

**SECURITIES AND EXCHANGE COMMISSION**  
**(Release No. 34-49468; File No. SR-CBOE-2004-11)**

**March 24, 2004**

**Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change and Amendments Nos. 1 and 2 Thereto by the Chicago Board Options Exchange, Inc. Relating to a Pilot Program for Modification of ROS on the Settlement Date of Futures and Options on Volatility Indexes**

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on February 20, 2004, the Chicago Board Options Exchange, Inc. (“CBOE” or “Exchange”) filed with the Securities Exchange Commission (“Commission” or “SEC”) the proposed rule change as described in Items I and II below, which Items have been prepared by CBOE. On March 15, 2004, CBOE filed Amendment No. 1 to the proposed rule change.<sup>3</sup> On March 18, 2004, CBOE filed Amendment No. 2 to the proposed rule change.<sup>4</sup> The Commission is publishing this notice to solicit comments on the proposed rule

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See letter from David Doherty, Attorney, Legal Division, CBOE, to Terri Evans, Assistant Director, Division of Market Regulation (“Division”), Commission, dated March 12, 2004 (“Amendment No. 1”) (replacing the original Form 19b-4 filing in its entirety).

<sup>4</sup> See letter from David Doherty, Attorney, Legal Division, CBOE, to Terri Evans, Assistant Director, Division, Commission, dated March 17, 2004 (“Amendment No. 2”). In Amendment No. 2, CBOE amended its initial filing to request approval of the proposed rule change on a pilot basis until November 17, 2004. CBOE also proposed to amend CBOE Rule 6.2A.03(vii) to make the description of those eligible to place orders on the electronic book for the proposed modified ROS opening procedure consistent with the description set forth in proposed CBOE Rule 6.2A.03(i). CBOE also represented that prior to implementing a systems change to prevent market makers logged onto ROS from trading with themselves, it will file a proposed rule change with the Commission pursuant to Section 19(b)(3)(A) of the Act and further clarified that Lead Market-Makers (“LLMs”) are treated the same under the modified ROS opening, except for the ability of LLMs to collectively set the AutoQuote values used by ROS.

change, as amended, from interested persons and to grant accelerated approval to the proposed rule change, as amended, on a pilot basis through November 17, 2004.

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

CBOE proposes to modify the method by which CBOE's Rapid Opening System ("ROS") determines the opening price of certain broad-based index options in limited circumstances on a pilot basis through November 17, 2004. The purpose of the proposed rule change is to facilitate the calculation of a final settlement price for futures and options contracts on volatility indexes. The text of the proposed rule change is set forth below. Proposed new language is in *italics*.

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**Rule 6.2A. Rapid Opening System**

This rule has no applicability to series trading on the CBOE Hybrid Opening System. Such series will be governed by Rule 6.2B.

(a) – (d) No change.

**... Interpretation and Policies:**

**.01 - .02** No change.

**.03** Modified ROS Opening Procedure For Calculation of Settlement Prices of Volatility Indexes.

All provisions set forth in Rule 6.2A and the accompanying interpretations and policies shall remain in effect unless superseded or modified by this Rule 6.2A.03. To facilitate the calculation of a settlement price for futures and options contracts on volatility indexes, the Exchange shall utilize a modified ROS opening procedure for any index option series with respect to which a volatility index is calculated (including any index option series opened under

Rule 6.2A.01). This modified ROS opening procedure will be utilized only on the final settlement date of the options and futures contracts on the applicable volatility index in each expiration month.

The following provisions shall be applicable when the modified ROS opening procedure set forth in this Rule 6.2A.03 is in effect for an index option with respect to which a volatility index is calculated: (i) all orders (including public customer, broker-dealer, Exchange market-maker and away market-maker and specialist orders), other than contingency orders, will be eligible to be placed on the Electronic Book for those option contract months whose prices are used to derive the volatility indexes on which options and futures are traded, for the purpose of permitting those orders to participate in the ROS opening price calculation for the applicable index option series; (ii) all market-makers, including any LMMs and SMMs, if applicable, who are required to log on to ROS or RAES for the current expiration cycle shall be required to log on to ROS during the modified ROS opening procedure if the market-maker is physically present in the trading crowd for that index option class; (iii) if the ROS system is implemented in an option contract for which LMMs have been appointed, the LMMs will collectively set the Autoquote values that will be used by ROS; (iv) ROS contracts to trade for that index option series will be assigned equally, to the greatest extent possible, to all logged-on market-makers, including any LMMs and SMMs if applicable; (v) all orders for participation in the modified ROS opening procedure, and any change to or cancellation of any such order, must be received prior to 8:25 a.m. (CST) in order to participate at the ROS opening price for that index option series; (vi) all orders for participation in the modified ROS opening procedure must be submitted electronically, except that market-makers on the Exchange's trading floor may submit paper tickets for market orders only; and (vii) until the Exchange implements a ROS system change

