares are not qualified for permitted offset treatment.

2. Statutory Basis

The proposed rule is intended eliminate a requirement that impedes options market makers from hedging, on a good faith margin basis, "out-of-the-money" options having standard exercise price intervals of less than five points. As such, the proposed rule change is consistent with and furthers the objectives of Section 6(b)(5) of the Act, 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

CBOE does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of 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 either 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 the Exchange consents, the Commission will:

(A) by order approve such proposed rule change; or

(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 proposal 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-2004-54 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-2004-54. 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. 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. Copies of such filing will also 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-2004-54 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.[9]

Margaret H. McFarland
Deputy Secretary

[9] 17 CFR 200.30-3(a)(12).