SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-48807; File No. SR-CBOE-2003-40)

November 19, 2003

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the Chicago Board Options Exchange, Inc. Relating to Options on Certain CBOE Volatility Indices

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 September 12, 2003, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II and III below, which Items have been prepared by the CBOE. On November 18, 2003, the CBOE filed Amendment No. 1 to the proposed rule change.[3] The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

The Exchange hereby proposes to amend certain of its rules to provide for the listing and trading of options on several volatility indexes; specifically: the CBOE Volatility Index ("VIX"); the CBOE Nasdaq 100® Volatility Index ("VXN"); and the

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 See letter from Jim Flynn, Attorney, CBOE, to Florence Harmon, Senior Special Counsel, Division of Market Regulation ("Division"), Commission, dated November 18, 2003 ("Amendment No. 1"). Amendment No. 1 revises the original rule filing by defining the reporting authority and terms of these index option contracts, including that the interval between strike prices shall be no less than $2.50, and accordingly replaces CBOE's original Exhibit A.

CBOE Dow Jones Industrial Average® Volatility Index ("VXD"). Options on each index would be cash-settled and will have European-style expiration. The text of the proposed rule change is available at the Office of the Secretary, CBOE, and at the Commission.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the 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. The 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

The purpose of the proposed rule change is to permit the Exchange to list and trade cash-settled, European-style options on the VIX, VXN, and VXD. The calculation of each index is based on a recently developed methodology that builds upon the calculation of the original CBOE Market Volatility Index, which is based on S&P 100® Index option ("OEX") quotes. Introduced by CBOE in September 2003, the revised VIX is an index that uses the quotes of certain S&P 500 Index® ("SPX" ®) option series to derive a measure of the volatility of the U.S. equity market. It provides investors with up-to-the-minute market estimates of expected volatility by extracting implied volatilities from real-time index option bid/ask quotes. The VIX is quoted in percentage points per annum. For example, an index level of 30.34 (the closing value from December 31, 2002) represents an annualized volatility of 30.34%. This new methodology will also be used to calculate VXN and VXD values.

Index Design and Calculation

Each index – VIX, VXN, and VXD -- will be calculated using real-quotes of the nearby and second nearby index puts and calls of the SPX, the Nasdaq 100 Index ("NDX®"), and the Dow Jones Industrial Index ("DJX®"), respectively. For options on each respective volatility index, the nearby index option series are defined as the series with the shortest time to expiration, but with at least eight (8) calendar days to expiration. The second nearby index option series are the series for the subsequent expiration month. Thus, with eight days left to expiration, an index will "roll" to the second and third contract months.

For each contract month, CBOE will determine the at-the-money strike price. It will then select the at-the-money and out-of-the money series with non-zero bid prices and determine the midpoint of the bid-ask quote for each of these series. The midpoint quote of each series is then weighted so that the further away that series is from the at-the-money strike, the less weight that is accorded to the quote. Then, to compute the index level, CBOE will calculate a volatility measure for the nearby options and then for the second nearby options. This is done using the weighted mid-point of the prevailing bid-ask quotes for all included option series with the same expiration date. These volatility measures are then interpolated to arrive at a single, constant 30-day measure of volatility.

As described above, each volatility index option will be structured as an option on a group of securities, namely options on the SPX, NDX, or DJX indexes and by extension the stocks underlying each respective index. The CBOE will use the actual quotes of specific index options to derive each corresponding volatility index. The underlying index options themselves are securities and are based on an index of the broader number of underlying securities.[4] Thus, the pricing components underlying the Index options will include the SPX, NDX, or DJX options and, by extension, the component stocks of each index. These pricing components will provide a measure of the volatility of price movements of the SPX, NDX, or DJX stock indexes. This structure is similar to the approach used by CBOE for its interest rate options.[5] Those products use the quotes of debt securities to derive an interest rate yield, which is converted into a measure that serves as the underlying for options. In the case of Index options, quotes from index option securities, which reflect a measure of stock price movements of the SPX, NDX and DJX stocks, will be used to derive a measure of volatility that will be the underlying for the respective volatility index options.

The CBOE will compute each index on a real-time basis throughout each trading day, from 8:30 AM until 3:15 PM (Chicago Time) CST. CBOE has calculated historical index values for the new VIX back to January 2, 1990. As of December 31, 2002, the closing values for each respective index were as follows: (1) VIX: 30.34; (2) VXN: 46.94; and (3) VXD: 31.81. Volatility index levels will be calculated by CBOE and disseminated

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4 500 securities in the SPX, 100 securities in the NDX, etc.

