

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-59417; File No. SR-CBOE-2008-115)

February 18, 2009

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of Amendments No. 1 and 2 and Order Granting Accelerated Approval to a Proposed Rule Change, as Modified by Amendments No. 1 and 2 Thereto, Relating to FLEX Options Expirations

I. Introduction

On November 19, 2008, 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 amend its rules regarding permissible expiration dates for Flexible Exchange Options (“FLEX Options”). On December 15, 2008, the proposed rule change was published for comment in the Federal Register.³ On January 28, 2009, the Exchange filed Amendment No. 1⁴ and on February 12, 2009, the Exchange filed Amendment No. 2.⁵ The Commission received no comments on the proposed rule change. This order provides notice of filing of Amendments No. 1 and 2 to the proposed rule change and grants accelerated approval to the proposed rule change, as modified by Amendments No. 1 and 2.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 59060 (December 5, 2008), 73 FR 76075 (“Notice”).

⁴ In Amendment No. 1, the Exchange: (1) further amended Rules 24A.7, 24A.8, 24B.7 and 24B.8 to clarify the applicable exercise limits for FLEX Options that expire on a third Friday-of-the-month expiration day (“Expiration Friday”); (2) made a typographical correction to the rule text proposed to be added to Rule 24A.7.

⁵ In Amendment No. 2, the Exchange (1) further amended Rules 24A.4 and 24B.4 to impose additional restrictions on FLEX Options that expire on any business day that falls on, or within two business days of, an Expiration Friday by specifying that they may only

II. Description of the Proposal

Under current CBOE Rules 24A.4 and 24B.4, FLEX Options⁶ may not expire on any business day that falls on, or within two business days of, an Expiration Friday.⁷

In this proposed rule change, the Exchange proposed to eliminate the expiration date restriction on FLEX Options expiring on or within two business days of Expiration Friday (“Blackout Period”) so that FLEX Options may expire on any business day. Under its proposal, position and exercise limits, as applicable under CBOE Rules, and reporting requirements would continue to apply.⁸ The Exchange further noted that both the Exchange and its member

have an a.m. exercise settlement value: (2) made a technical correction to the reference to the Exchange Rules contained in footnote 6 of the original proposed rule change.

⁶ FLEX Options (FLEX Index Options and FLEX Equity Options) provide investors with the ability to customize basic option features including size, expiration date, exercise style, and certain exercise prices. FLEX Index Options and Flex Equity Options are index options and options on specified equity securities, respectively, that are subject to the FLEX rules in Chapters XXIVA or XXIVB of the CBOE Rules. FLEX Index Options Series may be approved and open for trading on any index that has been approved for Non-FLEX Options trading or for warrant trading on the Exchange. FLEX Equity Options transactions are limited to transactions in options on underlying securities that have been approved by the Exchange in accordance with CBOE Rule 5.3, which includes, but is not limited to, stock options and exchange-traded fund options. In addition, other products are permitted to be traded pursuant to the FLEX trading procedures. For example, credit options are eligible for trading as FLEX Options pursuant to the FLEX rules in Chapters XXIVA and XXIVB. See CBOE Rules 24A.1(e) and (f), 24A.4(b)(1) and (c)(1), 24B.1(f) and (g), 24B.4(b)(1) and (c)(1), and 28.19.

⁷ For example, under the current rule, a FLEX Option could expire on the Tuesday before Expiration Friday, but could not expire on the Wednesday or Thursday before Expiration Friday. Similarly, a FLEX Option could expire on the Wednesday after Expiration Friday, but could not expire on the Monday or Tuesday after Expiration Friday. However, subject to certain aggregation requirements for cash settled options, the current FLEX Rules do permit the expiration of FLEX Options on the same day that Non-FLEX quarterly index options (“QIX”) and Non-FLEX Weekly Options expire.

⁸ FLEX Index Options overlying all industry indexes, all micro narrow-based indexes, and certain broad-based indexes are subject to position and exercise limits under CBOE Rules 24A.7, 24A.8, 24B.7, and 24B.8 and will continue to be under the proposal. FLEX Index Options on certain other broad-based indexes (specifically the BXM, DJX, NDX, OEX, RUT, SPX, VIX, VXD, VXN, XEO, CBOE S&P 500 Three-Month Realized Variance

organizations each have the authority, pursuant to CBOE Rule 12.10, to impose additional margin requirements as deemed advisable.

In addition to the position and exercise limits and reporting requirements described above, for FLEX Options that expire on Expiration Friday, the Exchange proposed to impose an aggregation requirement for position and exercise limit purposes. Specifically, for as long as the options positions remain open, positions in FLEX Options that expire on Expiration Friday would be aggregated with positions in Non-FLEX Options on the same underlying (e.g., the same underlying security in the case of a FLEX Equity Option and the same underlying index in the case of a FLEX Index Option) (“comparable Non-FLEX Options”). Such aggregated FLEX Options and comparable Non-FLEX Options would be subject to the same position and exercise limits that are applicable to the Non-FLEX Options.⁹ The aggregation requirement would apply to both cash and physically settled options.

