

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-64551; File No. SR-CBOE-2011-026)

May 26, 2011

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Granting Approval of Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 Thereto to Trade Options on Certain Individual Stock Based Volatility Indexes and Exchange-Traded Fund Based Volatility Indexes

On March 29, 2011, Chicago Board Options Exchange, Incorporated (the “Exchange” or “CBOE”) filed with the Securities and Exchange Commission (the “Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to trade options on certain individual stock based and exchange-traded fund (“ETF”) based volatility indexes. The proposed rule change was published for comment in the Federal Register on April 13, 2011.³ The Commission received no comments in response to the Notice.

On May 16, 2011, the Exchange submitted Amendment No. 1 to the proposed rule change, as described in Items I and II below, which items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on Amendment No. 1 from interested persons and is approving the proposed rule change, as modified by Amendment No. 1, on an accelerated basis.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of Amendment No. 1 to the Proposed Rule Change

CBOE proposes to amend its rules to list and trade options on certain individual stock based volatility indexes and ETF based volatility indexes. The proposed options will be cash-

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 64245 (April 7, 2011), 76 FR 20784 (“Notice”).

settled and will have European-style exercise. The text of the rule proposal is available on the Exchange's website (<http://www.cboe.org/legal>), at the Exchange's Office of the Secretary and at the Commission's Public Reference Room.

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 self-regulatory organization 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 those statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant parts of such statements.

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

1. Purpose

Amendment 1 replaces the original filing in its entirety. The purpose of Amendment 1 is to limit the original proposal to specific individual stock-based and exchange-traded-fund based ("ETF") volatility indexes.

The purpose of this proposed rule change is to permit the Exchange to list and trade cash-settled, European-style options on certain Individual Stock or ETF Based Volatility Indexes (collectively, "Vol Indexes"). Specifically, CBOE proposes to list options on Vol Indexes comprised of options on the following individual stocks: Apple Computer, Amazon, Goldman Sachs, Google and IBM. In addition, CBOE will list Vol Indexes comprised of options on the following ETFs: the US Oil Fund, LP ("USO"), the iShares MSCI Emerging Markets Index Fund ("EEM"), the iShares FTSE China 25 Index Fund ("FXI"), the iShares MSCI Brazil Index Fund ("EWZ"), the Market Vectors Gold Miners ETF ("GDX"), and the Energy Select Sector

SPDR ETF ("XLE"). These are in addition to options on the CBOE Gold ETF Volatility Index ("GVZ"), which has already been approved for trading by the Commission.⁴

Below is a chart identifying the specific Vol Indexes the Exchange is proposing to trade options on:

Ticker Symbol	Volatility Index Name	Underlying Option Class
VXAPL	CBOE Equity VIX on Apple	AAPL
VXAZN	CBOE Equity VIX on Amazon	AMZN
VXGS	CBOE Equity VIX on Goldman Sachs	GS
VXGOG	CBOE Equity VIX on Google	GOOG
VXIBM	CBOE Equity VIX on IBM	IBM
OVX	CBOE Crude Oil ETF Volatility Index	USO
VXEEM	CBOE Emerging Markets ETF Volatility Index	EEM
VXFXI	CBOE China ETF Volatility Index	FXI
VXEWS	CBOE Brazil ETF Volatility Index	EWZ
VXGDX	CBOE Gold Miners ETF Volatility Index	GDX
VXXLE	CBOE Energy Sector ETF Volatility Index	XLE

Index Design and Calculation

The calculation of a Vol Index will be based on the VIX and GVZ methodology applied to options on the individual stock or ETF that is the subject of the particular Vol Index. A Vol Index is an up-to-the-minute market estimate of the expected volatility of the underlying individual stock or ETF calculated by using real-time bid/ask quotes of CBOE listed options on the underlying instruments. A Vol Index uses nearby and second nearby options with at least 8 days left to expiration and then weights them to yield a constant, 30-day measure of the expected (implied) volatility.

For each contract month, CBOE will determine the at-the-money strike price. The Exchange 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

⁴ See Securities Exchange Act Release No. 62139 (May 19, 2010), 75 FR 29597 (May 26, 2010) (order approving proposal to list and trade GVZ options on the CBOE).

