

and FUCOs and the requirements of rule 53(a)(4) concerning the submission of copies of certain filings under the Act to retail rate regulatory commissions. Further, none of the circumstances described in rule 53(b) has occurred. Finally, rule 53(c) is, by its terms, inapplicable since the requirements of paragraphs 53(a) and 53(b) are satisfied.

It appears to the Commission that the declaration, to the extent that it relates to the proposed solicitation of proxies, should be permitted to become effective immediately under rule 62(d).

*It is ordered*, that the declaration, to the extent that it relates to the proposed solicitation of proxies be, and hereby is, permitted to become effective immediately under rule 62 and subject to the terms and conditions prescribed in rule 24 under the Act.

For the Commission, by the Division of Investment Management, under delegated authority.

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-49563; File No. SR-CBOE-2003-40]

### Self Regulatory Organizations; Chicago Board Options Exchange, Inc.; Order Granting Approval to Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 Relating to Options on Certain CBOE Volatility Indexes

April 14, 2004.

#### I. Introduction

On September 12, 2003, the Chicago Board Options Exchange, Inc. ("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")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to amend certain of its rules to provide for the listing and trading of options on the following volatility indexes: the CBOE Volatility Index ("VIX"), the CBOE Nasdaq 100 Volatility Index ("VXN"), and the CBOE Dow Jones Industrial Average Volatility Index ("VXD"). On November 18, 2003, the CBOE filed Amendment No. 1 to the proposed rule change.<sup>3</sup> On December 22, 2003, the

CBOE filed Amendment No. 2 to the proposed rule change.<sup>4</sup>

The proposed rule change was published for comment in the **Federal Register** on November 26, 2003.<sup>5</sup> The Commission received one comment letter from the Chicago Mercantile Exchange ("CME") on the proposal.<sup>6</sup>

#### II. Description of the Proposed Rule Change

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 was based on S&P 100 Index option 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.

Each index—VIX, VXN, and VXD—will be calculated using real-time 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

of Market Regulation ("Division"), Commission, dated November 18, 2003 ("Amendment No. 1"). Amendment No. 1 revised 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.

<sup>4</sup> See letter from Jim Flynn, Attorney, CBOE, to Florence Harmon, Senior Special Counsel, Division, Commission, dated December 18, 2003 ("Amendment No. 2"). Amendment No. 2 made a technical change to a paragraph contained in a subsection ("Exercise and Settlement") in Item 3 of the Form 19b-4 originally filed by CBOE and made corresponding changes to Exhibits B, C, and D. Specifically, Amendment No. 2 clarified that "the options on each respective volatility index will expire on the 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."

<sup>5</sup> See Securities Exchange Act Release No. 48807 (November 19, 2003), 68 FR 66516 (November 26, 2003).

<sup>6</sup> See letter dated December 17, 2003 from Craig S. Donohue, CME, Office of the CEO, to Jonathan G. Katz, Secretary, Commission ("CME Letter").

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 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.

Strike prices will be set to bracket the index in 2½ point increments; thus, the interval between strike prices will be no less than \$2.50. 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 proposed options on each index will expire 30 days prior to the expiration date of the options used in the calculation of that index. 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 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.

The position limits for options on each volatility index will be 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.<sup>7</sup>

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

<sup>7</sup> This is consistent with CBOE Rule 24.4 (Position Limits for Broad-Based Index Options).

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

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

<sup>3</sup> See letter from Jim Flynn, Attorney, CBOE, to Florence Harmon, Senior Special Counsel, Division

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.<sup>8</sup>

### III. Summary of Comment

The Commission received one comment letter from the CME on the proposal.<sup>9</sup> The CME contends that by proposing the position limits, exercise limits, and margin requirements applicable to options on broad-based indexes, as defined in CBOE's rules, the CBOE's proposed rule change implicitly requests the Commission to acknowledge that these volatility indexes should be classified as "broad-based" security indexes for purposes of the definition of narrow-based security index in the Act and the Commodity Exchange Act ("CEA").<sup>10</sup> The CME further argues that the volatility indexes are narrow-based security indexes under these statutory definitions. As the CME notes, the definition of narrow-based security index was established by the Commodity Futures Modernization Act of 2000 ("CFMA") for purposes of determining whether futures on indexes are security futures subject to the jurisdiction of the Commission and the Commodity Futures Trading Commission ("CFTC").