Further, in the case of FLEX Index Options only, FLEX Index Options expiring within the Blackout Period may only have an a.m. exercise settlement value.¹⁰ Currently, FLEX Index Options that expire on any day outside the Blackout Period can have an exercise settlement value determined by reference to one of three values: (i) an a.m. exercise settlement value; (ii) a p.m.

and S&P 500 Three-Month Realized Volatility), and FLEX Equity Options are not subject to position limits but would remain subject to reporting requirements under CBOE Rules 24A.7 and 24B.7, as is currently the case. Additionally, all FLEX Options remain subject to the position reporting requirements of CBOE Rule 4.13(a).

⁹ See proposed CBOE Rules 24A.7(d)(3) and 24B.7(d)(3). The applicable position limits are set forth in Rules 4.11, 24.4, 24.4A, 24.4B, and 29.5. The applicable exercise limits are set forth in Rules 4.12, 24.5, and 29.7. The Commission notes that certain broad-based Index Options traded in CBOE’s standardized option market do not have position and exercise limits and this would continue to be the case when they become fungible with FLEX positions. See Rule 24.4 (Position Limits for Broad-Based Index Options).

¹⁰ An opening exercise settlement value (“a.m. settlement”) is determined by reference to the reported level of the index as derived from opening prices of the component securities.

exercise settlement value;¹¹ or (iii) an average index value, provided that it conforms to the averaging parameters, if any, established by the Exchange. Under CBOE's proposal, FLEX Index Options expiring within the Blackout Period could only have an a.m. settlement and would be prohibited from having a p.m. settlement or a settlement value based on an average index value.¹²

In conjunction with the elimination of the expiration date restriction, the Exchange also proposed that FLEX Options be permitted in puts and calls that do not have the same exercise style, same expiration date and same exercise price as Non-FLEX Options that are already available for trading on the same underlying security or index, provided the options on an underlying security or index are otherwise eligible for FLEX trading.¹³ The proposed rules, however, allow FLEX Options to be traded before (but not after) the options are listed for trading as Non-FLEX Options. Once an outstanding FLEX Option series is listed for trading as a Non-FLEX Option series, (i) all existing open positions established under the FLEX trading procedures would be fully fungible with transactions in the respective Non-FLEX Option series, and (ii) any further trading in the series would be as Non-FLEX options subject to the Non-FLEX trading procedures and rules.¹⁴

¹¹ A closing exercise settlement value ("p.m. settlement") is determined by reference to the reported level of the index as derived from the closing prices of the component securities. See CBOE Rules 24A.4(b)(3) and 24B.4(b)(3).

¹² See Amendment No. 2.

¹³ See proposed CBOE Rules 24A.4 and 24B.4, Section 0.2 of Interpretations and Policies.

¹⁴ See proposed CBOE Rules 24A.4 and 24B.4, Section 0.2 of Interpretations and Policies.

III. Discussion

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.¹⁵ In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,¹⁶ in that it is designed, among other things, to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; 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 notes that the FLEX Option rules and the Blackout Period were initially proposed by the Exchange in October of 1992 and approved by the Commission in February of 1993.¹⁷ At the time the FLEX rules were first introduced, the Commission was very concerned about the adverse effects of exercise settlements based on the closing values of the component securities in indexes. Accordingly, while the FLEX Options rules permitted p.m. settlements in certain cases, to address these concerns the Exchange adopted the settlement restrictions described above that prohibited FLEX Options from expiring on, or within, two business days of an Expiration Friday. In approving the first FLEX Options rules, applicable to certain broad-based indexes only, the Commission stated that while it "... continues to believe that basing the settlement of index products on opening as opposed to closing prices on Expiration Fridays helps alleviate stock market volatility,..." these concerns are reduced in the case of Flex Options, since

¹⁵ In approving these proposed rule changes, the Commission has considered the proposed rules' impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹⁶ 15 U.S.C. 78f(b)(5).

