

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 Number SR-CBOE-2004-19 and should be submitted on or before May 21, 2004.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority,<sup>13</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-49614; File No. SR-CBOE-2004-23]

### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Chicago Board Options Exchange, Inc. and Amendment No. 1 Thereto To Permanently Approve the Modified ROS Opening Procedure Pilot Program, Which Occurs on the Settlement Date of Futures and Options on Volatility Indexes

April 26, 2004.

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 April 21, 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, II and III, below, which Items have been prepared by CBOE. On April 23, 2004, CBOE filed Amendment No. 1 to 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

CBOE seeks permanent approval of the modified Rapid Opening System ("ROS") opening procedure, which was approved by the Commission on a pilot basis through November 17, 2004.<sup>4</sup> The proposed rule change retains the text of CBOE Rule 6.2A.03 as currently approved on a pilot basis. 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, 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

On March 24, 2004, the Commission approved, on a pilot basis, the implementation of a modified ROS procedure. The modified ROS opening procedure pilot program facilitates 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 ROS for

index option series whose prices are used to derive the volatility indexes on which options and futures will be traded. The modified ROS opening procedure also expanded 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 that the modifications permit a more accurate determination of these settlement values, and assure that these values more closely converge with the prices of the index options from which they are derived. The modified ROS opening procedure pilot program is due to expire on November 17, 2004. CBOE now proposes that the modified ROS opening procedure pilot program be approved on a permanent basis.

CBOE requested approval of the modified ROS opening procedure on a pilot program basis following CBOE's proposal to list and trade options on several volatility indexes; 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 states that it may file additional proposed rule changes to provide for the listing of options on other volatility indexes in the future. CFE, which is a designated contract market approved by the Commodity Futures Trading Commission ("CFTC") and a wholly-owned subsidiary of CBOE, filed 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. CBOE believes that approval of the modified ROS opening procedure pilot program on a permanent basis will provide certainty as to the settlement process for market participants that trade those futures and options contract months on volatility indexes that expire beyond November 17, 2004.

##### Volatility Index Description

In general, CBOE states that 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

<sup>3</sup> See letter from David Doherty, Attorney, Legal Division, CBOE, to Terri Evans, Assistant Director, Division of Market Regulation, Commission, dated April 23, 2004 ("Amendment No. 1"). In Amendment No. 1, the CBOE deleted its proposed change to the cut-off time for the submission of orders for placement on the electronic book. According to CBOE, the CBOE intends to submit the modification to the cut-off time as a separate proposed rule change.

<sup>4</sup> See Securities Exchange Act Release No. 49468 (March 24, 2004), 69 FR 17000 (March 31, 2004) (SR-CBOE-2004-11).

<sup>5</sup> See Securities Exchange Act Release Nos. 48807 (November 19, 2003), 68 FR 66516 (November 26, 2003) (Notice of filing of File No. SR-CBOE-2003-40); 49563 (April 14, 2003), 69 FR 21589 (April 21, 2004) (Order approving File No. SR-CBOE-2003-40).

<sup>13</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.

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 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, May 2004 VIX futures and options would expire on Wednesday, May 19, 2004, which is the Wednesday immediately prior to the third Friday of May, which is the month preceding the expiration of the June 2004 SPX options. Since Volatility Indexes will be A.M.-settled, CBOE uses the modified ROS functionality to facilitate the calculation of a settlement price for futures and options contracts on Volatility Indexes.

#### 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 Lead Market-Maker ("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.

#### Modified ROS Opening Procedure Pilot Program

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 and 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 the 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 modified ROS opening procedure pilot program provides 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

<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 an LMM and SMM.

option class. Although it has previously been CBOE's observation that few, if any, non-bookable orders (including broker-dealer orders) are represented by firms for participation in the ROS opening,<sup>7</sup> 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. For example, a market participant that opens a position in a VIX futures contract may hedge that position by opening a position in SPX options, which prices are used in the calculation of VIX. If the market participant holds the VIX futures contract through settlement, the market participant must close out the hedge position that remains open in the SPX options. Since the settlement value of the VIX futures and options contracts are based on the opening prices of certain SPX option series, CBOE believes that the hedge will only be fully effective if the prices at which the market participant closes its SPX option positions converge with the corresponding prices of the SPX option series that determine the settlement value of the VIX. The ROS modified opening procedure pilot program allows this convergence to be achieved by allowing market participants to close out their open SPX positions and obtain the exact prices (*i.e.*, the opening prices) for those SPX series that will be used to calculate the VIX settlement value.

To participate in the modified ROS opening procedure pilot program on Settlement Date, all orders for placement on the electronic book are 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 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. Paper ticket limit orders may not be submitted because CBOE believes these orders, which would rest on the electronic book if not executed at the

<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").

opening, may not be able to be cancelled within the time period set forth in CBOE Rule 6.2A.03, as further explained below. In all circumstances, orders for placement on the electronic book must be received by 8:25 a.m.

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 are treated the same as market-makers in all respects under the modified ROS opening procedure provided for in CBOE Rule 6.2A.03.

Pursuant to 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>8</sup> Any customer orders not executed at the ROS opening will remain in the electronic book.

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>9</sup> CBOE states that

<sup>8</sup>For example, if the opening imbalance is twenty contracts and ten market-makers are 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>9</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 CBOE Rule 6.2A.03 to reflect this system change.

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 five 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.

#### Surveillance

As described in the Commission's order granting permanent approval to the ROS system,<sup>10</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>11</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. CBOE will also work with the Commission's Office of Compliance and Inspections and Examinations ("OCIE") to finalize any surveillance reports used in connection with the modified ROS opening procedure that is acceptable to OCIE.

