

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-64245; File No. SR-CBOE-2011-026)

April 7, 2011

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of a Proposed Rule Change to Trade Options on Individual Stock Based Volatility Indexes and Certain Exchange-Traded Fund Based Volatility Indexes

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the "Act"),¹ and Rule 19b-4 thereunder,² notice is hereby given that on March 29, 2011, the Chicago Board Options Exchange, Incorporated ("Exchange" or "CBOE") filed with the Securities and Exchange Commission (the "Commission") 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 the proposed rule change from interested persons.

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

CBOE proposes to amend its rules to list and trade options on individual stock based volatility indexes and certain exchange-traded fund based volatility indexes. CBOE will list a total of 40 combined individual stock and exchange-traded fund based volatility indexes. These are in addition to options on the CBOE Gold ETF Volatility Index ("GVZ"), which has already been approved for trading by the Commission. Such volatility index options must be based on an individual stock option or exchange-traded fund option that already trades on CBOE. The proposed options will be cash-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.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

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 the Statutory Basis for, the Proposed Rule Change

1. Purpose

The purpose of this proposed rule change is to permit the Exchange to list and trade cash-settled, European-style options on individual stock-based volatility indexes and select exchange-traded fund based volatility indexes (collectively, "Vol Indexes"). CBOE proposes to list a total of 40 combined Vol Indexes. Initially, CBOE proposes to list options on Vol Indexes comprised of options on the following individual stocks: Apple Computer, Amazon, IBM, Google, and Goldman Sachs. In addition, CBOE will list Vol Indexes comprised of options on the following exchange-traded funds ("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.³ From time to time, CBOE will announce the remaining Vol Indexes options it will trade.

³ See Securities Exchange Act Release No. 62139 (May 19, 2010) 75 FR 29597 (May 26,

In addition to GVZ, CBOE currently has approval to trade options on other volatility indexes that measure the volatility of broad-based indexes.⁴ The Exchange now wants to add volatility index options based on individual stock options that are very actively traded and on certain ETF options. This proposal would permit the Exchange to trade a Vol Index using any ETF option currently trading and eligible for options trading under Interpretations and Policies .06 and .07 to Rule 5.3 other than those ETFs specifically identified in Interpretation and Policy .06(iv). CBOE will continue to trade GVZ options under the prior approval issued by the Commission. The calculation of any Vol Index will use the same methodology, as described below, as is currently used for CBOE Volatility Index ("VIX") and GVZ options.

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 exchange-traded fund 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 exchange-traded fund 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.⁵

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

2010) (order approving proposal to list and trade GVZ options on the CBOE).

⁴ See Rule 24.9(a)(4) which identifies, *inter alia*, CBOE Volatility Index, CBOE Nasdaq 100 Volatility Index, CBOE Dow Jones Industrial Average Volatility Index and CBOE Russell 2000 Volatility Index as A.M.-settled index options eligible for options trading on CBOE.

⁵ See proposed new definitions of "Exchange-Traded Fund and Individual Stock Based Volatility Index" set forth in Rule 24.1(bb).

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. 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.⁶

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 Exchange-Traded Fund 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 5.5.⁷ 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.

⁶ CBOE will be the reporting authority for any Vol Index.

⁷ 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 exchange-traded fund 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 Exchange-Traded Fund 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 Exchange-Traded Fund Based Volatility Index options) on the business day immediately preceding the expiration date.⁸ Exercise will result in delivery of cash on the business day following expiration. Vol Index options will be A.M.-settled.⁹ 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

⁸ See proposed amendment to Rule 24.6, Days and Hours of Business.

⁹ See proposed amendment to Rule 24.9(a)(4) (adding Exchange-traded fund volatility indexes and Individual stock volatility indexes to the list of A.M.-settled index options approved for trading on the Exchange).

there are is no trade shall be the average of that options' bid price and ask price as determined at the opening of trading.¹⁰

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 exchange-traded fund or individual stock options. Exercise limits will be the equivalent to the proposed position limits.¹¹ 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

¹⁰ 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.

¹¹ See proposed amendment to rule 24.5 and proposed new Interpretations and Policy .04 to rule 24.5.

will be equivalent to the position limits established pursuant to Rule 24.4. The proposed position 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 Act¹² and the rules and regulations thereunder and, in particular, the requirements of Section 6(b) of the Act.¹³ Specifically, the Exchange believes the proposed rule change is consistent with the Section 6(b)(5)¹⁴ 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. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period up to 90 days (i) as the Commission may designate 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:

¹² 15 U.S.C. 78s(b)(1).

¹³ 15 U.S.C. 78f(b).

¹⁴ 15 U.S.C. 78f(b)(5).

(A) by order approve or disapprove the 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 arguments concerning the foregoing, including whether the proposed rule change 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. Please include File Number SR-CBOE-2011-026 on the subject line.

Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-CBOE-2011-026. 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 website (<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 website viewing and printing in the Commission's Public Reference Room, 100 F

Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of the Exchange. 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 publicly available. All submissions should refer to File Number SR-CBOE-2011-026 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁵

Cathy H. Ahn
Deputy Secretary

¹⁵ 17 CFR 200.30-3(a)(12).