¹⁷ See Securities Exchange Act Release Nos. 31361 (October 27, 1992), 57 FR 52655 (November 4, 1992)(SR-CBOE-92-17)(notice of filing of proposed rule change relating to FLEX Options) and 31920 (February 24, 1993), 58 FR 12280 (March 3, 1993)(Order approving SR-CBOE-92-17).

expiration of these stock options will not correspond to the normal expirations of other options and futures on Expiration Fridays thereby diminishing the impact that FLEX Options could have on the market.¹⁸ Further, in approving the CBOE FLEX market for individual equity options, the Commission further reiterated its concerns and stated that restricting expirations during the Blackout Period would reduce the possibility that expirations of FLEX Equity Options would cause additional pressure on the market for the underlying securities when Non-FLEX Options expire.¹⁹

As stated by the Exchange in its filing, it no longer believes that the Blackout Period is necessary to insulate Non-FLEX expirations from the potential adverse market impacts of FLEX expirations²⁰ and that the restriction places the Exchange at a competitive disadvantage to its over-the-counter (“OTC”) and futures counter-parts in the market for customized options.

The Commission continues to support the use of a.m. settlements in index options to reduce the potential for adverse effects on the underlying component securities. However, the Commission believes the current CBOE’s proposal to eliminate the Blackout Period for expiring

¹⁸ In its filing, the Exchange noted that, at the time of its 1992 proposal, the Exchange anticipated that there would be limited secondary trading in any FLEX Option series having a particular expiration date due to the diversity inherent in FLEX Options and that FLEX expiration concentrations should be rare. According to the Exchange, these observations appear to be accurate for the trading in FLEX Options to date and the Exchange anticipates this trend to continue.

¹⁹ See Securities Exchange Act Release No. 36841 (February 14, 1996), 61 FR 6666 (February 21, 1996).

²⁰ The Exchange stated that its experience in trading FLEX Options to date has shown the relatively small percentage of FLEX Options trading compared to overall trading on the Exchange and the lack of market disruptions or problems caused by or on existing FLEX Option expirations. In further support of its proposal, the Exchange noted that it is not aware of any market disruptions or problems caused by customized options in the OTC or futures markets that expire on or near Expiration Friday. Finally, the Exchange has represented that OCC can configure its systems to support the expiration of FLEX Options on any business day.

FLEX Options, including FLEX Index Options, has been appropriately structured by requiring a.m. settlements for FLEX Index Options,²¹ requiring, for FLEX Options expiring on Expiration Friday, the aggregation of all position and exercise limits with Non-FLEX Options on the same underlying index or security, requiring fungible FLEX and Non-FLEX Options in the same series to trade only pursuant to Non-FLEX trading rules, and maintaining heightened reporting requirements for large FLEX Options positions. The Commission believes that with these safeguards in place the Exchange's proposal to eliminate the current restrictions on Flex Option expirations on and around Expiration Friday should be approved.

As previously noted by the Commission, the CBOE's FLEX market was created to address the needs of sophisticated portfolio managers and other institutional investors who are increasingly using the OTC market to meet their investment needs. The Commission believes that CBOE's proposal to expand the eligible expiration dates for FLEX Options should give market participants greater flexibility in determining whether to execute their customized options in an exchange environment or in the OTC market.

²¹ The Commission notes that in Amendment No. 2 the Exchange modified its proposal to prohibit average pricing formulas as well as p.m. settlements during the Blackout Periods. As CBOE notes, average pricing may not raise similar concerns as p.m. settlement. However, because average pricing settlement is only permitted pursuant to parameters set by the CBOE, and to date it appears that it has not set such parameters (except for SPX), it is appropriate to have CBOE do so before such average pricing settlement is permitted around or on Expiration Friday. We would expect the Exchange to file a proposed rule change pursuant to Section 19(b) under the Act relating to such parameters.

The Commission believes that the CBOE proposal should help to promote the maintenance of a fair and orderly market consistent with the requirements of Section 6(b)(5) of the Act²² by extending the benefits of a listed, exchange market to additional FLEX Options. These benefits include, but are not limited to, a centralized market center, an auction market with posted transparent market quotations and transaction reporting, standardized parameters and procedures for clearance and settlement, and heightened contra-party creditworthiness due to the role of The Options Clearing Corporation (“OCC”) as issuer and guarantor of FLEX Options. Moreover, to the extent there may be a risk of adverse market effects attributable to options that would otherwise be traded in a non-transparent fashion in the OTC market, the Commission agrees with CBOE that such risks could be lessened by making these customized options eligible for trading in an exchange environment because of the added transparency, price discovery, and potential liquidity.

Because of the elimination of Blackout Periods surrounding Expiration Fridays, the Commission recognizes that the proposal will result, for the first time, in the possibility that FLEX Options positions may be established in Non-FLEX series. The Commission would be concerned if the FLEX Options could act as a surrogate for trading in standardized options, especially since the standardized options market contains certain protections for investors. This is of particular concern because the Commission recognizes that the FLEX Options market is designed to contain the benefits of an auction market with the features of negotiated transactions, and therefore continuous quotes may not always be available. However, the rules, as proposed by the CBOE, help to ensure that FLEX market participants cannot avoid the protections provided to retail investors in the standardized options market simply by trading FLEX Options.

