SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51220; File No. SR-CBOE-2004-89)

February 17, 2005

Self-Regulatory Organizations; Chicago Board Options Exchange, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change and Amendment Nos. 1 and 2 Thereto Relating to Reduced-Value Options on the Russell 2000 Stock Index

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder,[2] notice is hereby given that on December 23, 2004, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by CBOE. On February 10, 2005, CBOE filed Amendment No. 1 to the proposed rule change.[3] On February 14, 2005, CBOE filed Amendment No. 2 to the proposed rule change.[4] The Exchange filed the proposed rule change pursuant to Section 19(b)(3)(A) of the Act[5] and Rule 19b-4(f)(6) thereunder,[6] which renders it effective upon filing with the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

2 17 CFR 240.19b-4.

3 See Form 19b-4, dated February 10, 2005, which replaced the original filing in its entirety ("Amendment No. 1").

4 See Form 19b-4, dated February 14, 2005, which was a partial amendment ("Amendment No. 2"). In Amendment No. 2, CBOE represented, in part, that in the event the Frank Russell Company ceases to maintain or calculate the Index or if values are not disseminated every 15 seconds by a widely available source, CBOE will notify the Division of Market Regulation ("Division").

5 15 U.S.C. 78s(b)(3)(A).

6 17 CFR 240.19b-4(f)(6).

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

CBOE proposes to amend certain of its rules to provide for the listing and trading of reduced-value options on the Russell 2000® Index ("Russell 2000" or "Index"), a broad-based securities index. Options on each index would be cash-settled, a.m.-settled, and would have European-style expiration. The text of the proposed rule change is available on CBOE's web site (http://www.cboe.com), at the CBOE's principal office, 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, CBOE included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange 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 amend CBOE rules to allow the Exchange to list and trade reduced-value options on the Russell 2000.[7] Specifically, CBOE proposes listing

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7 The Exchange currently is approved to list and trade European-style, cash-settled options, including long-term index option series ("LEAPS"), on the Russell 1000 Index, Russell 2000 Index, Russell 3000 Index, Russell 1000 Growth Index, Russell 1000 Value Index, Russell 2000 Growth Index, Russell 2000 Value Index, Russell 3000 Growth Index, Russell 3000 Value Index, Russell Midcap Index, Russell Midcap Growth Index, Russell Midcap Value Index, Russell Top 200® Index, Russell Top 200® Growth Index, and the Russell Top 200® Value Index. See Securities Exchange Act Release Nos. 49388 (March 10, 2004), 69 FR 12720 (March 17, 2004); 48591 (October 2, 2003), 68 FR 58728 (October 10, 2003); 31382 (October 30, 1992), 67 FR 52802 (November 5, 1992).

cash-settled, a.m.-settled, European-style index options that are based on one-fifth ($1/5^{th}$) and one-tenth ($1/10^{th}$) the value of the Russell 2000 ("Reduced-Value Options"). The Russell 2000 is a broad-based securities index created in 1984 by the Frank Russell Company for the purpose of tracking the performance of small-cap companies. The Russell 2000 is a capitalization-weighted index and includes only common stocks belonging to corporations domiciled in the United States and its territories and that are traded on the New York Stock Exchange or the American Stock Exchange. The Russell 2000 is completely reconstituted annually to ensure that larger stocks do not distort the performance and characteristics of the true small-cap market.[8] The Russell 2000 includes the smallest 2000 securities in the Russell 3000.[9] CBOE has been trading European-style, cash-settled options on the Russell 2000 since 1992.

The proposed rule change will allow CBOE to attract additional business from customers that may not otherwise be able to invest in regular Russell 2000 options. Over the years, the value of the Russell 2000 has significantly increased such that, as of December 15, 2004, the value of the index stood at approximately 643. Accordingly, the premium for Russell 2000 options also has increased proportionately, making the use of Russell 2000 options as a hedging tool cost-prohibitive for some retail investors. To make trading Russell 2000 options accessible to a greater range of investors, CBOE proposes to introduce two new options contracts that are based on one-fifth ($1/5^{th}$) and one-tenth ($1/10^{th}$) the value of the Russell 2000, respectively. For example, a January (2005) Russell 2000 640 call would cost an investor approximately \$1,560, whereas, with adoption of the proposed reduced-value contracts, the $1/5^{th}$ version of the same call would cost an

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8 See http://www.russell.com or http://www.cboe.com for further description and background of the Index.

