

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-52739; File No. SR-CBOE-2004-53)

November 4, 2005

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of Proposed Rule Change and Partial Amendment No. 1 Relating to Margin Requirements for Complex Options Spreads.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”),¹ and Rule 19b-4² thereunder, notice is hereby given that on July 30, 2004, the Chicago Board Options Exchange, Incorporated (“CBOE” or the “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change and on August 23, 2005, filed a partial amendment to its proposed rule change³ as described in Items I, II and III below, which Items have been prepared by the CBOE. The Commission is publishing this notice to solicit comments on the proposed rule change from interested parties.

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

CBOE is proposing to incorporate margin requirements that are currently set forth in a Regulatory Circular into the Exchange's rules. The margin requirements pertain to complex option spreads. The text of the proposed rule change is available at the Office of the Secretary, CBOE and at the Commission.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ SR-CBOE-2004-53: Amendment No. 1. CBOE, in coordination with the New York Stock Exchange, Inc. (“NYSE”), filed the partial amendment to conform the complex options spreads strategies to which its rule amendments apply to those of the NYSE.

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

In its filing with the Commission, 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 IV 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, Proposed Rule Change

1. Purpose

The CBOE is proposing to incorporate the provisions of a Regulatory Circular (RG03-066 – Margin Requirements for Certain Complex Spreads, dated August 13, 2003) into the Exchange’s margin rules (Chapter 12). CBOE Regulatory Circular RG03-066 presents an interpretation of current margin requirements that allows the Exchange to derive, and put into effect, margin requirements for certain complex option spreads. This Regulatory Circular, a copy of which is attached as Exhibit A, was approved by the Commission on a one-year pilot basis.⁴ This Regulatory Circular has been reissued as RG04-90 (dated August 16, 2004) and RG05-37 (dated April 6, 2005) pursuant to extensions of the pilot period granted by the Commission.⁵

As shown in Exhibit B, the Exchange is proposing to add definitions in Rule 12.3(a) of a “long condor spread,” “short iron butterfly spread” and “short iron condor spread.” These definitions cover six of the seven strategies identified in RG03-066.

⁴ See Securities Exchange Act Release No. 48306 (Aug. 8, 2003), 68 FR 48974 (Aug. 15, 2003) (approving SR-CBOE-2003-24).

⁵ See Securities Exchange Act Release No. 50164 (Aug. 6, 2004), 69 FR 50405 (Aug. 16, 2004) and Securities Exchange Act Release No. 51407 (Mar. 22, 2005), 70 FR 15669 (Mar. 28, 2005).

Each definition covers two strategies identified in RG03-066 because each definition provides for a base strategy, in which all options expire at the same time, and a calendar spread strategy, in which a long option may expire after the other options expire concurrently.

The Exchange is proposing a revision to its current definition of a butterfly spread to provide for the remaining strategy, a calendar spread version of the long butterfly spread (configuration number three in RG03-066). These revisions consist of (1) splitting the current butterfly spread definition into two definitions, one for the long butterfly spread and one for the short butterfly spread, (2) fashioning the two definitions so that they are consistent with the style and format of the new definitions referred to in the prior paragraph, and (3) providing for a calendar spread version in the long butterfly spread definition.

In Regulatory Circular RG03-066, call options were utilized to construct three of the seven strategy examples. Each of these three strategies has a parallel application with put options. For brevity, the put option versions were not specifically identified in the Regulatory Circular, but the Regulatory Circular was intended to apply to the put option counterpart of each of the strategies demonstrated with call options. Both the put and call option versions are provided for in the newly proposed rule definitions. The remaining four complex spread strategies originally identified in the Regulatory Circular involved both call options and put options (that is, “iron” strategies). Each of these four strategies has a reciprocal configuration (that is, the call options can precede the put options in ascending sequence of exercise prices). However, there is no need to address the

reciprocal variations because there is no benefit from a margin requirement standpoint of including them in the iron strategy definitions.

As indicated in the Regulatory Circular and discussed in the Exchange's original filing of the Regulatory Circular with the Commission,⁶ each of the complex spreads identified in the proposed rule can be derived by combining and netting two or more option spreads (that is, the butterfly spread, the box spread and the time spread) that are already identified in the margin rules and ascribed a margin requirement. Furthermore, the sum of the margin required on the basic option spreads that can be combined and netted to form a complex spread covers the maximum risk of the complex spread and, as in the Regulatory Circular, is the margin requirement specified in the proposed rules. Each of the subject complex spread strategies has a known and limited risk when configured as specified in the proposed definitions. As proposed, current Rule 12.3(c)(5)(C)(6) is revised to provide a margin requirement for each of the long condor spread, short iron butterfly spread and short iron condor spread.