See Securities Exchange Act Release No. 49468, *supra* note 4.

<sup>10</sup>See ROS Permanent Approval Order, *supra* note 7.

<sup>11</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.

## 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. Permanent approval of the proposed rule change will provide certainty as to the settlement process for market participants that trade those futures and options contract months on Volatility Indexes that expire beyond the Pilot's expiration of November 17, 2004. Accordingly, CBOE believes that the proposed rule change is consistent with section 6(b) of the Act,<sup>12</sup> in general, and furthers the objectives of section 6(b)(5) of the Act,<sup>13</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.

#### 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. 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 self-regulatory organization consents, the Commission will:

(A) By order approve such 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

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

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

arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act. 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 Number SR-CBOE-2004-23 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 Number SR-CBOE-2004-23. 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 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 Number SR-CBOE-2004-23 and should be submitted on or before May 21, 2004.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>14</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-49618; File No. SR-DTC-2003-12]

### Self-Regulatory Organizations; The Depository Trust Company; Order Granting Approval of Proposed Rule Change Relating to the Processing of Maturity Presentments in DTC's Money Market Instrument Program

April 26, 2004.

On September 30, 2003, The Depository Trust Company ("DTC") filed with the Securities and Exchange Commission ("Commission") proposed rule change File No. SR-DTC-2003-12 pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act").<sup>1</sup> Notice of the proposed rule change was published in the **Federal Register** on November 19, 2003.<sup>2</sup> No comment letters were received. For the reasons discussed below, the Commission is now granting approval of the proposed rule change.

#### I. Description

The purpose of this filing is to allow DTC to implement new procedures regarding the processing of Maturity Presentments ("MP") to its Money Market Instrument ("MMI") Program.<sup>3</sup> Specifically, the new procedures allow DTC to implement an alignment approach in processing MPs and will allow an Issuing/Paying Agent ("IPA") to assign processing priorities to the MMI issuers for which the IPA acts as agent.

Under DTC's current procedures for the processing of MPs, early on the maturity date (generally around 2 a.m. eastern standard time) DTC initiates deliveries of the maturing paper from the accounts of participants having positions in the maturing paper to the MMI participant account of the IPA. Each MP is processed as the equivalent of a book-entry delivery-versus-payment transfer. As such, MPs "recycle" just as any delivery would if the net debit cap or collateralization controls applicable to an IPA's account prevent the delivery from updating (*i.e.*, being completed). Recycling MPs update once additional funds (*e.g.*, from intraday settlement progress payments ("SPP") or from new

issuances) are credited to the IPA's account.

With the exception of a recent DTC rule change enabling an IPA to target settlement credits from an SPP to a specific issuer's maturity presentments, MPs update on a random basis.<sup>4</sup> There is no provision in DTC's current procedures enabling an IPA to assure that the recycling MPs of a specific issuer update by allocating to that issuer's MPs all or a specified portion of the IPA's net debit cap or by applying new issuance settlement credits of a specific issuer to that issuer's MPs. By the same token, because of the random nature of MP processing, the IPA is unable to prevent a portion of its net debit cap as well as any "excess" or "residual" credits from being used to update the MPs of an issuer to which the IPA would prefer not to extend credit.<sup>5</sup>

The rule change provides for the application of new issuance settlement credits to the MPs of the same issuer on a best efforts basis and would give IPAs the option to prioritize the order and manner in which MPs are processed, including the option to designate an issuer as self-funding.<sup>6</sup> Systemically, it is DTC's intention to align activities within the MMI system so that monies from Issuer A's credits are generally applied to Issuer A's MPs, subject to existing collateral monitor and net debit controls.

Under the alignment approach, once an IPA has incurred a net debit up to its applicable net debit cap (or the IPA's collateral is fully used), subsequent MPs presented to the IPA's account will still recycle as they do today. When an IPA processes a new issuance of an MMI into the system and the issuance transaction updates into the receiving participant's account, the resulting credit will then become available in the

<sup>4</sup> Securities Exchange Act Release No. 48145 (July 9, 2003), 68 FR 42442 (July 17, 2003) [File No. SR-DTC-2003-03] (proposed rule change allowing DTC to modify its settlement progress payment procedures to allow DTC participants to direct proceeds from a specific SPP be used to fund a particular transaction).

<sup>5</sup> "Excess" credits refer to credits resulting from an issuer's new issuances that exceed that issuer's offsetting MPs, SPPs that are not targeted to a specific issuer's MPs, and any unallocated net debit cap. "Residual" credits refer to credit balances from new issuances and targeted SPPs that are not large enough to completely offset the same issuer's MPs.

<sup>6</sup> IPAs will be able to prioritize between issuers by using new Participant Terminal System ("PTS") functions. IPAs logged into DTC's MMII PTS function would select "Issuer Priority Control" to access the main menu of IPA-issuer options. This new functionality would allow IPAs to select which issuers' MPs would recycle at the bottom of the ATP queue, perform an issuer control inquiry on selected issuers, maintain an audit trail for selected issuers, and inquire about MPs for selected issuers.

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

<sup>2</sup> Securities Exchange Act Release No. 48775 (November 12, 2003), 68 FR 65333 (November 19, 2003).

<sup>3</sup> The references to maturity presentments are intended to cover, in addition to MPs, other payment obligations of MMI issuers, such as periodic principal payments and periodic interest payments.

<sup>14</sup> 17 CFR 200.30-3(a)(12).