that automatically generates cancellation orders for Exchange market-maker, away market-maker, specialist, and broker dealer orders which remain on the Electronic Book following the modified ROS opening procedure, any such orders that were entered in the Electronic Book but were not executed in the modified ROS opening procedure must be cancelled immediately following the opening of the applicable option series.

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## **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 had received on the proposed rule change. The text of these statements may be examined at the places specified in Item III 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**

The purpose of the proposed rule change is to facilitate the trading of options and futures on volatility indexes intended to be traded on CBOE or on the CBOE Futures Exchange LLC (“CFE”) by modifying certain of the rules that govern the ROS procedures for index option series whose prices are used to derive the volatility indexes on which options and futures will be traded. These modifications will expand the types of orders for these index options that may be included in ROS at the time when settlement values for volatility index options and futures are being determined. CBOE believes this will permit a more accurate determination of these

settlement values, and will assure that these values more closely converge with the prices of the index options from which they are derived.

This proposed rule change follows CBOE's recently filed proposal to provide for the listing and trading of options on several volatility indexes on CBOE; specifically, the CBOE Volatility Index ("VIX"); the CBOE Nasdaq 100 Volatility Index ("VXN"); and the CBOE Dow Jones Industrial Average Volatility Index ("VXD").<sup>5</sup> CBOE may file additional rule changes to provide for the listing of options on other volatility indexes in the future. The CFE, which is a designated contract market approved by the Commodity Futures Trading Commission ("CFTC") intends to file a rule change with the CFTC to provide for the listing and trading of futures on the VIX on CFE, and may list additional futures products on other volatility indexes in the future. The proposed rule change that is the subject of this filing is in anticipation of the commencement of trading in these new options and futures on volatility indexes on CBOE and on CFE.

**a. Volatility Index Description**

In general, CBOE states volatility indexes (including, without limitation, the VIX, VXN and VXD (each, a "Volatility Index")) provide investors with up-to-the-minute market estimates of expected near-term volatility of the prices of a broad-based group of stocks by extracting volatilities from real-time index option bid/ask quotes. Volatility Indexes are calculated using real-time quotes of the nearby and second nearby index puts and calls on established broad-based market indexes, referred to herein as a "Market Index." For example, the VIX measures the near-term volatility of the S&P 500 Index ("SPX"), the VXN measures the near-term volatility of the Nasdaq 100 Index ("NDX") and the VXD measures the near-term volatility of the Dow Jones Industrial Average ("DJX"). The futures and options on a Volatility Index expire on the

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<sup>5</sup> See Securities Exchange Act Release No. 48807 (November 19, 2003), 68 FR 66516

Wednesday immediately prior to the third Friday of the month that immediately precedes the month in which the options used in the calculation of that index expire (the “Settlement Date”). For example, April 2004 VIX futures and options would expire on Wednesday, April 14, 2004, which is the Wednesday immediately prior to the third Friday of April, which is the month preceding the expiration of the May 2004 SPX options. Since Volatility Indexes will be A.M.-settled, CBOE will utilize the ROS functionality to facilitate the calculation of a settlement price for futures and options contracts on Volatility Indexes.

**b. Current Market Index Opening Procedures**

ROS is CBOE’s automated system for opening classes of options at the beginning of the trading day or for re-opening classes of options during the trading day. In brief, the current ROS opening procedure involves market-makers participating on ROS by logging on each morning and identifying the classes of options in which they will participate for the opening. If ROS is being employed in a Designated Primary Market-Maker (“DPM”) or LMM trading crowd, the DPM and LMM are required to participate on ROS. A single opening price for each option series is calculated based on the orders contained in the electronic book and on the AutoQuote values set by the DPM, LMM, or other market-maker, as applicable, which AutoQuote values may be adjusted based on input from other LMMs and market-makers present at the opening. ROS then determines an opening price based on an algorithm that maximizes the number of public customer orders able to be executed at the opening. Currently, public customer orders, other than public customer contingency orders, are the only orders that can be placed in the electronic book for ROS. To ensure the participation of broker-dealer orders in the opening price calculation, CBOE Rule 6.2A(ii) requires the member representing a broker-dealer order to inform the DPM or Order

Book Official (“OBO”), as applicable, and the logged-in ROS market-makers of the terms of such orders prior to the time the class is locked. However, under current ROS opening procedures these broker-dealer orders are not eligible to be entered in the electronic book that is used by ROS to calculate opening prices.