Consistent with the Regulatory Circular, nothing in the proposed rule would prevent the subject complex spreads from being established outright. Thus, it would not be required that the applicable combination of individual option strategies first be establish and netted.

Like the Regulatory Circular, the proposed rule prohibits European style options in the case of the calendar version of a complex spread, and requires that the interval between each option series be equal in the case of all complex spread strategies. However, unlike the Regulatory Circular, the proposed rules would not limit complex

⁶ See Securities Exchange Act Release No. 48115 (July 1, 2003), 68 FR 41027 (July 9, 2003).

spreads to a margin account. The Exchange is additionally proposing a revision to Rule 12.3(e) – Customer Cash Account – Spreads, that adds the long condor spread, short iron butterfly spread and short iron condor spread as strategies permitted to be established and carried in a cash account, provided they are composed of cash-settled, European style options that all expire at the same time.

The Exchange has received no negative comments concerning Regulatory Circular RG03-66 since it has been issued. The Exchange is not aware of any negative consequences as a result of applying the margin requirements permitted by Regulatory Circular RG03-66.

2. Statutory Basis

The Exchange believes that the proposed margin requirements cover the maximum risk involved, providing sufficient safety and soundness for the clearing firm and the market overall. Additionally, the proposed rule would allow investors to more efficiently implement the subject complex spreads. As such, the proposed rule change is consistent with Section 6(b) of the Act⁷, in general, and furthers the objectives of Section 6(b)(5)⁸ 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 the 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 solicited or received with respect to the proposed rule change.

⁷ 15 U.S.C. 78f(b).

⁸ 15 U.S.C. 78f(b)(5).

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 self-regulatory organization 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 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-2004-53 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-9303.

All submissions should refer to File Number SR-CBOE-2004-53. 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, 100 F Street, NE, 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 available publicly. All submissions should refer to File Number SR-CBOE-2004-53 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

Jonathan G. Katz
Secretary

⁹ 17 CFR 200.30-3(a)(12).

EXHIBIT A

Regulatory Circular RG03-66

To: Member Organizations

From: Division of Regulatory Services

Date: August 13, 2003

Subject: Margin Requirements for Certain Complex Spreads

Exchange James Adams (312) 786-7718
Contacts: Richard Lewandowski (312) 786-7183

KEY POINTS

- Certain complex option spreads (specified below) are the equivalent of combining two or more spreads that are currently recognized in the margin rules of the Chicago Board Options Exchange (the “Exchange” or “CBOE”).
- Because these complex spreads can be shown to equate to aggregations of two or more currently recognized spreads, current margin rules are deemed to provide a margin requirement for each complex spread in that the rules provide a margin requirement for each spread in the equivalent aggregation.
- Member organizations may require margin for these complex spreads of not less than the sum of the margin required on each spread in the equivalent aggregation.
- The margin requirements set forth in this Regulatory Circular will be in effect as a pilot until August 8, 2004.

DISCUSSION

It is known that certain complex spread configurations are the net result of combining two or more spread strategies that are currently recognized in the Exchange's margin rules. Specific complex spread configurations are listed below, along with the currently recognized spreads to which they can be traced. The expiration months, exercise prices, interval between exercise prices, and option premiums used in each configuration are for illustration only. However, as illustrated, the expiration months and sequence of the exercise prices must fit the same pattern, and the intervals between the exercise prices must be equal. Note that netting of contracts in option series common to each of the currently recognized spreads in an aggregation reduces it to the complex spread.