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.⁵

CBOE will compute values for Vol Index underlying option series on a real-time basis throughout each trading day, from 8:30 a.m. until 3:00 p.m. (Chicago time) (or until 3:15 p.m. (Chicago time) as applicable for certain ETF Based Volatility Index options). Vol Index levels will be calculated by CBOE and disseminated at 15-second intervals to major market data vendors.

Options Trading

Vol Index options will be quoted in index points and fractions and one point will equal \$100. The minimum tick size for series trading below \$3 will be 0.05 (\$5.00) and above \$3 will be 0.10 (\$10.00). Initially, the Exchange will list in-, at- and out-of-the-money strike prices and the procedures for adding additional series are provided in Rule 5.5.⁶ Dollar strikes (or greater) will be permitted for Vol Index options where the strike price is \$200 or less and \$5 or greater where the strike price is greater than \$200.

⁵ CBOE will be the reporting authority for any Vol Index.

⁶ See Rule 5.5(c). "Additional series of options of the same class may be opened for trading on the Exchange when the Exchange deems it necessary to maintain an orderly market, to meet customer demand or when the market price of the underlying...moves substantially from the initial exercise price or prices." For purposes of this rule, "market price" shall mean the implied forward level based on any corresponding futures price or the calculated forward value of the respective Vol index.

Transactions in Vol Index options may be effected on the Exchange between the hours of 8:30 a.m. Chicago time and 3:15 p.m. (Chicago time), except (for Exchange-Trade Fund Based Volatility Index options) if the closing time for traditional options on the ETF is earlier than 3:15 p.m. (Chicago time), the earlier closing time shall apply. The Exchange is proposing to permit different closing times for ETF Based Volatility Index options because the trading hours for traditional options on ETFs vary.

Exercise and Settlement

The proposed options will typically expire on the Wednesday that is 30 days prior to the third Friday of the calendar month immediately following the expiration month (the expiration date of the options used in the calculation of the index). If the third Friday of the calendar month immediately following the expiring month is a CBOE holiday, the expiration date will be 30 days prior to the CBOE business day immediately preceding that Friday. For example, November 2011 Vol Index options would expire on Wednesday, November 16, 2011, exactly 30 days prior to the third Friday of the calendar month immediately following the expiring month.

Trading in the expiring contract month will normally cease at 3:00 pm (Chicago time) (or at 3:15 p.m. (Chicago time) as applicable for ETF Based Volatility Index options) on the business day immediately preceding the expiration date.⁷ Exercise will result in delivery of cash on the business day following expiration. Vol Index options will be A.M.-settled.⁸ The exercise settlement value will be determined by a Special Opening Quotations ("SOQ") of a Vol Index calculated from the sequence of opening prices of a single strip of options expiring 30 days after the settlement date. The opening price for any series in which there are [sic] is no trade shall be

⁷ See proposed amendment to Rule 24.6, Days and Hours of Business.

⁸ See proposed amendment to Rule 24.9(a)(4) (adding Individual Stock or ETF Based Volatility Indexes to the list of A.M.-settled index options approved for trading on the Exchange).

the average of that options' bid price and ask price as determined at the opening of trading.⁹

The exercise-settlement amount will be 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 a CBOE holiday, the last trading day for expiring options will be the day immediately preceding the last regularly-scheduled trading day.

Position and Exercise Limits

For regular options trading, the Exchange is proposing to establish position limits for Vol Index options at 50,000 contracts on either side of the market and no more than 30,000 contracts in the nearest expiration month. CBOE believes that a 50,000 contract position limit is appropriate due to the fact that the options which are the underlying components for a Vol Index are among the most actively traded option classes currently listed. In determining compliance with these proposed position limits, Vol Index options will not be aggregated with the underlying ETF or individual stock options. Exercise limits will be the equivalent to the proposed position limits.¹⁰ Vol Index options will be subject to the same reporting requirements triggered for other options dealt in on the Exchange.

For FLEX options trading, the Exchange is proposing that the position limits for FLEX Vol Index Options will be equal to the position limits for Non-FLEX Options on the same Vol Index. Similarly, the Exchange is proposing that the exercise limits for FLEX Vol Index Options will be equivalent to the position limits established pursuant to Rule 24.4. The proposed position

⁹ See proposed amendment to Rule 24.9(a) (5) (revising rule to make "Volatility Index" options generic for purposes of this provision, which sets forth the method of determining the day that the exercise settlement value is calculated and of determining the expiration date and the last trading day for CBOE Volatility Index Options). The Exchange is also proposing to make technical changes to this rule provision as well.