**c. Proposed Modified ROS Opening Procedure**

Since ROS partially calculates the opening prices of Market Index option series based upon orders contained in the electronic book, and since these opening prices will be used to derive the settlement values of corresponding Volatility Indexes for purposes of Volatility Index options and futures, CBOE believes it is necessary to modify the ROS opening procedures to permit all orders (including public customer, broker-dealer, CBOE market-maker, away market-maker, and specialist orders), other than contingency orders, to be eligible to be placed on the electronic book solely for the purpose of the ROS opening. These orders may be placed on the book in those Market Index option contract months the prices of which are used to derive the Volatility Indexes on which options and futures will be traded. CBOE believes that expanding the scope of orders eligible for entry into the electronic book for purposes of the ROS opening will make it easier for all market participants to participate fully in the establishment of the settlement values of Volatility Indexes in an efficient and automated manner. This modified ROS opening procedure will be used only on the final Settlement Date of the options and futures contracts on the applicable Volatility Index in each expiration month, which is when Volatility Index settlement values are determined. The ROS opening procedures currently set forth in CBOE rules will continue to govern ROS openings of Market Index option classes on all other days.

To ensure market-maker participation in the modified ROS opening procedure, the proposed rule change would provide that all market-makers, including LMMs and Supplemental

Market-Makers (“SMMs”),<sup>6</sup> if applicable, who are required to log on to ROS or Retail Automatic Execution System (“RAES”) for the current expiration cycle are required to log on to ROS during the modified ROS opening procedure if the market-maker is physically present in the trading crowd for that Market Index option class. Although it has previously been CBOE’s observation<sup>7</sup> that few, if any, non-bookable orders (including broker-dealer orders) are represented by firms for participation in the ROS opening, CBOE believes that CBOE market-makers and other broker-dealers that trade Volatility Index futures and options and that use Market Index options for hedging purposes will want their Market Index option orders to be included in ROS to ensure the convergence of the values of their settled Volatility Index positions with the values of their positions in related Market Index options.

To participate in the modified ROS opening procedure on Settlement Date, all orders for placement on the electronic book would generally be required to be submitted electronically. For market-makers on CBOE’s trading floor, compliance with this requirement may be fulfilled through the submission of the order to a floor broker that has access to the CBOE’s Order Routing System or through the submission of the order through a hand-held terminal that has futures and options routing functionality. CBOE will also permit market-makers on the trading floor to submit paper ticket market orders to the OBO for placement in the electronic book. In all circumstances, orders for placement on the electronic book must be received by 8:25 a.m. Paper ticket limit orders

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<sup>6</sup> CBOE Rule 8.15 and Interpretation .02 to CBOE Rule 24.13 permit the appropriate Market Performance Committee to appoint one or more market-makers in good standing with an appointment in an option class for which a DPM has not been appointed as LMMs and SMMs.

<sup>7</sup> See Securities Exchange Act Release No. 48529 (September 24, 2003), 68 FR 56658 (October 1, 2003) (SR-CBOE-2002-55) (“ROS Permanent Approval Order”).



may not be submitted because CBOE believes these orders, which would rest on the electronic book if not executed at the opening, may not be able to be cancelled within the time period set forth in the proposed rule, as further explained below.

The current ROS procedures pursuant to CBOE Rule 6.2A(i) would then take effect and calculate the opening price, at which point the maximum number of orders (including broker-dealer or market-maker orders) would be crossed and the balance of orders, if any, to be traded at the opening price will be assigned to participating market-makers. If the ROS system is implemented in an option contract for which LMMs have been appointed, the LMMs will review the order imbalances and collectively set the AutoQuote values that will be used by ROS in calculating the opening prices for the Market Index option series. CBOE believes that having all of the LMMs participate in this process will contribute toward the establishment of a fair and accurate final settlement price for the Volatility Index futures and options since it will allow for the primary market-makers in the applicable Market Index option contract, as reflected by their designation as LMMs, to all have input in the ROS calculation that will ultimately derive that price. Other than the role of collectively setting the AutoQuote values that will be used by ROS, LMMs would be treated the same as market-makers in all respects under the modified ROS opening procedure provided for in proposed CBOE Rule 6.2A.03.<sup>8</sup>

Pursuant to proposed CBOE Rule 6.2A.03(iv), contracts traded in ROS for a Market Index option series will be assigned equally, to the greatest extent possible, to all logged-on market-makers, including any LMMs and SMMs if applicable.<sup>9</sup> Any customer orders not executed at the ROS opening will remain in the electronic book.

