

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-56855; File No. SR-CBOE-2006-90)

November 28, 2007

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Approving Proposed Rule Change as Modified by Amendment No. 1 Thereto to List and Trade Delayed Start Option Series

I. Introduction

On November 7, 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 list and trade Delayed Start Option SeriesTM (“DSOs”) on any security index that has been approved for trading on the Exchange. On September 5, 2007, the Exchange filed Amendment No. 1 to the proposed rule change. The proposed rule change, as amended, was published for comment in the Federal Register on September 17, 2007.³ The Commission received no comments on the proposal. This order approves the proposed rule change, as amended, and designates DSOs as “standardized options” pursuant to Rule 9b-1 under the Act.⁴

II. Description of the Proposal

The Exchange is proposing to introduce for trading a new type of security index option product called DSOs. DSOs would possess all of the characteristics of existing index options with one variation: at the commencement of trading of a particular DSO, and until a predetermined date (the “strike setting date”), there would be no set exercise price. Instead, prior

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 56378 (September 10, 2007), 72 FR 52944 (September 17, 2007) (“Notice”).

⁴ 17 CFR 240.9b-1.

to the opening of a particular DSO series, a pre-established methodology would be applied to determine the strike price of the DSO, and the strike price would then be fixed on the strike setting date according to that formula. The Exchange notes that DSOs, which address the dependence of an index option's vega (volatility exposure) on the relationship between the option's strike price and the underlying index level, are designed as a tool to allow customers to manage risk associated with the volatility of a particular index.⁵

Product Description. DSOs would be identical to other option series that currently trade except that the exercise price for a DSO would be fixed based on the closing value of the underlying index on a predetermined strike setting date prior to expiration. The particular strike setting date would be specified at the time the DSO is initially opened for trading and would be no sooner than one month, and no later than twelve months, after the series' opening. The particular expiration date would also be specified at the time the DSO is initially opened for trading and would be no later than what is currently permitted under CBOE rules.⁶

Initially, CBOE proposes to establish the strike setting dates for all series of DSOs at three months prior to the option's expiration date. However, as proposed, CBOE would have the ability to issue series of DSOs with more or less time than three months between the strike setting date and expiration date. Accordingly, the particular strike setting date and the expiration date, and thus the corresponding length of the interval between the strike setting date and expiration, would be set prior to issuance of each particular series. No changes to any terms of an existing DSO series could be made once a series commences trading.

⁵ See Notice, supra note 3, at 52945.

⁶ Presently, the longest term for an option series expiration is thirty-nine months from the listing date. See CBOE Rule 5.8(a) and proposed CBOE Rule 24.9(d)(2).

Establishment of Strike Price. On the strike setting date, the DSO would be assigned a strike price, which would be at-the-money, in-the-money, or out-of-the-money, according to the pre-established terms of the particular DSO series. A DSO's exercise price would be fixed based on the closing value of the underlying index on the strike setting date, rounded to the nearest one-eighth (.125) value, or such smaller value as the Exchange may designate at the time the DSO is listed, provided that the value cannot be smaller than 0.01.⁷ For example, using a one-eighth interval, if the S&P 500® Index ("SPX") closes at 1004.12 on the strike setting date, an at-the-money DSO would be assigned a strike price of 1004.125. After the strike setting date, the DSO would trade the same as other options until expiration.

An in- or out-of-the money DSO would trade in the exact same manner as an at-the-money DSO, except that the strike price would be set to a predetermined level either in- or out-of-the-money on the strike setting date (e.g., 5% in-the-money, or 5% out-of-the-money). For example, if the Exchange determines to list a 5% out-of-the-money DSO on the SPX, and the SPX closes at 1000 on the strike setting date, the strike price would be established at 1050. The amount by which the strike price of an in- or out-of-the money DSO series would be set in- or out-of-the-money on the strike setting date would be announced prior to the inception of trading of that particular series and could not change thereafter.

⁷ Because of system limitations, the Exchange currently plans to round DSO exercise prices to the nearest .125. However, should the system functionality permit it in the future, the Exchange wants the flexibility to be able to determine to round DSO exercise prices to a smaller value, provided that the particular increment would be designated at the time the DSO is listed and that it would not be any smaller than 0.01.