5 See Securities Exchange Act Release Nos. 26938 (June 15, 1989), 54 FR 26285 (June 22, 1989); and 33106 (October 26, 1993), 54 FR 58358 (November 1, 1993).

at 15-second intervals to market information vendors via the Options Price Reporting Authority ("OPRA").

Index Option Trading

Strike prices will be set to bracket the index in 2 ½ point increments; thus, the interval between strike prices will be no less than $2.50.[6] The minimum tick size for series trading below $3 will be 0.05 and for series trading above $3 the minimum tick will be 0.10. The trading hours for options on the volatility indexes will be from 8:30 AM to 3:15 PM (Chicago Time) CST.[7]

Exercise and Settlement

The proposed options on each index will expire 30 days prior to the expiration date of the options used in the calculation of that index. For example, September 2003 VIX options would expire on Wednesday, September 17, 2003, exactly 30 days prior to the expiration of the October 2003 SPX options, which would be the only options used in the VIX calculation on that date. Trading in the expiring contract month will normally cease at 3:15 PM (Chicago Time) (CST) on the last day of trading. Exercise will result in delivery of cash on the business day following expiration. VIX, VXN and VXD options will be A.M.-settled. The exercise settlement value will be determined by a Special Opening Quotation ("SOQ") of each respective volatility index calculated from the sequence of

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6 See supra note 3.

7 See, Exhibit B to the proposed rule change filed by CBOE, presents proposed contract specifications for VIX options; Exhibit C presents proposed contract specifications for VXN options; and, Exhibit D presents proposed contract specifications for VXD options, of the proposed rule filing, which sets out the contract specifications for each product.

opening prices of the options that comprise that index. The opening price for any series in which there is no trade shall be the average of that option's bid price and ask price as determined at the opening of trading.

The exercise-settlement amount is equal to the difference between the exercise-settlement value and the exercise price of the option, multiplied by $100. When the last trading day is moved because of Exchange holidays, the last trading day for expiring options will be the day immediately preceding the last regularly-scheduled trading day.

Surveillance

The Exchange states that it will use the same surveillance procedures currently utilized for each of the Exchange's other index options to monitor trading in options on each volatility index. The Exchange represents that these surveillance procedures are adequate to monitor the trading of options on these volatility index. For surveillance purposes, the Exchange will have complete access to information regarding trading activity in the pertinent underlying securities.

Position Limits

The Exchange proposes to establish position limits for options on each volatility index -VIX, VXN and VXD - at 25,000 contracts on either side of the market and no more than 15,000 of such contracts may be in series in the nearest expiration month.[8] The Exchange states that this is consistent with Exchange Rule 24.4 (Position Limits for Broad-Based Index Options).

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[8] This is consistent with Exchange Rule 24.4 (Position Limits for Broad-Based Index Options).

Exchange Rules Applicable

Except as modified herein, the Exchange Rules in Chapter XXIV will be applicable to the VIX, VXN, and VXD options. Each volatility index will be classified as a "broad-based index" and, under CBOE margin rules, specifically, Exchange Rule 12.3(c)(5)(A), the margin requirement for a short put or call on the respective volatility indexes shall be 100% of the current market value of the contract plus up to 15% of the respective underlying index value.

Additionally, CBOE affirms that it possesses the necessary systems capacity to support new series that would result from the introduction of VIX, VXN and VXD options. CBOE also has been informed that OPRA has the capacity to support such new series.[9]

2. Statutory Basis

CBOE believes that the proposed rule change, as amended, is consistent with Section 6(b) of the Act[10] in general and furthers the objectives of Section 6(b)(5),[11] in particular, in that it will permit trading in options based VIX, VXN, and VXD on the volatility indices pursuant to rules designed to prevent fraudulent and manipulative acts and practices and to promote just and equitable principles of trade, and thereby will provide investors with the ability to invest in options based on an additional index.

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9 See, Exhibit E to the proposed rule change filed by CBOE, which set out the contract specifications for each product.

10 15 U.S.C. 78f(b).

11 15 U.S.C. 78f(b)(5).

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

CBOE does not believe that the proposed rule change will impose any burden on competition.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

No written comments were solicited or received with respect to the proposed rule change.

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 such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the CBOE consents, the Commission will:

A. by order approve the 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, as amended, is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. 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 at the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to File No. SR-CBOE-2003-40 and should be submitted by [insert date 21 days from date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[12]

Margaret H. McFarland
Deputy Secretary

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12 17 CFR 200.30-3(a)(12).