¹⁰ See proposed amendment to rule 24.5 and proposed new Interpretations and Policy .04 to rule 24.5.

and exercise limits for FLEX Vol Index Options are consistent with the treatment of position and exercise limits for Flex GVZ and other Flex Index Options. The Exchange is also proposing to amend subparagraph (4) to Rules 24A.7(d) and 24B.7(d) to provide that as long as the options positions remain open, positions in FLEX Vol Index Options that expire on the same day as Non-FLEX Vol Index Options, as determined pursuant to Rule 24.9(a)(5), shall be aggregated with positions in Non-FLEX Vol Index Options and shall be subject to the position limits set forth in Rules 4.11, 24.4, 24.4A and 24.4B, and the exercise limits set forth in Rules 4.12 and 24.5.

The Exchange is proposing to establish a Vol Index Hedge Exemption, which would be in addition to the standard limit and other exemptions available under Exchange rules, interpretations and policies. The Exchange proposes to establish the following procedures and criteria which must be satisfied to qualify for a Vol Index hedge exemption:

- The account in which the exempt option positions are held ("hedge exemption account") has received prior Exchange approval for the hedge exemption specifying the maximum number of contracts which may be exempt under the proposed new Interpretation. The hedge exemption account has provided all information required on Exchange-approved forms and has kept such information current. Exchange approval may be granted on the basis of verbal representations, in which event the hedge exemption account shall within two (2) business days or such other time period designated by the Department of Market Regulation furnish the Department of Market Regulation with appropriate forms and documentation substantiating the basis for the exemption. The hedge exemption account may apply from time to time for an increase in the maximum number of contracts exempt from the position limits.

- A hedge exemption account that is not carried by a CBOE member organization must be carried by a member of a self-regulatory organization participating in the Intermarket Surveillance Group.
- The hedge exemption account maintains a qualified portfolio, or will effect transactions necessary to obtain a qualified portfolio concurrent with or at or about the same time as the execution of the exempt options positions, of a net long or short position in Equity-Based Volatility Index futures contracts or in options on Vol Index futures contracts, or long or short positions in Vol Index options, for which the underlying Vol Index is included in the same margin or cross-margin product group cleared at the Clearing Corporation as the Vol Index option class to which the hedge exemption applies. To remain qualified, a portfolio must at all times meet these standards notwithstanding trading activity.
- The exemption applies to positions in Vol Index options dealt in on the Exchange and is applicable to the unhedged value of the qualified portfolio. The unhedged value will be determined as follows: (1) the values of the net long or short positions of all qualifying products in the portfolio are totaled; (2) for positions in excess of the standard limit, the underlying market value (a) of any economically equivalent opposite side of the market calls and puts in broad-based index options, and (b) of any opposite side of the market positions in Vol Index futures, options on Vol Index futures, and any economically equivalent opposite side of the market positions, assuming no other hedges for these contracts exist, is subtracted from the qualified portfolio; and (3) the market value of the resulting unhedged portfolio is equated to the appropriate number of exempt contracts as follows—the unhedged qualified portfolio is divided by the correspondent closing index

value and the quotient is then divided by the index multiplier or 100.

- Only the following qualified hedging transactions and positions will be eligible for purposes of hedging a qualified portfolio (i.e. futures and options) pursuant to the propose new Interpretation .01:
 - Long put(s) used to hedge the holdings of a qualified portfolio;
 - Long call(s) used to hedge a short position in a qualified portfolio;
 - Short call(s) used to hedge the holdings of a qualified portfolio; and
 - Short put(s) used to hedge a short position in a qualified portfolio.
- The following strategies may be effected only in conjunction with a qualified stock portfolio:
 - A short call position accompanied by long put(s), where the short call(s) expires with the long put(s), and the strike price of the short call(s) equals or exceeds the strike price of the long put(s)(a "collar"). Neither side of the collar transaction can be in-the-money at the time the position is established. For purposes of determining compliance with Rules 4.11 and proposed Rule 24.4C, a collar position will be treated as one (1) contract;
 - A long put position coupled with a short put position overlying the same Vol Index and having an equivalent underlying aggregate index value, where the short put(s) expires with the long put(s), and the strike price of the long put(s) exceeds the strike price of the short put(s) (a "debit put spread position"); and
 - A short call position accompanied by a debit put spread position, where the short call(s) expires with the puts and the strike price of the short call(s) equals or exceeds the strike price of the long put(s). Neither side of the short call, long put