	<i>PUTS</i>			<i>CALLS</i>					
	Feb 45 @ .5	Feb 50 @ 1	Feb 55 @ 2	Feb 45 @ 16.5	Feb 50 @ 12	Feb 55 @ 8	Feb 60 @ 6	Feb 65 @ 5	Apr 60 @ 7
Long Butterfly					1	-2	1		
Long Butterfly						1	-2	1	
Net - Configuration I					1	-1	-1	1	
Long Butterfly					1	-2	1		
Short Box		1	-1		-1	1			
Net - Configuration II		1	-1			-1	1		
Long Butterfly					1	-2	1		
Long Butterfly						1	-2	1	
Short Box		1	-1		-1	1			
Net - Configuration III		1	-1				-1	1	
Long Time Spread							-1		1
Long Butterfly					1	-2	1		
Net - Configuration IV					1	-2			1
Long Time Spread							-1		1
Long Butterfly					1	-2	1		
Long Butterfly				1	-2	1			
Net - Configuration V				1	-1	-1			1
Long Time Spread							-1		1
Long Butterfly					1	-2	1		
Short Box		1	-1		-1	1			
Net - Configuration VI		1	-1			-1			1
Long Time Spread							-1		1
Long Butterfly					1	-2	1		
Long Butterfly				1	-2	1			
Short Box	1	-1		-1	1				
Net - Configuration VII	1	-1				-1			1

As illustrated above, the complex spread configurations equate to aggregations of currently recognized spreads. Therefore, for complex spreads fitting the above configurations, whether established outright or through netting, member firms must

require initial and maintenance margin of not less than the sum of the margin required on each of the currently recognized spreads in the applicable aggregation subject to the following limitations:

- the complex spread must be carried in a margin account,
- European style options are not permitted for the configurations involving time spreads (IV through VII),
- the intervals between exercise prices must be equal, and
- each complex spread must comprise four option series, except for Configuration IV, which must comprise three option series.

Summing the margin required on each currently recognized spread in each of the applicable aggregations renders a margin requirement for the subject complex spread configurations as follows:

Configuration	Margin Requirement
I	Pay for the net debit in full
II	Exercise price interval (aggregate), net credit may be applied
III	Exercise price interval (aggregate), net credit may be applied
IV	Pay for the net debit in full
V	Pay for the net debit in full
VI	Exercise price interval (aggregate), net credit may be applied
VII	Exercise price interval (aggregate), net credit may be applied

Using Configuration III as an example, the margin requirement and SMA debit or margin call would be as follows:

	PUTS		CALLS			
	Feb 50 @ 1	Feb 55 @ 2	Feb 50 @ 12	Feb 55 @ 8	Feb 60 @ 6	Feb 65 @ 5
Long Butterfly #1			1	-2	1	
Long Butterfly #2				1	-2	1
Short Box #1	1	-1	-1	1		
Net – Configuration III	1	-1			-1	1

EXHIBIT B

(additions: underlined, deletions:[bracketed])

CHICAGO BOARD OPTIONS EXCHANGE, INC.

CHAPTER XII

Margins

Rule 12.3. Margin Requirements

12.3 (a) *Definitions.* For purposes of this Rule, the following terms shall have the meanings specified below.

(1) through (4) – No change

(5) The term “long butterfly spread” means **long put / two short puts / long put or long call / two short calls / long call** where: the options are on the same underlying instrument, the long options are different option series, the short options are the same option series, the exercise prices of the positions are in ascending order, either all options expire at the same time or a long option expires after the other options expire concurrently, and the interval between exercise prices is equal. In the case of long butterfly spreads composed of cash-settled, European style index options, all options must expire at the same time. [The term "butterfly spread" means an aggregation of positions in three series of either put or call options all having the same underlying component or index and time of expiration, and based on the same aggregate current underlying value, where the interval between the exercise price of each series is equal, which positions are structured as either A) a "long butterfly spread" in which two short options in the same series are offset by one long option with a higher exercise price and one long option with a lower exercise price or B) a

"short butterfly spread" in which two long options in the same series offset one short option with a higher exercise price and one short option with a lower exercise price.]

(6) The term "short butterfly spread" means **short put / two long puts / short put or short call / two long calls / short call** where: the options are on the same underlying instrument, the short options are different option series, the long options are the same option series, the exercise prices of the positions are in ascending order, all options expire at the same time, and the interval between exercise prices is equal.

(7) The term "long condor spread" means **long put / short put / short put / long put or long call / short call / short call / long call** where: the options are on the same underlying instrument, each option is a different option series, the exercise prices of the options are in ascending order, either all options expire at the same time or a long option expires after the other options expire concurrently, and the interval between exercise prices is equal. In the case of long condor spreads composed of cash-settled, European style index options, all options must expire at the same time.