### IV. Commission's Findings and Order Granting Accelerated Approval of Amendment No. 2.

After careful review, the Commission finds that the CBOE's proposal to permit trading in options based on certain volatility indices (VIX, VXN, and VXD), as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange<sup>11</sup> and, in particular, the requirements of section 6 of the Act<sup>12</sup> and the rules and

regulations thereunder. The Commission believes that the CBOE's proposal gives options investors the ability to make an additional investment choice in a manner consistent with the requirements of section 6(b)(5) of the Act.<sup>13</sup> The Commission further believes that trading options on these volatility indexes provides investors with an important trading and hedging mechanism.

The Commission finds that it is consistent with the Act for the CBOE to apply its rules for trading of broad-based index options to apply to the VIX, VXN and VXD. The Commission believes that because these three volatility indexes are composed of the puts and calls on indexes which the Commission has previously determined are appropriate to treat as broad-based for purposes of CBOE's rules,<sup>14</sup> it is appropriate to apply to the volatility index options the position limits, exercise limits and margin requirements that apply to CBOE's component index options.

The Commission also finds that CBOE has adequate surveillance procedures in place to monitor for manipulation of the volatility index options. 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.

The Commission also finds the CBOE's trading rules and other product specifications appropriate, including strike prices that will be set to bracket the index in 2½ point increments and minimum tick size. Because the exercise of these options will be cash settled, VIX, VXN and VXD options will be A.M.-settled on the business day following expiration, in a manner that will deter manipulation.

The Commission also finds determinative CBOE's representations that it possesses the necessary systems capacity to support new series that would result from the introduction of VIX, VXN and VXD options and that CBOE also has been informed that OPRA has the capacity to support such new series.

In its comment letter, the CME expressed concern that approval of the CBOE's proposal would imply that the Commission believed that the VIX, VXN and VXD volatility indexes were not "narrow-based security indexes" as defined in the Act and the CEA. The CFMA established a regulatory framework under which the Commission and the CFTC jointly regulate futures on single securities and narrow-based security indexes ("security futures"). To distinguish between security futures on narrow-based security indexes, which are jointly regulated by the CFTC and the Commission, and futures contracts on broad-based security indexes, which are under the exclusive jurisdiction of the CFTC, the CEA and the Act, each includes an objective definition of the term "narrow-based security index." A futures contract on an index that meets the definition of a narrow-based security index is a security future. A futures contract that does not meet the definition of a narrow-based security index is a futures contract on a broad-based security index.<sup>15</sup>

In approving the CBOE's proposed rule change, the Commission is not determining whether the volatility indexes are "narrow-based" security indexes as that term is defined in the Act. Moreover, the Commission notes that the CEA does not apply to the volatility index options CBOE proposes to list and trade.<sup>16</sup>

The Commission finds good cause, consistent with section 19(b)(2) of the Act,<sup>17</sup> to approve Amendment No. 2 to the proposed rule change prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. The Commission believes that accelerating the approval of the changes proposed in Amendment No. 2 is appropriate because the changes are technical in nature, are provided for the purpose of clarification and to eliminate confusion among investors, and because the amendment raises no new issues.

### V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the Amendment No. 2, including whether Amendment No. 2 is consistent with the Act.

<sup>8</sup> See, Exhibit E to the proposed rule change filed by CBOE, which set out the contract specifications for each product.

<sup>9</sup> See CME Letter, *supra* note 6.

<sup>10</sup> See Section 3(a)(55)(B) of the Exchange Act and Section 1a(25) of the Commodity Exchange Act ("CEA").

<sup>11</sup> In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>12</sup> 15 U.S.C. 78f.

<sup>13</sup> 15 U.S.C. 78f(b)(5).

<sup>14</sup> See Securities Exchange Act Release Nos. 40969 (January 22, 1999), 64 FR 4911 (February 1, 1999); 44994, (October 26, 2001), 66 FR 55772 (November 2, 2001).

<sup>15</sup> See 17 CFR 41.1(c).

