

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-56631; File No. CBOE-2007-99)

October 9, 2007

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated.; Notice of Filing of Proposed Rule Change, as Modified by Amendment No. 1, Relating to a Delta Hedging Exemption From Equity Options Position 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 August 21, 2007, the Chicago Board Options Exchange, Incorporated (“CBOE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) a proposed rule change as described in Items I, II, and III below, which Items have been prepared substantially by the CBOE. The Exchange filed Amendment No. 1 to the proposal on October 4, 2007.³ The Commission is publishing this notice to solicit comments on the proposed rule change, as modified by Amendment No. 1, from interested persons.

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

The Exchange proposes to create a delta hedging exemption from equity options position limits. The text of the proposed rule change is available at CBOE, the Commission’s Public Reference Room, and www.cboe.com/legal.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 1 replaces and supersedes the previously filed proposed rule change in its entirety.

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. 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

All options traded on the Exchange are subject to position and exercise limits, as provided under CBOE Rules 4.11 and 4.12.⁴ Position limits are imposed, generally, to maintain fair and orderly markets for options and other securities by limiting the amount of control one or more affiliated persons or entities may have over one particular options class or the security or securities that underlie that options class. Exchange rules also contain various hedge exemptions to allow certain hedged positions in excess of the applicable standard position limit.⁵

Over the years, CBOE has increased the size of options position and exercise limits, as well as the size and scope of available hedge exemptions to the applicable position limits.⁶ These hedge exemptions generally require a one-to-one hedge (i.e., one stock option contract must be hedged by the number of shares underlying the options contract, typically 100 shares).

⁴ Position limits for index options are provided separately under CBOE Rules 24.4, 24.4A, and 24.4B.

⁵ See Interpretation and Policy .04 to Rule 4.11.

⁶ See, e.g., Securities Exchange Act Release No. 55176 (January 25, 2007), 72 FR 4741 (February 1, 2007) (SR-CBOE-2007-08); Securities Exchange Act Release No. 51244 (February 23, 2005), 70 FR 10010 (March 1, 2005) (SR-CBOE-2003-30); and Securities Exchange Act Release No. 45603 (March 20, 2002), 67 FR 14751 (March 27, 2002) (SR-CBOE-00-12).

In practice, however, many firms do not hedge their options positions in this manner. Instead, these firms engage in what is commonly known as “delta hedging.” Delta hedging varies the number of shares of the underlying security used to hedge an options position based upon the relative sensitivity of the value of the option contract to a change in the price of the underlying security.⁷ Delta hedging is a widely accepted method for risk management.

Delta Neutral-Based Equity Hedge Exemption. The Exchange proposes to adopt a new exemption from equity options position and exercise limits⁸ for positions held by CBOE members and certain of their affiliates that are “delta neutral”⁹ under a “permitted pricing model” (as defined below), subject to certain conditions (“Exemption”). The proposed Exemption would apply only to equity options (stock options and options on exchange-traded funds (“ETFs”)).¹⁰

Any equity option position that is not delta neutral would be subject to position and exercise limits, subject to the availability of other exemptions. Only the “option contract equivalent of the net delta” of such position would be subject to the appropriate position limit.¹¹

⁷ To illustrate, a stock option contract with a delta of .5 will move \$0.50 for every \$1.00 move in the underlying stock.

⁸ Rule 4.12 establishes exercise limits for an option at the same level as the option’s position limit under Rule 4.11; therefore, no changes are proposed to Rule 4.12.

⁹ The term “delta neutral” is defined in proposed Rule 4.11.04(c)(A) as referring to an equity option position that is hedged, in accordance with a permitted pricing model, by a position in the underlying security or one or more instruments relating to the underlying security, for the purpose of offsetting the risk that the value of the option position will change with incremental changes in the price of the security underlying the option position.

¹⁰ The Exchange intends to submit a separate proposed rule change to adopt a delta neutral-based hedge exemption for certain index options and to expand the delta neutral-based hedge exemption for ETF options to allow highly correlated instruments to be included in any ETF option net delta calculation.

¹¹ Under proposed Rule 4.11.04(c)(B), the term “options contract equivalent of the net delta” is defined as the net delta divided by the number of shares underlying the option contract, and the term “net delta” is defined as, at any time, the number of shares (either long or short) required to offset the risk that the value of an equity option position will

Only financial instruments relating to the security underlying an equity options position could be included in any determination of an equity options position's net delta or whether the options position is delta neutral. In addition, members could not use the same equity or other financial instrument position in connection with more than one hedge exemption. Therefore, a stock position used as part of a delta hedging strategy could not also serve as the basis for any other equity hedge exemption.