Exercise Style. All DSOs would feature European-style exercise until the strike setting date (i.e., the option contract could not be exercised during this period). After the strike setting date, the DSO would be subject to the exercise style (i.e., American or European) of the particular index option class. The period during which exercise is restricted would therefore depend upon the particular DSO's strike setting date, expiration date, and expiration style. For instance, in the case of a DSO that is subject to American-style exercise, is issued with a nine-month expiration, and has a strike setting date fixed at three-months prior to expiration, then the period of non-exercise would be six months.⁸

Trading Increments, Margin, and Trading Symbols. The Exchange proposes to list DSO puts to correspond with each DSO call in a particular index option class. As with all other options, the premium quotation would be stated in decimals, and one point would equal \$100. The minimum tick for options trading below \$3.00 would be 0.05 (\$5.00) and for all other series, 0.10 (\$10.00).

DSOs in any particular index option class would be treated the same as any other options on the same index for the purpose of determining customer margin.⁹ Therefore, a buyer of DSOs would have to pay the premium in full, while a seller would have to put up the entire premium, plus 15% of the underlying value for a broad-based index option, or the premium plus 20% for a narrow-based or micro narrow-based index option.

⁸ Similarly, a DSO that is subject to European-style exercise with a nine-month expiration and a strike setting date fixed at three months prior to expiration would have a nine-month period of non-exercisability. The strike setting interval would be publicly announced prior to the inception of trading of a particular DSO series. No changes to any terms of existing DSO series could be made once the series trades (with the exception of the establishment of the exercise price).

⁹ See CBOE Rule 12.3. However, the Exchange does not initially plan to permit spread margining between DSO and non-DSO options for the time period between the initial listing of a DSO and its strike setting date. The Exchange intends to consider what spread margin would be appropriate and address the subject under a separate rule filing.

Prior to the strike setting date, margin on any DSO would be based on the then-current level of the underlying index. For example, a DSO whose strike price would be set at-the-money would be margined as an at-the-money option in the same index option class prior to the strike setting date, because prior to the strike setting date the DSO's price would be directly related to the price of an at-the-money option. Prior to the strike setting date, in- and out-of-the-money DSOs would be margined the same as any other in- and out-of-the-money options in the same index option class.

Prior to the strike setting date, DSOs would be distinguished from existing options by a unique root symbol and a special strike price code designating an at-the-money, in-the-money, or out-of-the-money option. The Exchange intends to trade the DSO series under separate symbols from other option series on the same index option class. The exact exercise price, and a unique DSO strike price code, would be fixed on the strike setting date pursuant to the method established at the time the option series was originally opened for trading. The strike price code would specify the exact strike price of the particular DSO option series (rounded to the nearest eighth or smaller increment, if applicable).

Position and Exercise Limits. Positions in any DSO would be subject to the same rules governing position and exercise limits upon other options in the same index option class and, for purposes of determining position limits, DSO positions would be aggregated with positions in other series of the same option class.¹⁰ Similarly, members and member organizations trading in DSOs would continue to be subject to the same reporting requirements and margin and clearing firm requirements as provided under Interpretations and Policies .03 and .04 to CBOE Rule 24.4.

¹⁰ See CBOE Rules 4.11, 4.12, 24.4, 24.4A, and 24.4B. In addition, the Exchange is proposing to clarify in Rule 24.4B (Position Limits for Options on Micro Narrow-Based Indexes as Defined Under Rule 24.2(d)) that position in Short Term Option Series and Quarterly Options, together with DSO positions, shall be aggregated with positions in options contracts in the same class.

Pricing of a DSO. Similar to other index options, the pricing of an at-the-money DSO, for example, would reflect the price of the underlying index, implied volatility, interest rates, time to expiration, and strike price. Therefore, the price for a DSO would generally approximate the concurrent price for a similar option, with one significant deviation: whereas other options are priced based on current levels of implied volatility, a DSO is priced using an expectation of implied volatility levels at the time the strike price is set, which is generally derived from the current level of implied volatility. The dependence of a particular DSO's price on expected implied volatility is what the Exchange believes would make DSOs useful to market participants that are interested in volatility trading.

Customer Suitability. Although the Exchange believes that DSOs may be suitable for all types of investors, the Exchange has proposed to limit the trading of DSOs to investors with prior options trading experience.¹¹ Also, prior to the commencement of trading of DSOs, the Exchange would make available on its Web site all information necessary to inform members and customers of the addition of new DSO series to a particular option class.

Surveillance. The Exchange represents that it has in place appropriate surveillance procedures to monitor trading activity in DSOs and intends to monitor trading activity in DSOs like any other option series listed in that same index option class.¹²

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

¹¹ See Notice, supra note 3, at 52947. See also Proposed CBOE Rule 9.9, Interpretations and Policies .01.

¹² See Notice, supra note 3, at 52948.

a national securities exchange.¹³ In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,¹⁴ 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 notes that options similar to CBOE's proposed DSOs currently trade in the over-the-counter market. The introduction of CBOE's proposed DSOs will provide investors with an exchange-traded product to manage the risk associated with changes in volatility of a particular security index, thereby providing additional investment options to investors in the context of a transparent exchange-traded market for these products.