<sup>16</sup> Separately, the Commission and the CFTC issued an order excluding from the definition of the term "narrow-based security index" certain indexes comprised of options series on broad-based security indexes. See Securities Exchange Act Release No. 49469 (March 25, 2004).

<sup>17</sup> 15 U.S.C. 78s(b)(2).

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](mailto:rule-comments@sec.gov). Please include File No. SR-CBOE-2003-40 on the subject line.

*Paper comments:*

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609.

All submissions should refer to File No. SR-CBOE-2003-40. 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>). 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 Section, 450 Fifth Street, NW., Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the CBOE. 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 No. SR-CBOE-2003-40 and should be submitted on or before May 12, 2004.

**VI. Conclusion**

It is therefore ordered, pursuant to section 19(b)(2) of the Act,<sup>18</sup> that the proposed rule change (File No. SR-CBOE-2003-40), as amended, be, and it hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>19</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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**SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-49567; File No. SR-CHX-2004-12]

**Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the Chicago Stock Exchange, Inc. Relating to the Implementation of a Fully-Automated Functionality for the Handling of Particular Orders Called CHXpress**

April 15, 2004.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (the "Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on February 20, 2004, the Chicago Stock Exchange, Inc. ("CHX" 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 Exchange. On April 8, 2004, the Exchange amended the proposed rule change.<sup>3</sup> 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 CHX proposes to amend CHX Article XX, Rule 37 to implement a new automated functionality for handling particular orders, called CHXpress. Below is the text of the proposed rule change.<sup>4</sup> Proposed new language is in *italics*.

\* \* \* \* \*

<sup>19</sup> 17 CFR 200.30-3(a)(12).

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

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

<sup>3</sup> See letter from Ellen J. Neely, Senior Vice President and General Counsel, CHX, to Nancy J. Sanow, Assistant Director, Division of Market Regulation ("Division"), Commission, dated April 7, 2004, and the attached Form 19b-4, which replaced the original filing in its entirety ("Amendment No. 1").

<sup>4</sup> With the Exchange's consent, the Commission has made technical corrections to the text of the proposed rule change, which the Exchange has committed to correct formally by filing an amendment. Telephone conversation between Ellen J. Neely, Senior Vice President and General Counsel, CHX, and David Hsu, Attorney, Division, Commission, on April 15, 2004.

**ARTICLE XX**

Regular Trading Sessions

\* \* \* \* \*

Guaranteed Execution System and Midwest Automated Execution System

\* \* \* \* \*

**Rule 37.**

(a) Guaranteed Executions. The Exchange's Guaranteed Execution System (the BEST System) shall be available, during the Primary Trading Session and the Post Primary Trading Session, to Exchange member firms and, where applicable, to members of a participating exchange who send orders to the Floor through a linkage pursuant to Rule 39 of this Article, in all issues in the specialist system which are traded in the Dual Trading System and Nasdaq/NM Securities. System orders shall be executed pursuant to the following requirements, *subject to section (b)(11) of this Rule 37*:

\* \* \* \* \*

(b) Automated Executions. The Exchange's Midwest Automated Execution System (the MAX System) may be used to provide an automated delivery and execution facility for orders that are eligible for execution under the Exchange's BEST Rule (Article XX, Rule 37(a)) and certain other orders. In the event that an order that is subject to the BEST Rule is sent through MAX, it shall be executed in accordance with the parameters of the BEST Rule and the following. In the event that an order that is not subject to the BEST Rule is sent through MAX, it shall be executed in accordance with the parameters of the following:

\* \* \* \* \*

(8) All orders sent through MAX shall include the appropriate account type designator. The following are acceptable account types:

- "P"—Principal/Professional Order
- "D"—Program Trade, index arbitrage for Member/Member Organization
- "A"—Agency
- "C"—Program Trade, non-index arbitrage for Member/Member Organization
- "I"—Individual Investor
- "J"—Program Trade, index arbitrage for Individual Customer
- "K"—Program Trade, index arbitrage for other agency
- "U"—Program Trade, non-index arbitrage for Individual Customer
- "Y"—Program Trade, non-index arbitrage for other agency
- "E"—CHXpress Order
- "Z"—Professional Order—Automatic Execution

\* \* \* \* \*

<sup>18</sup> 15 U.S.C. 78s(b)(2).