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<sup>8</sup> See Amendment No. 2, supra note 4.

<sup>9</sup> For example, if the opening imbalance is twenty contracts and ten market-makers are

CBOE states that it is in the process of modifying the ROS system software to prevent a market-maker who is logged on to ROS from trading against an order on behalf of the market-maker or the market-maker firm that may be resting in the electronic book.<sup>10</sup> CBOE states that it will also implement a ROS system change to automatically generate cancellation orders for those broker-dealer and market-maker orders that are not executed during the ROS opening. CBOE expects this work to be completed in approximately six months. Meanwhile, CBOE will use an interim process whereby market-maker and broker-dealer orders remaining on the electronic book because they were not executed in ROS (e.g., limit orders) would be required to be cancelled immediately following the opening of those option contracts to prevent market-maker and broker-dealer orders from remaining in the electronic book. In interpreting the requirement of immediate cancellation in this context, CBOE expects market-makers and broker-dealers to make a good faith effort to cancel these orders as soon as possible, taking into consideration the applicable circumstances. For example, it may take a member slightly longer to cancel an order submitted through a floor broker than if the member has a hand-held terminal with futures and options routing functionality.

#### **d. Surveillance**

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logged on to ROS, each market-maker will be assigned two contracts. If the opening imbalance is twenty-one contracts and ten market-makers are logged on to ROS, the algorithm will assign the greatest amount to the first market-maker chosen in the rotation (three contracts) with each remaining nine market-makers receiving two contracts.

<sup>10</sup> CBOE has represented that prior to implementation of the system change, it will file a rule change with the Commission pursuant to Section 19(b)(3)(A) of the Act to amend proposed Exchange Rule 6.2A.03 to reflect this system change. See Amendment No. 2, supra note 4.

As described in the Commission's order granting permanent approval to the ROS system,<sup>11</sup> CBOE currently has in place surveillance procedures that are designed to ensure, among other things, that market-makers exercise their discretion to set certain AutoQuote values consistent with their obligation to price options fairly. CBOE has also established supplemental ROS surveillance procedures for the modified ROS opening.<sup>12</sup> In addition to these procedures, CBOE's Department of Market Regulation will conduct surveillance to identify any broker-dealer or market-maker orders that may have been improperly executed on the electronic book which should have been cancelled following the modified ROS opening procedure.

## 2. Statutory Basis

CBOE states that the proposed rule change is designed to facilitate the calculation of the final settlement values of Volatility Indexes in an efficient and automated fashion that reflects all buying and selling interest in the associated Market Index. Accordingly, CBOE believes that the proposed rule change is consistent with Section 6(b) of the Act,<sup>13</sup> in general, and furthers the objectives of Section 6(b)(5) of the Act<sup>14</sup> in particular in that it should 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.

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<sup>11</sup> See ROS Permanent Approval Order, *supra* note 7.

<sup>12</sup> See letter from David Doherty, Attorney, Legal Division, CBOE, to Terri Evans, Assistant Director, Division, dated March 24, 2004 ("Supplemental ROS Surveillance Procedures"). CBOE requested confidential treatment for these surveillance procedures pursuant to 17 CFR 200.83.

<sup>13</sup> 15 U.S.C. 78f(b).

<sup>14</sup> 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 would impose any burden on competition that is 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 solicited or received with respect to the proposed rule change.

**III. 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. Comments may also be submitted electronically at the following e-mail address: [rule-comments@sec.gov](mailto:rule-comments@sec.gov). All comment letters should refer to File No. SR-CBOE-2004-11, and 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, comments may be sent in hard copy or by e-mail, but not by both methods. 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. Copies of such filing will also be available for inspection and copying at the principal office of the CBOE. All submissions should refer to File No. SR-CBOE-2004-11 and should be submitted by [insert date 21 days from date of publication].

**IV. Commission's Findings and Order Granting Accelerated Approval of Proposed Rule Change**

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.<sup>15</sup> In particular, the Commission believes that the proposed rule change is consistent with the requirements of Section 6(b)(5) of the Act<sup>16</sup> that the rules of a national securities exchange, in part, 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, protect investors and the public interest.