9 The Russell 3000® Index contains the largest 3,000 companies incorporated in the United States and the U.S. territories. The companies are ranked by total market capitalization.

investor $312.00 and a 1/10th version of the call would cost only $156.00.[10] CBOE will make no modifications to the Russell 2000 index methodology or calculation, for which the Frank Russell Company is the reporting authority. In addition to regular index options, the Exchange also may provide for the listing of LEAPS in accordance with CBOE Rule 24.9.[11]

The Exchange believes that offering reduced-value Russell 2000 options will provide an important opportunity for investors to hedge and speculate upon the market risks associated with the stocks comprising the Russell 2000, without having to extend great outlays of capital. This should attract a wider range of investors and, in turn, create a more active and liquid trading environment for all options on the Russell 2000. The Exchange will continue listing and trading the existing Russell 2000 options contracts, and the reduced-value Russell 2000 options will trade under their own trading symbols that are different than Russell 2000 trading symbol (RUT).

The Commission and the Options Clearing Corporation will be notified of the trading symbol, and CBOE will issue a circular detailing the option contract specifications to CBOE membership prior to the listing of options series on the reduced-value Russell 2000. In addition, the Exchange will disseminate prices for the reduced-value Russell 2000 contracts every 15 seconds through the Option Price Reporting Authority. The Exchange will notify the Division of Market Regulation immediately in the event the Frank Russell Company ceases to maintain or calculate the Index or if the Index values are not disseminated every 15 seconds by a widely available source.[12] CBOE further represents that, if the Russell 2000 Index ceases to be

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[10] Estimates are based on a randomly selected last sale price (intra-day) for the 2005 January 640 call on the Russell 2000 during the December 15, 2004 trading day. The approximate cost to an investor does not include applicable fees or commissions that may be incurred in the execution of trades.

[11] This is consistent with the Exchange's ability to list LEAPS on all other Russell Indexes. See supra note 7.

[12] See Amendment No. 2.

maintained or calculated, or if the Index values are not disseminated every 15 seconds by a widely available source, it will not list any additional series for trading and will limit all transactions in such options to closing transactions only for the purpose of maintaining a fair and orderly market and protecting investors.

Strike prices for the reduced-value Russell 2000 contracts will be set to bracket the index in 2 ½ point increments for strikes at or below 200 and in 5-point increments for strikes above 200. The minimum tick size for series trading below $3 will be $0.05 and for series trading above $3 the minimum tick will be $0.10. The trading hours for reduced-value options on the Russell 2000 will be 8:30 a.m. to 3:15 p.m. (CST).

Position and Exercise Limits

Consistent with CBOE Rule 24.4(d), positions in reduced-value index options shall be aggregated with positions in full-value indices. As such, the position and exercise limits applicable to the one-fifth value and one-tenth value Russell 2000 options shall be, conversely, increased by a factor of 5 and 10, respectively. To illustrate, for the purposes of determining the applicable position limits for the one-tenth value Russell 2000, ten reduced-value Russell 2000 contracts would be equal to one Russell 2000 contract and, for the one-fifth value Russell 2000, five reduced-value Russell 2000 contracts would be equal to one Russell 2000 contract. Reducing the contract size of the Russell 2000 Index option by one-tenth (or one-fifth) while increasing the position limit from 50,000 contracts to 500,000 contracts (or from 50,000 contracts to 250,000), would have no effect on the monetary value of the portfolio that could be controlled by a particular person or firm. This also is consistent with previous filings in which the Exchange introduced reduced-value versions of other broad-based indexes.[13]

The Exchange also proposes making a technical correction to Rule 24.4(d), which provides, "[p]ositions in reduced-value index options shall be aggregated with positions in full-value indices. For such purposes, ten (10) reduced-value contracts shall equal one contract." The latter sentence in this rule presumes that all reduced-value index options shall be reduced only to one-tenth the value of the original index. The Exchange believes that it is more appropriate to amend this sentence in the form of an example to illustrate the calculations to make based on the ratio of the reduced-value contract being proposed. As such, the rule will now provide two examples; one in which the index would be reduced by one-tenth and one in which the index would be reduced by one-fifth.