(8) The term "short iron butterfly spread" means **long put / short put / short call / long call** where: the options are on the same underlying instrument, each option is a different option series, the exercise prices of the options are in ascending order, the short options have the same exercise price, either all options expire at the same time or a long option expires after the other options expire concurrently, and the interval between exercise prices is equal. In the case of short iron butterfly spreads composed of cash-settled, European style index options, all options must expire at the same time.

(9) The term "short iron condor spread" means **long put / short put / short call / long call** where: the options are on the same underlying instrument, each option is a different option series, the exercise prices of the options are in ascending order, either all options expire at the same time or a long option expires after the other options expire concurrently, and the interval between exercise prices is equal. In the case of short iron condor spreads composed of cash-settled, European style index options, all options must expire at the same time.

[(6)](10) The term "box spread" means an aggregation of positions in a long call option and short put option with the same exercise price ("buy side") coupled with a long put option and short call option with the same exercise price ("sell side") all of which have the same underlying component or index and time of expiration, and are based on the same aggregate current underlying value, and are structured as either: A) a "long box spread" in which the sell side exercise price exceeds the buy side exercise price or B) a "short box spread" in which the buy side exercise price exceeds the sell side exercise price.

[(7)](11) The term "underlying stock basket" means a group of securities which includes each of the component securities of the applicable index and which meets the following conditions (i) the quantity of each stock in the basket is proportional to its representation in the index, (ii) the total market value of the basket is equal to the underlying index value of the index options or warrants to be covered, (iii) the securities in the basket cannot be used to cover more than the number of index options or warrants represented by that value and (iv) the securities in the basket

shall be unavailable to support any other option or warrant transaction in the account.

[(8)](12) The term "cash equivalent" is as defined in Section 220.2 of Regulation T of the Board of Governors of the Federal Reserve System.

[(9)](13) The term "listed" for purposes of this Chapter 12 means a security traded on a registered national securities exchange or automated facility of a registered national securities association.

[(10)](14) The term "OTC margin bond" for purposes of this Chapter 12 means (1) any debt securities not traded on a national securities exchange that meet all of the following requirements (a) at the time of the original issue, a principal amount of not less than \$25,000,000 of the issue was outstanding; (b) the issue was registered under Section 5 of the Securities Act of 1933 and the issuer either files periodic reports pursuant to the Act or is an insurance company under Section 12(g)(2)(G) of the Act; or (c) at the time of the extension of credit the creditor has a reasonable basis for believing that the issuer is not in default on interest or principal payments; or (2) any private pass-through securities (not guaranteed by a U.S. government agency) that meet all of the following requirements: (a) an aggregate principal amount of not less than \$25,000,000 was issued pursuant to a registration statement filed with the Commission; and (b) current reports relating to the issue have been filed with the Commission; and (c) at the time of the credit extension, the creditor has a reasonable basis for believing that mortgage interest, principal payments and other distributions are being passed through as required and that the servicing agent is meeting its material obligations under the terms of the offering.

(b) – No change

(c)(1) through (c)(5)(C)(5) - No change

[6] *Butterfly Spread*. This subparagraph (c)(6)(C)(6) applies to a butterfly spread as defined in subparagraph (a)(5) of this Rule where all option positions are listed or guaranteed by the carrying broker-dealer.

(1) In respect of a long butterfly spread as defined in subparagraph (a)(5) of this Rule, the net debit must be paid in full.

(2) In respect of a short butterfly spread as defined in subparagraph (a)(5) of this Rule, margin must be deposited and maintained equal to at least the amount of the aggregate difference between the two lowest exercise prices with respect to short butterfly spreads comprised of calls options or the aggregate difference between the two highest exercise prices with respect to short butterfly spreads comprised of put options. The net proceeds from the sale of short option components may be applied to the requirement.]

(6) Long Butterfly Spread or Long Condor Spread. This subparagraph (c)(5)(C)(6) applies to a long butterfly or condor spread as defined in subparagraphs (a)(5) and (a)(7), respectively, of this Rule where all option positions are listed or guaranteed by the carrying broker-dealer. In respect of a long butterfly or long condor spread as defined in subparagraphs (a)(5) and (a)(7), respectively, of this Rule, the net debit must be paid in full.

