SECURITIES AND EXCHANGE COMMISSION


Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Approving Proposed Rule Change To Establish a Pilot Program To Modify FLEX Option Exercise Settlement Values and Minimum Value Sizes


On December 3, 2009, Chicago Board Options Exchange, Incorporated (“CBOE”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”) and Rule 19b–4 thereunder, a proposed rule change to establish a pilot program to modify exercise settlement values and minimum value sizes for Flexible Exchange Options (“FLEX Options”). The proposed rule change was published in the Federal Register on December 24, 2009. The Commission received six comments regarding the proposal. One commenter provided background information about financial derivatives as they related to variable annuity products, and five commenters supported the proposed rule change.

The Exchange is proposing two pilots with this proposed rule change. First, CBOE is proposing to implement a fourteen-month pilot program to permit p.m. and specified average price settlements of FLEX Index Options that expire on, or within two business days of, a third-Friday-of-the-month expiration (‘‘Blackout Period’’).7 Under current FLEX Option rules, only a.m. settlements based on opening prices of the underlying components of an index can be used to settle a FLEX Index Option if it expires within the Blackout Period. In its proposal, CBOE has stated that, at least two months prior to the expiration of the pilot program, it will provide the Commission with an annual report analyzing volume and open interest for each broad-based FLEX Index Options class overlying an Expiration Friday, p.m.-settled FLEX Index Options series.8 The annual report will also contain information and analysis of FLEX Options trading patterns, and index price volatility and underlying share trading activity for each broad-based index class overlying an Expiration Friday, p.m.-settled FLEX Index Option that exceeds certain minimum open interest parameters.9 The Exchange will also provide to the Commission, on a periodic basis, interim reports of volume and open interest.

CBOE also proposes to eliminate the minimum value size requirements for all FLEX Options on a fourteen-month pilot basis. CBOE will submit a pilot program report if it elects to extend or expand the pilot program, or to make the program permanent. The pilot program report would include data and analysis of open interest and trading volume, and analysis of the types of investors that initiated opening FLEX

The Exchange was given 30 days to file a report analyzing volume and open interest for each broad-based FLEX Index Options class overlying an Expiration Friday, p.m.-settled FLEX Index Options series. CBOE also proposed to eliminate the minimum value size requirements for all FLEX Options on a fourteen-month pilot basis. CBOE will submit a pilot program report if it elects to extend or expand the pilot program, or to make the program permanent. The pilot program report would include data and analysis of open interest and trading volume, and analysis of the types of investors that initiated opening FLEX

3 A FLEX option is a customized option that provides parties to the transaction with the ability to limit the transaction price movement for any reason, including in response to market conditions.
5 See Letter to Elizabeth M. Murphy, Secretary, Commission, from Mark E. White, Assistant Superintendent, Regulation Section, Office of the Superintendent of Financial Institutions Canada, dated January 7, 2010 (noting that the Office did not feel comfortable making comments on the particular proposal). CBOE also proposes to eliminate the minimum value size requirements for all FLEX Options on a fourteen-month pilot basis.
6 CBOE also proposes to eliminate the minimum value size requirements for all FLEX Options on a fourteen-month pilot basis. CBOE will submit a pilot program report if it elects to extend or expand the pilot program, or to make the program permanent.
7 See Notice, supra note 4, 74 FR at 68436.
8 See Notice, supra note 4, 74 FR at 68437. Any positions established under the pilot would not be impacted by the expiration of the pilot. For example, a position in a p.m.-settled FLEX Index Option series that expires on Expiration Friday in May 2015 could be established during the 14-month pilot. If the pilot program were not extended, then the position could continue to exist. However, any further trading in the series would be restricted to transactions at least one side of the trade is a closing transaction. The Exchange stated that it would notify members of this restriction in a circular to members. See Notice, supra note 4, 74 FR at 68436.

Florence E. Harmon, Deputy Secretary.

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See Notice, supra note 4, 74 FR at 68436.
and averaged price settlements for FLEX Index Options during the Blackout Period may allow more market participants to benefit from trading customized-type options in the Exchange’s FLEX Options market rather than the OTC market.

Moreover, the Commission believes that CBOE’s proposed fourteen-month pilot will allow for the CBOE and the Commission to monitor the potential for adverse market effects. In particular, the Commission notes that CBOE will provide the Commission with both annual and interim reports analyzing volume and open interest for each broad-based FLEX Index Options class over an expiration Friday, p.m.-settled FLEX Index Options series. The annual report will also contain information and analysis of FLEX Options trading patterns, and index price volatility and underlying share trading activity for series that exceed certain minimum interest parameters. This information will enable the Commission to evaluate whether allowing p.m. settlements for FLEX Index Options trading patterns, and index price volatility and underlying share trading activity for series that exceed certain minimum interest parameters.

Finally, we note that the combination of eliminating restrictions on settlement values during the Blackout Period, together with reducing the minimum size, increases the potential for the FLEX Options market to act as a surrogate for the non-FLEX Options market. The Commission has previously expressed concern that the FLEX Options market not act as a surrogate for trading in standardized options, especially because the standardized options market contains certain protections for investors. For example, because the FLEX Options market is designed to contain the benefits of an auction market with the features of negotiated transactions, continuous quotes may not always be available. In addition, due to their customized nature, FLEX Options do not have trading rotations at either the opening or closing of trading. The p.m. settlement and minimum size pilot information should help the Commission assess the impact on these markets as well as on the standardized market and determine whether other changes are necessary.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (SR–CBOE–2009–087) be, and it hereby is, approved.

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

Florence E. Harmon,
Deputy Secretary.

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Milliman, Inc., dated January 8, 2010 (supporting the reduction of minimum size requirements and noting that “[t]he ability to hedge the risk for smaller notional amounts is vital for small and medium-size insurance companies and for smaller sized liability portfolios for large insurers.”).


See, e.g., Submission via SEC WebForm from Ram Kelkar, Capital Markets and Trading.