

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-57429; File No. SR-CBOE-2006-36)

March 4, 2008

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Granting Approval of Proposed Rule Change, as Modified by Amendments No. 1, 2, and 3 Thereto, to Modify the Minimum Value Size for an Opening Transaction in a Currently-Opened FLEX Equity Series and to Establish a Pilot Program that Reduces the Minimum Number of Contracts Required for a FLEX Equity Option Opening Transaction in a New Series

I. Introduction

On April 14, 2006, 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 thereunder,² a proposed rule change to make changes to the minimum value size for an opening transaction in a currently-opened FLEX Equity series and to establish a one-and-a-half-year pilot program that reduces the minimum number of contracts required for a FLEX Equity Option opening transaction in a new series (“Pilot Program”).³ On December 24, 2007, CBOE filed Amendments No. 1 and 2 to the proposed rule change.⁴ The amended proposed rule change was published for comment in the Federal Register on January 24, 2008.⁵ The Commission received no comments on the proposal. On March 3, 2008, CBOE filed Amendment No. 3 to the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ CBOE defines the term “FLEX Equity Option” to mean an option on a specified underlying equity security that is subject to the rules in Chapters 24A and 24B. See CBOE Rule 24A.1(e) and CBOE Rule 24B.1(f), respectively.

⁴ Amendment No. 1 replaced and superseded the original filing in its entirety. Amendment No. 2 replaced and superseded Amendment No. 1 in its entirety.

⁵ See Securities Exchange Act Release No. 57161 (January 16, 2008), 73 FR 4293 (January 24, 2008).

proposed rule change.⁶ This order approves the proposed rule change, as modified by Amendments No. 1, 2, and 3.

II. Description of the Proposal

CBOE is proposing to reduce the minimum value size for an opening transaction (other than FLEX Quotes responsive to a FLEX Request for Quotes) in any FLEX Equity Option⁷ series in which there is no open interest at the time the Request for Quotes is submitted on a pilot basis for one-and-a-half years. Currently, the minimum opening transaction value size in the case of a FLEX Equity Options in a newly established series is the lesser of (i) 250 contracts or (ii) the number of contracts overlying \$1 million in the underlying securities.⁸ Under the Pilot Program, the Exchange proposes to reduce the “250 contracts” component to “150 contracts;” the \$1 million underlying value component will continue to apply unchanged.⁹ If the Exchange were to propose an extension, expansion, or permanent implementation of the Pilot Program, the Exchange would submit, along with a filing proposing any necessary amendments to the Pilot Program, a pilot program report. The report would be submitted to the Commission at least ninety days prior to the expiration date of the one-and-a-half year Pilot Program.

⁶ Amendment No. 3 is a technical amendment that corrects a typographical error in the proposed rule language and is not subject to notice and comment.

⁷ FLEX Equity Options are flexible exchange-traded options contracts which overlie equity securities. FLEX Equity Options provide investors with the ability to customize basic option features including size, expiration date, exercise style, and certain exercise prices.

⁸ Under this formula, an opening transaction in a FLEX Equity series in a stock priced at \$40 or more would reach the \$1 million limit before it would reach the contract size limit, i.e., 250 contracts times the multiplier (100) times the stock price (\$40) equals \$1 million in underlying value. For a FLEX Equity series in a stock priced at less than \$40, the 250 contract size limit applies.

⁹ Under this proposed formula, an opening transaction in a FLEX Equity series in a stock priced at approximately \$66.67 or more would reach the \$1 million limit before it would reach the contract size limit, i.e., 150 contracts times the multiplier (100) times the stock price (\$66.67) equals just over \$1 million in underlying value. For a FLEX Equity series in a stock priced at less than \$66.67, the 150 contract size limit would apply.