²² 15 U.S.C. 78f(b)(5).

In this regard, once a series is open for trading, new FLEX Options are not permitted in that series. In addition, once a Non-FLEX Options series is open, all outstanding FLEX Options in the same series become fungible with the standardized market, are traded pursuant to standardized market trading rules, and are aggregated for position and exercise limit purposes. These rules help to alleviate these surrogate concerns and should help to ensure that FLEX Options market continues to operate as intended.

Finally, the Commission expects the CBOE to report any undue effects that may occur due to the elimination of the Blackout Period. This includes taking any prompt action should any unanticipated consequences develop.

The Commission finds good cause, pursuant to Section 19(b)(2) of the Act,²³ for approving the proposal, as modified by Amendments No. 1 and 2, prior to the thirtieth day after the date of publication of notice of filing of Amendments No. 1 and 2 in the Federal Register.²⁴

In Amendment No. 1, the Exchange proposed to clarify the applicable exercise limits for FLEX Options that expire on an Expiration Friday. Specifically, the Exchange proposed that such FLEX Options shall be aggregated with positions in comparable Non-FLEX Options and shall be subject to the exercise limits set forth in Rule 4.12 (which pertains to exercise limits for Non-FLEX Equity Options), 24.5 (which pertains to exercise limits for Non-FLEX Index Options), or 29.7 (which pertains to exercise limits for Non-FLEX Credit Options), as applicable. The Commission believes that aggregating FLEX options that expire on a third Friday-of-the-month expiration day with comparable Non-FLEX Options and applying the Non-

²³ 15 U.S.C. 78s(b)(2).

²⁴ Pursuant to Section 19(b)(2) of the Act, 15 U.S.C. 78s(b)(2), the Commission may not approve any proposed rule change, or amendment thereto, prior to the thirtieth day after the date of publication of the notice thereof, unless the Commission finds good cause for so doing.

FLEX Options exercise limits is consistent with the manner in which the Exchange proposed to aggregate and apply position limits for such FLEX Options and comparable Non-FLEX Options and should provide additional safeguards to reduce any risk of adverse market effects that might occur as a result of large FLEX exercises in FLEX Option series that expire near Non-FLEX expirations.

In Amendment No. 2, the Exchange proposed to further revise proposed Rules 24A.4 and 24B.4 to include an additional restriction that FLEX Index Options that have expiration dates that fall within the Blackout Period may not have an exercise settlement value based on a specified average. Thus, as revised, the proposed rule would require that FLEX Index Options expiring within the Blackout Period only have an a.m. exercise settlement value.²⁵

The limitation on exercise settlement value calculations proposed in Amendment No. 2 is intended to serve as an additional safeguard against potential adverse effects that might be associated with triple witching and p.m. settlements.²⁶ Because CBOE, for the most part, has not set any average pricing parameters, the Commission is unclear what the potential market impact could be on or around Expiration Friday. Therefore, it is reasonable and consistent with Section

²⁵ Currently, FLEX Index Options that expire on any day outside the old blackout period can have an exercise settlement value determined by reference to one of three values: (i) an a.m. exercise settlement value; (ii) a p.m. exercise settlement value; or (iii) an average index value, provided that it conforms to the averaging parameters, if any, established by the Exchange. The Exchange originally proposed that FLEX Index Options that have expiration dates that fall within the Blackout Period may not have a p.m. exercise settlement value.

²⁶ The expiration of the contracts for stock index futures, stock index options, and stock options all expire on the same days occurring on the third Friday of March, June, September, and December (which is referred to as “triple witching”). The Exchange’s proposed limitations on p.m. exercise settlement values and exercise settlement values based on a specified average would apply during triple witching expirations, as well as on all other Expiration Fridays.

6(b)(5) of the Act²⁷ for CBOE to restrict average pricing during the Blackout Period until it sets forth a specific proposal and the potential market impact can be adequately addressed.²⁸

Based on the above, the Commission finds good cause for approving the CBOE's proposal, as modified by Amendments No. 1 and 2, on an accelerated basis, pursuant to Section 19(b)(2) of the Act.

V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendments No. 1 and 2 to File No. SR-CBOE-2008-115, including whether Amendments No. 1 and 2 are 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-2008-115 on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-CBOE-2008-115. 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>).

²⁷ 15 U.S.C. 78f(b)(5).

²⁸ See supra note 21.

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 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of Amex. 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-2008-115 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VI. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule changes are consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²⁹ that the proposed rule change (SR-CBOE-2008-115), as modified by Amendments No. 1 and 2 thereto, be and hereby is approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³⁰

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Deputy Secretary

²⁹ 15 U.S.C. 78s(b)(2).

³⁰ 17 CFR 200.30-3(a)(12).