SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51766; File No. SR-CBOE-2004-54)

May 31, 2005

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

I. Introduction

On July 30, 2004, the Chicago Board Options Exchange, Incorporated ("CBOE" or "Exchange") 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[2] thereunder, a proposed rule change seeking to amend rules relating to margin treatment on stock transactions effected by an options market maker to hedge options positions. On February 22, 2005, the CBOE filed a partial amendment to its proposed rule change.[3] The proposed rule change, as amended, was published for comment in the Federal Register on April 13, 2005.[4] The Commission received no comments on the proposal.

II. Description

The Exchange has proposed to eliminate a rule that essentially disallows favorable margin treatment on stock transactions initiated by options market makers to hedge an

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.

4 See Securities Exchange Act Release No. 51497 (April 6, 2005), 70 FR 19536 (April 13, 2005).

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. 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, provided the underlying security meets the definition of a "permitted offset." 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.

The Exchange has stated that 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 Exchange has proposed to remove the "in-or-at-the-money" requirement.[5]

The Exchange noted that the "in-or-at-the-money" requirement is not consistent with current options market-maker hedging technique. 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

5 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.

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.

The Exchange further noted that the "in-or-at-the-money" requirement is unnecessary because, 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.

III. Discussion and Commission Findings

After careful review, 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.[6] In particular, the Commission believes that the proposed rule change is consistent with Section 6(b)(5) of the Act[7], which requires that the rules of the exchange be designed, among other things, to remove impediments to and perfect the mechanisms of a free and open market, and, in general, to protect investors and the public interest. The Commission finds that amending the rules relating to margin treatment on stock transactions effected by an options market maker to hedge options positions, by eliminating the "in-or-at-the-money" requirement, is consistent with the requirements of Section 6(b)(5), in that the "in-or-at-the-money"

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6 In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

7 15 U.S.C. 78f(b)(5).

requirement 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.

IV. Conclusion.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[8] that the proposed rule change (File No. SR-CBOE-2004-54), as amended, be, and it hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[9]

Margaret H. McFarland
Deputy Secretary

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8 15 U.S.C. 78s(b)(2).

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