Given that FLEX Equity Option transactions can occur in increments of 100 or more contracts in subsequent opening transactions,¹⁰ the Exchange believes it is reasonable to permit the initial series opening transaction size to be 150 contracts (or \$1 million in underlying value, whichever is less). The Exchange believes that the proposed reduction of the minimum value size for opening a series provides FLEX-participating members with greater flexibility in structuring the terms of FLEX Equity Options that best comports with their and their customers' particular needs. The Exchange notes that the opening size requirement for FLEX Equity Options was originally put in place to limit participation in FLEX Equity Options to sophisticated, high net worth investors rather than retail investors.¹¹ According to CBOE, it has recently received requests from broker-dealers representing institutional clients that the minimum value size for opening transactions be reduced. In proposing the reduction of the 250 contract component to 150 contracts, CBOE stated in its filing that it is cognizant of the desire to continue to provide both the requisite amount of investor protection that the minimum opening size requirement was originally designed to achieve, as well as the need for market participants to have the flexibility to serve their customers' particular investment needs.

¹⁰ Specifically, the minimum value size for a transaction in any currently-opened FLEX Equity Option series is 100 contracts in the case of opening transactions and 25 contracts in the case of closing transactions (or any lesser amount in a closing transaction that represents the remaining underlying size, whichever is less). Additionally, the minimum value size for a FLEX Quote entered in response to a Request for Quotes in FLEX Equity Options is the lesser of 25 contracts or the remaining underlying size in a closing transaction. See Exchange Rules 24A.4(a)(4)(iii) – (iv) and 24B.4(a)(5)(iii) – (iv). A “FLEX Quote” refers to (i) FLEX bids and offers entered by Market-Makers and (ii) orders to purchase and orders to sell FLEX Options entered by Exchange members other than Market-Makers, in each case in response to a Request for Quotes. See CBOE Rules 24A.1(h) and 24B.1(k).

¹¹ The existing customer base for FLEX Options includes both institutional investors and high net worth individuals.

The Exchange also believes that modifying the minimum opening transaction value size in this way will further broaden the base of institutional investors that use FLEX Equity Options to manage their trading and investment risk, including investors that currently trade in the over-the-counter (“OTC”) market for customized options which can take on contract characteristics similar to FLEX Options but for which similar opening size restrictions do not apply. CBOE believes market participants benefit from being able to trade these customized options in an exchange environment in several ways, including, but not limited to, enhanced efficiency in initiating and closing out positions; increased market transparency; and heightened contra-party creditworthiness due to the role of The Options Clearing Corporation as issuer and guarantor of FLEX Equity Options.

Finally, the Exchange is also proposing to modify the minimum value size for an opening transaction in a currently-opened FLEX Equity series (other than FLEX Quotes responsive to a FLEX Request for Quotes). Presently, the minimum transaction value size for an opening transaction in a currently-opened series is 100 contracts. The Exchange is proposing to modify the minimum size formula to the lesser of (i) 100 contracts or (ii) the number of contracts overlying \$1 million in the underlying securities. This change would only impact those FLEX Equity series in which the underlying stock is trading at more than \$100.¹²

¹² Under this proposed formula, a transaction in a currently-opened FLEX Equity series in a stock priced at more than \$100 would reach the \$1 million limit before it would reach the contract size limit, *i.e.*, 100 contracts times the multiplier (100) times the stock price (\$100) equals \$1 million in underlying value. Telephone conference between Jennifer Lamie, Assistant General Counsel, CBOE, and Kristie Diemer, Special Counsel, Division of Trading and Markets, Commission, on February 28, 2008 clarifying that the underlying stock price would have to be trading at “more than \$100” versus “\$100 or more” to meet a \$1 million limit before the 100 contract size limit. (“February 28 Telephone Conversation.”)

The FLEX minimum size requirements for subsequent opening transactions in a currently-opened series is higher for certain stocks priced over \$100 than the minimum size needed to initially open the series in similarly priced stocks. The Exchange therefore believes that, this change is necessary for there to be consistency between the minimum size requirements for new series and currently-opened series when the underlying stock is trading at more than \$100.¹³

III. Discussion and Commission Findings

The Commission has carefully reviewed the proposed rule change and finds that it is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.¹⁴ In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,¹⁵ which, among other things, requires that the rules of a national securities exchange be designed to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest.