transaction can be in-the-money at the time the position is established. For purposes of determining compliance with Rules 4.11 and proposed Rule 24.4C, the short call and long put positions will be treated as one (1) contract.

- The hedge exemption account shall:
 - liquidate and establish options, their equivalent or other qualified portfolio products in an orderly fashion; not initiate or liquidate positions in a manner calculated to cause unreasonable price fluctuations or unwarranted price changes.
 - liquidate any options prior to or contemporaneously with a decrease in the hedged value of the qualified portfolio which options would thereby be rendered excessive.
 - promptly notify the Exchange of any material change in the qualified portfolio which materially affects the unhedged value of the qualified portfolio.
- If an exemption is granted, it will be effective at the time the decision is communicated. Retroactive exemptions will not be granted.

Exchange Rules Applicable

Except as modified herein, the rules in Chapters I through XIX, XXIV, XXIVA, and XXIVB will equally apply to Vol Index options.

The Exchange is proposing that the margin requirements for Vol Index options be set at the same levels that apply to equity options under Exchange Rule 12.3. Margin of up to 100% of the current market value of the option, plus 20% of the underlying volatility index value must be deposited and maintained. The pertinent provisions of Rule 12.3, Margin Requirements, have been amended to reflect these proposed revisions. Additional margin may be required pursuant to Exchange Rule 12.10.

The Exchange hereby designates Vol Index options as eligible for trading as Flexible Exchange Options as provided for in Chapters XXIVA (Flexible Exchange Options) and XXIVB (FLEX Hybrid Trading System). The Exchange notes that Vol Index FLEX Options will only expire on business days that non-FLEX options on Vol Indexes expire. This is because the term "exercise settlement value" in Rules 24A.4(b)(3) and 24B.4(b)(3), Special Terms for FLEX Index Options, has the same meaning set forth in Rule 24.9(5). As is described earlier, the Exchange is proposing to amend Rule 24.9(a)(5) to provide that the exercise settlement value of Vol Index options for all purposes under CBOE Rules will be calculated as the Wednesday that is thirty days prior to the third Friday of the calendar month immediately following the month in which a Vol Index options expire.

Capacity

CBOE has analyzed its capacity and represents that it believes the Exchange and the Options Price Reporting Authority have the necessary systems capacity to handle the additional traffic associated with the listing of new series that would result from the introduction of Vol Index options.

Surveillance

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

2. Statutory Basis

The Exchange believes the proposed rule change is consistent with the Act¹¹ and the rules and regulations thereunder and, in particular, the requirements of Section 6(b) of the Act.¹² Specifically, the Exchange believes the proposed rule change is consistent with the Section 6(b)(5)¹³ requirements that the rules of an exchange be designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts, to remove impediments to and to perfect the mechanism for a free and open market and a national market system, and, in general, to protect investors and the public interest. The Exchange believes that the introduction of Vol Index options will attract order flow to the Exchange, increase the variety of listed options to investors, and provide a valuable hedging tool to investors.

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 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. Discussion

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.¹⁴ Specifically, the Commission finds that the proposal is consistent with Section 6(b)(5) of the

¹¹ 15 U.S.C. 78s(b)(1).

¹² 15 U.S.C. 78f(b).

¹³ 15 U.S.C. 78f(b)(5).

¹⁴ In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

Act,¹⁵ which requires, among other things, that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices, to 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.