In addition, DSOs will be subject to CBOE's rules applicable to other standardized options. For example, positions in a DSO will be subject to CBOE's rules governing position and exercise limits and, for the purposes of determining position limits, DSO positions will be aggregated with positions in other series of the same option class. Similarly, CBOE members and member organizations trading in DSOs will be subject to the reporting requirements and clearing firm requirements provided under CBOE rules. Further, DSOs in any particular index option class will be treated the same as any other options on the same index for the purpose of determining customer margin.

The Commission notes that the Exchange has represented that it has surveillance procedures in place that are adequate to monitor trading in DSOs. In particular, the Exchange

¹³ 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).

¹⁴ 15 U.S.C. 78f(b)(5).

will monitor trading activity in DSOs as it does for other option series listed in the same index option class. Further, the Exchange will limit trading of DSOs to investors with prior options trading experience, and will provide information about DSOs on its Web site, including information that describes the terms and operation of DSOs.

Accordingly, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder, and should promote just and equitable principles of trade while protecting investors and the public interest.

IV. Designation of DSOs as Standardized Options Pursuant to Rule 19b-1

Rule 9b-1 under the Act establishes a disclosure framework for standardized options that are traded on a national securities exchange and cleared through a registered clearing agency.¹⁵ Under this framework, the exchange on which a standardized option is listed and traded must prepare an Options Disclosure Document (“ODD”) that, among other things, identifies the issuer and describes the uses, mechanics, and risks of options trading, in language that can be easily understood by the general investing public. The ODD is treated as a substitute for the traditional prospectus. A broker-dealer must provide a copy of the ODD to each customer at or before approving the customer’s account for trading any standardized option.¹⁶ Any amendment to the ODD must be distributed to each customer whose account is approved for trading the options class for which the ODD relates.¹⁷

¹⁵ “Standardized options” are defined in Rule 9b-1(a)(4) as “options contracts trading on a national securities exchange, an automated quotation system of a registered securities association, or a foreign securities exchange which relate to options classes the terms of which are limited to specific expiration dates and exercise prices, or such other securities as the Commission may, by order, designate.” 17 CFR 240.9b-1(a)(4).

¹⁶ See 17 CFR 240.9b-1(d)(1).

¹⁷ See 17 CFR 240.9b-1(d)(2).

Pursuant to Rule 9b-1 under the Act, use of the ODD is limited to “standardized options” for which there is an effective registration statement on Form S-20 under the Securities Act of 1933 (“Securities Act”) or that are otherwise exempt from registration.¹⁸ Pursuant to Rule 9b-1(a)(4), the Commission may, by order, designate as “standardized options” securities that do not otherwise meet the definition of “standardized options” but which “the Commission believes should be included within the [options] disclosure framework.”¹⁹ The Commission has used this authority in the past, for example, in connection with the listing and trading of Index

¹⁸ See 17 CFR 240.9b-1(b)(1) and (c)(8). See also 17 CFR 230.238 (“Rule 238”). Rule 238 under the Securities Act provides an exemption from the Securities Act for any standardized option, as defined by Rule 9b-1(a)(4) under the Act, with limited exceptions. Rule 238 does not exempt standardized options from the anti-fraud provisions of Section 17 of the Securities Act, 15 U.S.C. 77q. Also, offers and sales of standardized options by or on behalf of the issuer of the underlying security or securities, an affiliate of the issuer, or an underwriter, will constitute an offer or sale of the underlying security or securities as defined in Section 2(a)(3) of the Securities Act, 15 U.S.C. 77b(a)(3). See also Securities Act Release No. 8171 (December 23, 2002), 68 FR 188 (January 2, 2003) (Exemption for Standardized Options From Provisions of the Securities Act of 1933 and From Registration Requirements of the Exchange Act of 1934).

¹⁹ See Securities Exchange Act Release No. 19055 (September 16, 1982), 47 FR 41950, 41954 (September 23, 1982).

Participations,²⁰ FLEX options,²¹ credit default options,²² and credit default basket options.²³

CBOE has requested that the Commission designate DSOs as standardized options so that the ODD may be used for DSOs.²⁴

The Commission hereby designates DSOs, as separately defined in the Options Clearing Corporation's ("OCC") proposal,²⁵ as standardized options for purposes of Rule 9b-1 under the Act. DSOs do not meet the definition of standardized options because they do not have a specific exercise price. Whereas the exercise price of a conventional standardized option is determined when the option series is first listed for trading, the exercise price for a DSO would not be determined until the strike setting date. Instead, prior to the listing of the particular DSO series, the Exchange will specify a formula to determine the strike price of the DSO on the pre-

²⁰ See Securities Exchange Act Release No. 26709 (April 11, 1989), 54 FR 15280 (April 17, 1989) (SR-Phlx-88-07; SR-Amex-88-10; SR-CBOE-88-09).