The Commission believes that the proposed rule change, in reducing the minimum opening size from 250 contracts to 150 contracts (or an underlying value of \$1 million,

¹³ For example, a new FLEX Equity series in a stock trading at \$110 could open with an initial transaction size of 91 contracts, *i.e.*, 91 contracts times the multiplier (100) times the stock price (\$110) equals just over \$1 million in underlying value. Once the series is opened, absent the proposed change, any further opening transactions would require a minimum contract size of 100 contracts, despite the fact that with the stock price of \$110, this would be valued at \$1.1 million, more than the value of the initial opening transaction.

¹⁴ 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).

¹⁵ 15 U.S.C. 78f(b)(5).

whichever is less) in an initial opening transaction, should allow CBOE to better meet the needs of investors in the FLEX Equity Options market. The requirements as proposed, however, should still be significant enough to limit FLEX Equity Options to institutional and high net worth customers, the intended customers, rather than retail investors. In addition, the Commission agrees with the Exchange that the proposal to lower the opening size may allow more market participants to benefit from trading customized-type options in the Exchange's FLEX Equity Options market as opposed to the OTC market. As noted above, some of the benefits of trading on an exchange may include, among others, enhanced efficiency in initiating and closing out positions; increased market transparency; and heightened contra-party creditworthiness due to the role of The Options Clearing Corporation as issuer and guarantor of FLEX Equity Options.

As noted above, the proposal to reduce the minimum number of contracts required for a FLEX Equity Option in an initial opening transaction is being approved on a one-and-a-half-year pilot basis. The Commission has requested that CBOE provide a report to it should CBOE wish to extend the Pilot Program or implement the change on a permanent basis. At a minimum, the report must provide (i) data and analysis on the open interest and trading volume in FLEX Equity Options for which series were opened with a minimum opening size of 150 to 249 contracts and less than \$1 million in underlying value; and (ii) analysis on the types of investors that initiated opening FLEX Equity Options transactions (i.e., institutional, high net worth, or retail, if any). The report, along with any filing to extend or permanently implement the Pilot Program,¹⁶ should

¹⁶ CBOE agreed to submit any related filing (in addition to the report) at least ninety days prior to the expiration of the Pilot Program in the February 28 Telephone Conversation. See supra, note 12.

be submitted to the Commission at least ninety days prior to the expiration date of the one-and-a-half-year Pilot Program.

The report should provide the Commission with information on whether the intended customers (institutional and high net worth) are in fact the investors utilizing the lower opening contract requirement in the FLEX Equity Options market, as well as whether the lower opening size has increased liquidity in FLEX Equity Options. Based on the report's information, the Commission should be able to determine whether the Pilot Program should be extended or approved on a permanent basis, consistent with the Act.

The Commission also believes that the aspect of the proposal that modifies the minimum value size for an opening transaction in a currently-opened FLEX Equity series (other than FLEX Quotes responsive to a FLEX Request for Quotes) to the lesser of (i) 100 contracts or (ii) the number of contracts overlying \$1 million in the underlying securities is also consistent with the Act and the rules and regulations thereunder. The Commission agrees with the Exchange that this change will provide consistency between the minimum size requirements for opening transactions in both new series and currently-opened series when the underlying stock is trading at more than \$100. The change avoids the result that, for situations where the underlying stock is priced over \$100, the effect of current CBOE rules is to require a higher opening amount for currently-opened series than for newly established series.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁷ that the proposed rule change (SR-CBOE-2006-36), as modified by Amendments No. 1, 2, and 3, be, and hereby is, approved with respect to the minimum value size for an opening transaction in a currently-opened FLEX Equity series (other than FLEX Quotes responsive to a FLEX Request for Quotes) and to establish a Pilot Program for one-and-a-half-years with respect to the reduced minimum number of contracts required for a FLEX Equity Option Opening transaction in a new series.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁸

Florence E. Harmon
Deputy Secretary

¹⁷ 15 U.S.C. 78s(b)(2).

¹⁸ 17 CFR 200.30-3(a)(12).