As a national securities exchange, the CBOE is required under Section 6(b)(1) of the Act¹⁶ to enforce compliance by its members, and persons associated with its members, with the provisions of the Act, Commission rules and regulations thereunder, and its own rules. In addition, brokers that trade options on Vol Indexes will also be subject to best execution obligations and FINRA rules.¹⁷ Applicable exchange rules also require that customers receive appropriate disclosure before trading options on Vol Indexes.¹⁸ Further, brokers opening accounts and recommending options transactions must comply with relevant customer suitability standards.¹⁹

Options on Vol Indexes will trade as options under the trading rules of the CBOE. The Commission believes that the listing rules proposed by CBOE for options on Vol Indexes are consistent with the Act. Vol Index options will be quoted in index points and fractions and one point will equal \$100. The minimum tick size for series trading below \$3 will be 0.05 (\$5.00) and above \$3 will be 0.10 (\$10). Dollar strikes (or greater) will be permitted for Vol Index options where the strike price is \$200 or less and \$ or greater where the strike price is greater than \$200. This should provide investors with greater flexibility in the trading of options on Vol

¹⁵ 15 U.S.C. 78f(b)(5).

¹⁶ 15 U.S.C. 78f(b)(1).

¹⁷ See NASD Rule 2320.

¹⁸ See CBOE Rule 9.15.

¹⁹ See FINRA Rule 2360(b) and CBOE Rules 9.7 and 9.9.

Indexes and further the public interest by allowing investors to establish positions that are better tailored to meet their investment objectives. The Commission notes that CBOE will compute Vol Index levels and disseminate the values at 15-second intervals to major market data vendors.

The Commission believes that the Exchange's proposed position limits and exercise limits for options on Vol Indexes are appropriate and consistent with the Act. The Commission notes that the particular Vol Index options in this proposed rule change track liquid underlying stocks and ETFs. In addition, the Commission notes that the position limits are similar to those for options on the GVZ which the Commission previously approved. The Commission also notes that the margin requirements for equity options as specified in CBOE Rule 12.3 will also apply to options on Vol Indexes. The Commission finds this to be reasonable and consistent with the Act.

The Commission also believes that the Exchange's proposal to allow options on Vol Indexes to be eligible for trading as FLEX Options is consistent with the Act. The Commission previously approved rules relating to the listing and trading of FLEX Options on CBOE, which give investors and other market participants the ability to individually tailor, within specified limits, certain terms of those options.²⁰ The current proposal incorporates options on Vol Indexes that trade as FLEX Options into these existing rules and regulatory framework. In addition, the Commission notes that the position and exercise limits for FLEX options on Vol Indexes will be the same as those previously approved for options on the GVZ.

The Commission believes that the hedge exemption for position limits on options on Vol Indexes in proposed Interpretations and Policies .01 to CBOE Rule 24.4C are reasonable. The exemption is limited and sets objective standards for when the exemption applies. The

²⁰ See Securities Exchange Act Release No. 31910 (February 23, 1993), 58 FR 12056 (March 2, 1993).

Commission believes that this approach ensures that position limits are not improperly circumvented but at the same time are flexible enough to accommodate hedging strategies employed by market participants.

Lastly, the Commission notes that CBOE represented that it has an adequate surveillance program to monitor trading of options on Vol Indexes and intends to apply its existing surveillance program to support the trading of these options. Finally, in approving the proposed rule change, the Commission has also relied upon the Exchange's representation that it has the necessary systems capacity to support new options series that will result from this proposal.

IV. Accelerated Approval of Proposed Rule Change, as Modified by Amendment No. 1

Amendment No. 1 limits the universe of Vol Indexes to specific individual stock-based and ETF based volatility indexes. Amendment No. 1 does not propose any new changes but instead narrows the scope of the original proposal. The Commission notes that CBOE is required to file a rule filing under Rule 19b-4 under the Act²¹ that would require Commission approval before listing options on any additional Vol Indexes. The Commission finds good cause, pursuant to Section 19(b)(2) of the Act,²² for approving the proposed rule change, as modified by Amendment No. 1, prior to the 30th day after the date of publication of notice in the Federal Register.

²¹ 17 CFR 240.19b-4.

²² 15 U.S.C. 78s(b)(2).

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²³ that the proposed rule change (SR-CBOE-2011-026), as modified by Amendment No. 1, be, and hereby is, approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁴

Cathy H. Ahn
Deputy Secretary

²³ 15 U.S.C. 78s(b)(2).

²⁴ 17 CFR 200.30-3(a)(12).