Exercise and Settlement

Exercise and settlement on the reduced-value Russell 2000 options will be identical to existing options on the Russell 2000. The reduced-value options will expire on the Saturday following the third Friday of the expiration month. Trading in the expiring contract month will normally cease at 3:15 p.m. (CST) on the business day preceding the last day of trading in the component securities of the Index (ordinarily the Thursday before expiration Saturday, unless there is an intervening holiday). The exercise settlement value of the Index at option expiration will be calculated by Reuters, on behalf of the Frank Russell Company, based on the opening prices of the component securities on the last business day prior to expiration. If a component security fails to

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13 See Securities Exchange Act Release No. 43000 (June 30, 2000), 65 FR 42409 (July 10, 2000) (notice of filing and immediate effectiveness of rule change SR-CBOE-00-15) (proposing the listing of options on reduced-value versions of the Nasdaq 100 Stock Index).

open for trading, the exercise settlement value will be determined in accordance with CBOE Rules 24.7(e) and 24.9(a)(4). When the last trading day is moved because of Exchange holidays (such as when CBOE is closed on the Friday before expiration), the last trading day for expiring options will be Wednesday, and the exercise settlement value of index options at expiration will be determined at the opening of regular trading on Thursday.

Maintenance

Because the Russell 2000 is to be monitored and maintained by the Frank Russell Company, the Frank Russell Company will be responsible for making all necessary adjustments to the indexes to reflect component deletions, share changes, stock splits, stock dividends (other than an ordinary cash dividend), and stock price adjustments due to restructuring, mergers, or spin-offs involving the underlying components. Some corporate actions, such as stock splits and stock dividends, require simple changes to the available shares outstanding and the stock prices of the underlying components. Other corporate actions, such as share issuances, change the market value of the Index and would require the use of an index divisor to effect adjustments.

The Russell 2000 is re-constituted annually on June 30, based on prices and available shares outstanding as of the preceding May 31. New index components are added only as part of the annual re-constitution, after which, should a stock be removed from an index for any reason, it cannot be replaced until the next re-constitution.

Although CBOE is not involved in the maintenance of the Russell 2000, the Exchange represents that it will monitor the Russell 2000 on a quarterly basis and will notify the Staff in the Division by filing a rule change pursuant to Rule 19b-4 if: (1) the number of securities in the index drops by 1/3rd or more; (2) 10% or more of the weight of the index is represented by component securities having a market value of less than $75 million; (3) less than 80% of the weight of the index is represented by component securities that are eligible for options trading pursuant to CBOE Rule 5.3; (4) 10% or more of the weight of the index is represented by component securities trading less than 20,000 shares per day; or (5) the largest component security accounts for more than 15% of the weight of each Index or the largest five components in the aggregate account for more than 50% of the weight of the Index. These are, generally, similar maintenance procedures that were adopted by CBOE for the monitoring of several other Russell Indexes.[14]

Surveillance

Because the index underlying the reduced-value options remains unchanged, the Exchange represents that CBOE's surveillance procedures are adequate to monitor the trading in reduced-value options and LEAPS on the Russell 2000. Further, the Exchange shall have complete access to the information regarding the trading activity of the underlying securities.