Permitted Pricing Model. Under the proposed rule, the calculation of the delta for any equity option position, and the determination of whether a particular equity option position is delta neutral, must be made using a permitted pricing model. A "permitted pricing model" is defined in proposed Rule 4.11.04(c)(C) to mean the pricing model maintained and operated by The Options Clearing Corporation ("OCC") and the pricing models used by (i) a member or its affiliate subject to consolidated supervision by the Commission pursuant to Appendix E of Rule 15c3-1 under the Act; (ii) a financial holding company ("FHC") or a company treated as an FHC under the Bank Holding Company Act of 1956, or its affiliate subject to consolidated holding

change with incremental changes in the price of the security underlying the option position, as determined in accordance with a permitted pricing model.

company group supervision;¹² (iii) a Commission-registered OTC derivatives dealer;¹³ and (iv) a national bank.¹⁴

Aggregation of Accounts. Members and non-member affiliates relying on the Exemption would be required to ensure that the permitted pricing model is applied to all positions in or relating to the security underlying the relevant options position that are owned or controlled by the member, or its affiliates.

However, the net delta of an options position held by an entity entitled to rely on the Exemption, or by a separate and distinct trading unit of such entity, may be calculated without

¹² The pricing model of an FHC or of an affiliate of an FHC would have to be consistent with: (i) the requirements of the Board of Governors of the Federal Reserve System (“FRB”), as amended from time to time, in connection with the calculation of risk-based adjustments to capital for market risk under capital requirements of the FRB, provided that the member or affiliate of a member relying on this exemption in connection with the use of such model is an entity that is part of such company’s consolidated supervised holding company group; or (ii) the standards published by the Basel Committee on Banking Supervision, as amended from time to time and as implemented by such company’s principal regulator, in connection with the calculation of risk-based deductions or adjustments to or allowances for the market risk capital requirements of such principal regulator applicable to such company – where “principal regulator” means a member of the Basel Committee on Banking Supervision that is the home country consolidated supervisor of such company – provided that the member or affiliate of a member relying on this exemption in connection with the use of such model is an entity that is part of such company’s consolidated supervised holding company group. See subparagraph (C)(3) of proposed Rule 4.11.04(c).

¹³ The pricing model of a Commission-registered OTC derivatives dealer would have to be consistent with the requirements of Appendix F to Rules 15c3-1 and 15c3-4 under the Act, as amended from time to time, in connection with the calculation of risk-based deductions from capital for market risk thereunder. Only an OTC derivatives dealer and no other affiliated entity (including a member) would be able to rely on this part of the Exemption. See subparagraph (C)(4) of proposed Rule 4.11.04(c).

¹⁴ The pricing model of a national bank would have to be consistent with the requirements of the Office of the Comptroller of the Currency, as amended from time to time, in connection with the calculation of risk-based adjustments to capital for market risk under capital requirements of the Office of the Comptroller of the Currency. Only a national bank and no other affiliated entity (including a member) would be able to rely on this part of the Exemption. See subparagraph (C)(5) of proposed Rule 4.11.04(c).

regard to positions in or relating to the security underlying the option position held by an affiliated entity or by another trading unit within the same entity, provided that: (i) the entity demonstrates to the Exchange's satisfaction that no control relationship, as defined in Rule 4.11.03, exists between such affiliates or trading units, and (ii) the entity has provided the Exchange written notice in advance that it intends to be considered separate and distinct from any affiliate, or, as applicable, which trading units within the entity are to be considered separate and distinct from each other for purposes of the Exemption.¹⁵

The Exchange has set forth in Regulatory Circular RG04-45 ("Aggregation Circular") the conditions under which it will deem no control relationship to exist between affiliated broker-dealers and between separate and distinct trading units within the same broker-dealer. The Exchange proposes to amend the Aggregation Circular to include affiliated entities, not only affiliated broker-dealers as in the current version.

Any member or non-member affiliate relying on the Exemption must designate, by prior written notice to the Exchange, each trading unit or entity whose options positions are required by Exchange rules to be aggregated with the options positions of such member or non-member affiliate relying on the Exemption for purposes of compliance with Exchange position or exercise limits.¹⁶

Obligations of Members and Affiliates. Any member relying on the Exemption would be required to provide a written certification to the Exchange that it is using a permitted pricing model as defined in the rule for purposes of the Exemption. In addition, by such reliance, such member would authorize any other person carrying for such member an account including, or with whom such member has entered into, a position in or relating to a security underlying the

¹⁵ See subparagraph (D) of proposed Rule 4.11.04(c).