²¹ See Securities Exchange Act Nos. 31910 (February 23, 1993), 58 FR 12056 (March 2, 1993) (SR-CBOE-92-17; SR-OCC-92-33; ODD 93-1) (order designating FLEX index options as standardized options under Rule 9b-1); and 36841 (February 14, 1996), 61 FR 6666 (February 21, 1996) (SR-CBOE-95-43 and SR-PSE-95-24) and 37336 (June 19, 1996), 61 FR 33558 (June 27, 1996) (SR-Amex-95-57) (orders approving the listing and trading of FLEX equity options, and designating them as standardized options pursuant to Rule 9b-1 under the Act).

²² See Securities Exchange Act Release No. 55871 (June 6, 2007), 72 FR 32372 (June 12, 2007) (SR-CBOE-2006-84).

²³ See Securities Exchange Act Release No. 56275 (August 17, 2007), 72 FR 47097 (August 22, 2007) (SR-CBOE-2007-26).

²⁴ See Notice, supra note 3, at 52947.

²⁵ The OCC has filed with the Commission a proposed rule change to enable it to clear and settle DSOs proposed to be listed by CBOE (the "OCC Proposal"). See Securities Exchange Act Release No. 56856 (November 28, 2007) (SR-OCC-2007-13) (order noticing and granting accelerated approval). The OCC Proposal defines the term "delayed start option" to mean "an option that at the commencement of trading does not have an exercise price but instead has an exercise price setting formula pursuant to which the exercise price will be fixed on the exercise price setting date for the series of delayed start option." This definition of DSOs is being added to Article 1, Section 1 of the OCC's By-Laws.

determined strike setting date according to the terms of the formula.²⁶ No changes to any terms of existing DSO series could be made once the series begins trading.

Aside from the determination of the exercise price, DSOs resemble standardized options in other significant respects. DSOs have an underlying security index and a specific expiration date. Like other standardized options, they also have standardized terms pertaining to the rights and obligations of holders and writers. The fact that DSOs lack a specified exercise price at the commencement of trading does not detract from their character as options. Compared with FLEX options, which the Commission has also declared to be “standardized options,”²⁷ the terms of DSOs would be even more standardized in that a strike price formula, settlement, expiration date, and exercise style would be fixed by the Exchange for each DSO series. In addition, similar to DSOs, credit default options and credit default basket options, which were recently designated by the Commission as “standardized options,” also have many characteristics of standardized options, except for exercise price.²⁸

The Commission also believes that the fact that the OCC, the clearing agency for standardized options, is willing to serve as issuer of DSOs supports the view that adding DSOs to the standardized option disclosure framework is reasonable.²⁹

Therefore, the Commission herein designates DSOs, such as those proposed by CBOE, as standardized options for purposes of Rule 9b-1 under the Act.³⁰

²⁶ Prior to the opening of the particular DSO series, the Exchange will announce the strike setting date as well as the expiration date of the DSO.

²⁷ See supra note 21 (citing to the applicable orders regarding FLEX equity and index options).

²⁸ See supra notes 22 and 23 (citing to the approval orders for credit default options and credit default basket options, respectively).

²⁹ The Commission notes that CBOE presently intends to offer DSOs in early 2008, and has represented that they will not introduce DSOs before the supplement to the ODD has been submitted to the Commission pursuant to Rule 9b-1 under the Act. Telephone conversation between Richard Holley III, Senior Special Counsel, Division of Trading and Markets, Commission, and Jennifer M. Lamie, Assistant General Counsel, CBOE, on November 16, 2007.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,³¹ that the proposed rule change (SR-CBOE-2006-90) as modified by Amendment No. 1 thereto, be, and hereby is, approved.

IT IS FURTHER ORDERED, pursuant to Rule 9b-1(a)(4) under the Act,³² that DSOs, as defined in proposed rule change SR-OCC-2007-13, are hereby designated as standardized options.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³³

Nancy M. Morris
Secretary

³⁰ 17 CFR 240.9b-1.

³¹ 15 U.S.C. 78s(b)(2).

³² 17 CFR 240.9b-1(a)(4).

³³ 17 CFR 200.30-3(a)(12) and 17 CFR 200.30-3(a)(51).