Margin

The Russell 2000 is a "broad-based index" and, under CBOE margin rules, the margin requirement for a short put or call on each respective reduced-value Russell 2000 option contract shall be 100% of the current market value of the contract, plus up to 15% of the respective underlying index value.[15] More specifically, for purchases of puts or calls with more than 9 months until expiration, customers must deposit and continue to maintain 75% of the total cost of the option's current market value.[16] When the time until expiration reaches 9 months, the option

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[14] See Securities Exchange Act Release No. 48591 (October 2, 2003), 68 FR 58727 (October 10, 2003) (order approving SR-CBOE-2003-17) (listing and trading of options on 11 Russell Indexes).

[15] See CBOE Rule 12.3(c)(5)(A).

[16] See CBOE Rule 12.3(c)(4)(B).

no longer has value for margin purposes.[17] Purchases of puts or calls with 9 months or less until expiration must be paid for in full. Writers of uncovered puts or calls must deposit and continue to maintain 100% of the option proceeds plus 15% of the aggregate contract value (current index level x $100) minus the amount, if any, by which the option is out-of-the-money, subject to a minimum for calls of option proceeds plus 10% of the aggregate contract value and a minimum for puts of option proceeds plus 10% of the aggregate exercise price amount.[18]

Other Exchange Rules Applicable

Except as modified herein, the Rules in Chapter XXIV will govern the trading of options on the aforementioned Russell Indexes on the Exchange. Additionally, in accordance with CBOE Rule 24A.4(b) (Special Terms for FLEX Index Options), CBOE reserves the right to approve and open for trading FLEX options on the reduced-value versions of the Russell 2000, and, in accordance with Rule 24A.7(a)(i), because the Russell 2000 is a broad-based index, there shall be no position or exercise limits for these FLEX index options. Finally, CBOE affirms that it possesses the necessary systems capacity to support new series that would result from the introduction of the reduced-value Russell Index options, including LEAPS. The Exchange will consider the potential impact on system capacity before listing FLEX reduced-value options on the Russell 2000. The Exchange also, concurrent with this the submission of this rule filing, provided the Division with a letter that describes the potential impact that the introduction of these options will have on quoting capacity.

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17 See id.

18 For calculating maintenance margin, the option's current market value, as opposed to the total cost/option proceeds method, must be used. Additional margin may be required pursuant to Exchange Rule 12.10.

2. Statutory Basis

CBOE believes that the proposed rule change is consistent with Section 6 of the Act,[19] in general, and furthers the objectives of Section 6(b)(5) of the Act,[20] in particular, in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, 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 will 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 either solicited or received with respect to the proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Because the foregoing proposed rule change does not:

(i) significantly affect the protection of investors or the public interest;

(ii) impose any significant burden on competition; and

(iii) become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate, it has become effective pursuant to Section 19(b)(3)(A) of the Act[21] and Rule 19b-4(f)(6) thereunder.[22] In addition, the Exchange provided the Commission with written notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of

19 15 U.S.C. 78f.

20 15 U.S.C. 78f(b)(5).

21 15 U.S.C. 78s(b)(3)(A).

22 17 CFR 240.19b-4(f)(6).

the filing of the proposed rule change, as required by Rule 19b-4(f)(6). At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.[23]

CBOE asked the Commission to waive the 30-day operative delay contained in Rule 19b-4(f)(6)(iii) under the Act.[24] The Commission believes that such waiver is consistent with the protection of investors and the public interest, since the proposed rule change merely allows CBOE to begin listing and trading additional versions of the Russell 2000 index option, which has previously been approved by the Commission. The Commission does not believe that the filing raises any new regulatory issues. Therefore, the Commission hereby waives the 30-day operative delay.[25]

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act. 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

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23 For purposes of calculating the 60-day abrogation period, the Commission considers the proposal to have been filed on February 14, 2005, the date the CBOE filed Amendment No. 2.

24 17 CFR 240.19b-4(f)(6)(iii).

25 For purposes only of waiving the 30-day pre-operative period, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-CBOE-2004-89 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-2004-89. 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 Room. 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-2004-89 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[26]

Margaret H. McFarland
Deputy Secretary

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[26] 17 CFR 200.30-3(a)(12).