¹⁶ See proposed Rule 4.11.04(c)(D)(3).

relevant option position to provide to the Exchange or OCC such information regarding such account or position as the Exchange or OCC may request as part of the Exchange's confirmation or verification of the accuracy of any net delta calculation under this Exemption.¹⁷

The options positions of a non-member affiliate relying on the Exemption must be carried by a member with which it is affiliated. A member carrying an account that includes an equity option position for a non-member affiliate that intends to rely on the Exemption would be required to obtain from such non-member affiliate a written certification that it is using a permitted pricing model as defined in the rule for purposes of the Exemption.¹⁸

Reporting. Under proposed Rule 4.11.04(c)(F), each member relying on the Exemption would be required to report, in accordance with Rule 4.13,¹⁹ (i) all equity option positions (including those that are delta neutral) that are reportable thereunder, and (ii) on its own behalf or on behalf of a designated aggregation unit pursuant to Rule 4.11.04(c)(D), for each such account that holds an equity option position subject to the Exemption in excess of the levels specified in Rule 4.11, the net delta and the options contract equivalent of the net delta of such position.

¹⁷ See subparagraph (E) of proposed Rule 4.11.04(c).

¹⁸ In addition, the member would be required to obtain from such non-member affiliate a written statement confirming that such non-member affiliate: (a) is relying on the Exemption; (b) will use only a permitted pricing model for purposes of calculating the net delta of its option positions for purposes of the Exemption; (c) will promptly notify the member if it ceases to rely on the Exemption; (d) authorizes the member to provide to the Exchange or the OCC such information regarding positions of the non-member affiliate as the Exchange or OCC may request as part of the Exchange's confirmation or verification of the accuracy of any net delta calculation under the Exemption; and (e) if the non-member affiliate is using the OCC Model, has duly executed and delivered to the Exchange such documents as the Exchange may require to be executed and delivered to the Exchange as a condition to reliance on the Exemption. See subparagraph (E)(3) of proposed Rule 4.11.04(c).

¹⁹ Exchange Rule 4.13 requires, among other things, that members report to the Exchange aggregate long or short positions on the same side of the market of 200 or more contracts of any single class of options contracts dealt in on the Exchange.

The Exchange and other self-regulatory organizations are working on modifying the Large Options Position Report system and/or OCC reports to allow a member to indicate that an equity options position is delta neutral.

Records. Under proposed Rule 4.11.04(c)(G), each member relying on the Exemption would be required to (i) retain, and would be required to undertake reasonable efforts to ensure that any non-member affiliate of the member relying on the exemption retains, a list of the options, securities and other instruments underlying each options position net delta calculation reported to the Exchange hereunder, and (ii) produce such information to the Exchange upon request.²⁰

Reliance on Federal Oversight. As provided under proposed Rule 4.11.04(c)(C), a permitted pricing model includes proprietary pricing models used by members and affiliates that have been approved by the Commission, the FRB or another federal financial regulator. In adopting the proposed Exemption the Exchange would be relying upon the rigorous approval processes and ongoing oversight of a federal financial regulator. The Exchange notes that it would not be under any obligation to verify whether a member's or its affiliate's use of a proprietary pricing model is appropriate or yielding accurate results.

CBOE will announce the effective date of the proposed rule change in a regulatory circular to be published no later than 60 days after Commission approval. The effective date shall be no later than 30 days after publication of the regulatory circular.

²⁰ A member would be authorized to report position information of its non-member affiliate pursuant to the written statement required under proposed Rule 4.11.04(c)(E)(3)(ii)(d).

2. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the Act,²¹ in general, and furthers the objectives of Section 6(b)(5) of the Act,²² in particular, in that it is designed in particular, in that it is designed to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, 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 Exchange believes the proposed delta neutral-based hedge exemption from equity options position and exercise limits is appropriate in that it is based on a widely accepted risk management method used in options trading. Also, the Commission has previously stated its support for recognizing options positions hedged on a delta neutral basis as properly exempted from position limits.²³

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

The Exchange believes that the proposed rule change will not impose any burden on competition 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 either solicited or received.

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

²¹ 15 U.S.C. 78f(b).

²² 15 U.S.C. 78f(b)(5).

²³ See Securities Exchange Act Release No. 40594 (October 23, 1998), 63 FR 59362, 59380 (November 3, 1998) (S7-30-97) (adopting rules relating to OTC Derivatives Dealers).

such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which CBOE 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 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-2007-99 on the subject line.

Paper comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-CBOE-2007-99. 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 Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. Copies of the 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-2007-99 and should be submitted on or before [insert date 21 days after publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²⁴

Nancy M. Morris
Secretary

²⁴ 17 CFR 200.30-3(a)(12).