(7) Short Butterfly Spread, Short Iron Butterfly Spread or Short Iron Condor Spread. This subparagraph (c)(5)(C)(7) applies to a short butterfly, short iron butterfly or short iron condor spread as defined in subparagraphs (a)(6), (a)(8) and (a)(9),

respectively, of this Rule where all option positions are listed or guaranteed by the carrying broker-dealer. In respect of a short butterfly, short iron butterfly or short iron condor spread as defined in subparagraphs (a)(6), (a)(8) and (a)(9), respectively, of this Rule, margin must be deposited and maintained equal to at least the amount of the exercise price interval. The net proceeds from the sale of short option components may be applied to the requirement.

~~[(7)](8)~~ *Box Spread.* This subparagraph ~~[(c)(6)(B)(7)]~~ ~~(c)(5)(C)(8)~~ applies to box spreads as defined in subparagraph ~~(a)[(6)](10)~~ of this Rule where all option positions are listed or guaranteed by the carrying broker-dealer.

(1) In respect of a long box spread as defined in subparagraph ~~(a)[(6)](10)~~ of this Rule, the net debit must be paid in full.

(2) In respect of a short box spread as defined in subparagraph ~~(a)[(6)](10)~~ of this Rule, margin must be deposited and maintained equal to at least the amount of the aggregate difference between the exercise prices. The net proceeds from the sale of short option components may be applied to the requirement.

~~[(8)](9)~~ *Long Box Spread in European Style Options.* In respect of a long box spread as defined in subparagraph ~~(a)[(6)](10)~~ of this Rule, in which all component options have a European style exercise provision and are listed or guaranteed by the carrying broker-dealer; margin must be deposited equal to at least 50% of the aggregate difference in the exercise prices. The net proceeds from the sale of short option components may be applied to the requirement. For margin purposes, the long box spread may be valued at an amount not to exceed 100% of the aggregate difference in the exercise prices.

(d) – No change

(e) *Customer Cash Account --Spreads.* A European style cash-settled index option, stock index warrant or currency index warrant carried in a short position is deemed a covered position, and eligible for the cash account, provided a long position in a European style cash-settled index option, stock index warrant or currency warrant having the same underlying component or index that is based on the same aggregate current underlying value, is held in or purchased for the account on the same day provided:

(1) – No change

(2) Long Butterfly Spreads, Short Butterfly Spreads, Long Condor Spreads, Short Iron Butterfly Spreads or Short Iron Condor Spreads. The captioned spreads, as defined in subparagraphs (a)(5), (a)(6), (a)(7), (a)(8) and (a)(9), respectively, of this Rule, are permitted in a cash account only if they are composed of cash settled, European style options and all options expire at the same time, [Put or call options carried in a short position are deemed covered positions and eligible for the cash account provided the account contains long positions of the same type which in conjunction with the short options constitute a butterfly spread as defined in subparagraph (a)(5) of this Rule] and provided:

[(A) all component options are European style,]

[(B) all component options are cash settled,]

[(C)](A) the long options are held in, or purchased for the account on the same day,

[(D)](B) in respect of a long butterfly spread or long condor spread as defined in subparagraphs (a)(5) and (a)(7), respectively, of this Rule, the net debit is paid in full,

[(E)](C) in respect of a short butterfly spread, short iron butterfly spread or short iron condor spread as defined in subparagraphs (a)([5]6), (a)(8) and (a)(9), respectively, of this Rule, either there is held in the account at the time the positions are established or received into the account promptly thereafter:

(1) cash or cash equivalents of not less than the amount of the exercise price interval[aggregate difference between the two lowest exercise prices with respect to short butterfly spreads comprised of call options or the aggregate difference between the two highest exercise prices with respect to short butterfly spreads comprised of put options], to which requirement the net proceeds from the sale of short option components may be applied, or

(2) an escrow agreement. The escrow agreement must certify that the bank holds for the account of the customer as security for the agreement 1) cash, 2) cash equivalents or 3) a combination thereof having an aggregate market value at the time the positions are established of not less than the amount of the exercise price interval[aggregate difference between the two lowest exercise prices with respect to short butterfly spreads comprised of call options or the aggregate difference between the two highest exercise prices with respect to short butterfly spreads comprised of put options] and that the bank will promptly pay the member organization such amount in

the event the account is assigned an exercise notice [on the call (put) with the lowest (highest) exercise price].

[(F)](D) all component options are listed or guaranteed by the carrying broker-dealer.

(3) – No change

12.3(f) through (k) – No change

...Interpretations and Policies:

.01 - .19 – No change