SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-52367; File No. SR-CBOE-2004-86)

August 31, 2005

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Granting Approval of Proposed Rule Change Relating to the Modified ROS Opening Procedure

I. Introduction

On December 15, 2004, the Chicago Board Options Exchange, Incorporated ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("Commission") a proposed rule change pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder,[2] to amend the Exchange's Rapid Opening System ("ROS")[3] modified opening procedure set forth in CBOE Rule 6.2A.03. On July 5, 2005, the Exchange filed Amendment No. 1 to the proposed rule change.[4] The proposed rule change was published for comment in the Federal Register on July 28, 2005.[5] The Commission received no comments on the proposal. This order approves the proposed rule change, as amended.

II. Description of the Proposed Rule Change

Current CBOE Rule 6.2A.03 sets forth certain procedures that modify the normal operation of ROS for index options with respect to which volatility indexes are calculated, to be utilized on the final settlement date ("Settlement Date") of futures and options contracts that

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

2 17 CFR 240.19b-4.

3 ROS is the Exchange's automated system for opening certain classes of options at the beginning of the trading day or for re-opening those classes of options during the trading day.

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

5 See Securities Exchange Act Release No. 52101 (July 21, 2005), 70 FR 43726 ("Notice").

are traded on the applicable volatility index.[6] Specifically, the modified ROS opening procedure provides that on such Settlement Date, all orders, other than contingency orders, are eligible to be placed on the book in those index option contract months whose prices are used to derive the volatility indexes on which options and futures are traded, for the purposes of permitting those orders to participate in the ROS opening price calculation for the applicable index option series.[7]

In setting forth the purpose of the proposed rule change, CBOE cites the example of market participants actively trading futures on the CBOE Volatility Index ("VIX futures"), who have utilized the modified ROS opening procedure to place orders for options on the S&P 500 Index ("SPX") on the book on the Settlement Date of the VIX futures contract to unwind hedge strategies involving SPX options that were initially entered into upon the purchase or sale of the futures.[8] According to CBOE, to the extent that (i) traders who are liquidating hedges predominately are on one side of the market and (ii) those traders' orders predominate over other orders during the SPX opening on Settlement Date, trades to liquidate hedges may contribute to an order imbalance during the SPX opening on Settlement Date.

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6 The final settlement date of futures and options contracts on volatility indexes occurs on the Wednesday that is 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.

7 See CBOE Rule 6.2A.03. See also Securities Exchange Act Release Nos. 49468 (March 24, 2004), 69 FR 17000 (March 31, 2004); and 49798 (June 3, 2004), 69 FR 32644 (June 10, 2004).

8 See Notice. In particular, CBOE states, the commonly-used hedge for VIX futures involves holding a portfolio of the SPX options that will be used to calculate the settlement value of the VIX futures contract on the Settlement Date. Traders holding hedged VIX futures positions to settlement can be expected to trade out of their SPX options on the Settlement Date. Id.

CBOE proposes to implement changes to the modified ROS opening procedure to encourage additional participation by market participants who may wish to place off-setting orders against the imbalances. Currently, all orders for participation in the modified procedure must be received by 8:28 a.m. (CT).[9] The proposed rule change would amend Rule 6.2A.03 to require that all index option orders for participation in the modified ROS opening that are related to positions in, or a trading strategy involving, volatility index options or futures, and any changes or cancellations to these orders, be received prior to 8:00 a.m. (CT).[10] In addition, the proposed rule would require information regarding any order imbalances to be published as soon as practicable after 8:00 a.m. (CT), and thereafter at approximately 8:20 a.m. (CT), on the Settlement Date.[11]

The proposed rule change also provides a limited exception that would permit cancellations and changes to booked orders falling under this provision that are made to correct a legitimate error. The member submitting the change or cancellation would be required to prepare and maintain a memorandum setting forth the circumstances that resulted in the change or cancellation and would be required to file a copy of the memorandum with the Exchange no later than the next business day in a form and manner prescribed by the Exchange. In addition,

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9 See current CBOE Rule 6.2A.03(v).

10 The proposed rule change includes provisions setting forth generally the criteria by which the Exchange would consider index options orders to be related to positions in, or a trading strategy involving, volatility index options or futures for purposes of the rule. See Notice.

11 The Exchange represents that it would publish the imbalance on its Web site. See Notice.

two Floor Officials would have the ability to suspend the new rule in the event of unusual market conditions.[12]

The Exchange also proposes (i) to move the cut-off time for the submission of all other index option orders for participation in the modified ROS opening on Settlement Date mornings from 8:28 a.m. (CT) to 8:25 a.m. (CT); (ii) to change the time standards reflected in the rule from CST to CT, since Chicago is in the Central Time zone; and (iii) to revise the rule language in current CBOE Rule 6.2A.03(viii) to reflect that the Exchange has recently implemented a systems change to ROS that automatically generates cancellation orders for Exchange market-maker, away market-maker, specialist, and broker-dealer orders which remain on the electronic book following the modified ROS opening procedure.

III. Discussion

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations applicable to a national securities exchange.[13] In particular, the Commission believes that the proposed rule change is consistent with the requirements on Section 6(b)(5) of the Act[14] that the rules of a national securities exchange, in part, promote just and equitable principles of trade, remove impediments to and

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[12] For example, the CBOE states that if a significant market event occurs between 8:00 a.m. (CT) and 8:25 a.m. (CT), Floor Officials may determine to suspend the rule provision in the interest of maintaining a fair and orderly market so that limit orders placed in the book to unwind hedged volatility index futures positions are not unfairly disadvantaged as a result of a significant market move that would result in limit orders going unexecuted.

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

[14] 15 U.S.C. 78f(b)(5).

perfect the mechanism of 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 proposed rule change will improve the modified ROS opening procedure by exposing for a longer period of time order imbalances in index options resulting from the unwinding of hedged volatility index future positions. The Exchange further believes that the market participants to whom the proposed rule change applies would not be materially affected by the 8:00 a.m. (CT) cut-off time, because the last day of trading in volatility index futures in the applicable expiring month occurs on the day before Settlement Date, and holders of open volatility index futures are generally aware before 8:00 a.m. (CT) of the related index options series that they need to place on the book in order to adequately unwind their hedges. The Commission believes that the proposed rule change may serve the intended benefit without imposing an undue burden on these participants. The Commission notes that it has approved a similar rule in another context.[15]

The proposed rule change would also modify the deadline for submitting all other index options orders for participation in the modified ROS opening procedure, and any changes to or cancellations of any orders, from 8:28 a.m. (CT) to 8:25 a.m. (CT). The Exchange believes that this rule change would give Lead Market-Makers on the CBOE additional time to review order imbalances on the book in order to setting the Autoquote values that are used in the modified ROS opening procedures. The Commission believes this proposed adjustment is reasonable to achieve the intended benefit.

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[15] See NYSE Rule 123C(6). See, e.g., Securities Exchange Act Release No. 25804 (June 15, 1988), 53 FR 23474 (June 22, 1988) (order approving File Nos. SR-NYSE-87-11 and 88-04).

The Commission further believes that the other associated aspects of the proposed rule change are appropriate to clarify the application of the rule and to provide for its reasonable implementation.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[16] that the proposed rule change (SR-CBOE-2004-86), as amended by Amendment No. 1, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[17]

Jonathan G. Katz
Secretary

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16 15 U.S.C. 78s(b)(2).

17 17 CFR 200.30-3(a)(12).