The proposed rule change seeks to generally modify the current ROS opening procedures to allow broker-dealer orders, other than contingency orders, to be incorporated into the electronic book for purposes of the ROS opening for any index option series with respect to which a Volatility Index is calculated. CBOE also proposes to allow LLMs, when applicable, to review the order imbalances as well as collectively set AutoQuote values, and to require that all market-makers log on to ROS during the modified ROS opening procedure if the market-maker is physically present in the trading crowd for that index option class. This modified ROS opening procedure would only be used on the final Settlement Date of the options and futures contracts on the applicable Volatility Index in each expiration month, which is when Volatility Index settlement values are determined. The current, unmodified, ROS opening procedures would be applied on all other days.

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<sup>15</sup> In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>16</sup> 15 U.S.C. 78f(b)(5).

The Commission believes that the proposed rule change, including incorporating these additional orders into the electronic book for purposes of the ROS opening, should ensure that broker-dealer orders are fairly incorporated into the opening, as well as contribute to the establishment of fair and accurate final settlement values of Volatility Index futures and options.<sup>17</sup> Further, the incorporation of broker-dealer orders into the electronic book should enable market participants that hedge Volatility Index futures or options contract positions against option positions in the related Market Index to ensure convergence of the value of those two positions at the time of settlement. The ROS modified opening procedure should allow this convergence by allowing market participants to close out their open Market Index option positions and obtain the exact price (*i.e.*, the opening price) for those series that will be used to calculate the Volatility Index settlement value. The Commission notes that CBOE has also submitted supplemental surveillance procedures designed to ensure, among other things, that market-makers exercise their discretion to set certain AutoQuote values consistent with their obligation

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<sup>17</sup> The Commission notes that it had previously required that CBOE develop a workable plan for the electronic incorporation of non-bookable orders in ROS. This requirement was waived in light of the limited number of non-bookable orders that are present at the open and CBOE's forthcoming ability to record information on non-bookable orders under the Consolidated Options Audit Trail ("COATS") Plan when Phase V of COATS is implemented. CBOE has represented as part of this filing that it is still unable to incorporate non-bookable orders on a daily basis because of certain technological limitations with respect to index products. Telephone conversation between David Doherty, Attorney, CBOE, and Christopher Solgan, Attorney, Division, Commission, on March 24, 2004. The Commission expects that CBOE will continue to actively monitor the quality of executions received by non-bookable orders that are not incorporated into the modified ROS opening and that CBOE will continue to explore methods to electronically incorporate non-bookable orders in the standard ROS opening in the event that non-bookable orders are more actively represented in the opening.

to price options fairly and that identify whether any accounts have engaged in manipulative or violative activity.<sup>18</sup>

The Commission finds good cause for approving the proposal prior to the thirtieth day after the date of publication of notice of filing thereof in the Federal Register. CBOE has requested that the Commission grant accelerated approval of the proposed rule change on a pilot basis through November 17, 2004. The Commission notes that the CFE intends to begin trading futures contracts on VIX commencing on Friday, March 26, 2004. Since the VIX futures contracts will be settled using the modified ROS process, accelerated approval of the proposed rule change would allow CFE to inform members of the process by which settlement values would be determined in conjunction with the commencement of trading these products. For these reasons, the Commission believes that there is good cause, consistent with Sections 6(b)(5) and 19(b) of the Act,<sup>19</sup> to approve CBOE's proposal, as amended, on an accelerated basis.

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<sup>18</sup> See Supplemental ROS Surveillance Procedures, supra note 12. CBOE has represented, and the Commission expects, that the Exchange will work with the Commission's Office of Compliance Inspections and Examinations ("OCIE") to finalize any surveillance reports used in connection with the modified ROS opening in a manner acceptable to OCIE. The Commission also expects CBOE to assess its surveillance procedures from time to time to determine whether they are adequate to ensure that market makers do not engage in manipulative or improper trading practices. Further, the Commission expects CBOE to consider whether any additional surveillance procedures are necessary to prevent manipulative or other improper practices.

<sup>19</sup> 15 U.S.C. 78f(b)(5) and 78s(b).

**V. Conclusion**

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>20</sup> that the proposed rule change, as amended, (SR-CBOE-2004-11) is hereby approved on an accelerated basis as a pilot program to expire on November 17, 2004.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>21</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>20</sup> 15 U.S.C. 78s(b)(2).

<sup>21</sup> 17 CFR 200.30-3(a)(12).