submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR–CBOE–2004–34 and should be submitted on or before July 1, 2004.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[14]

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–49798; File No. SR–CBOE–2004–23]

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendments Nos. 1 and 2 Thereto by the Chicago Board Options Exchange, Inc. to Permanently Approve the Modified ROS Opening Procedure Pilot Program, Which Occurs on the Settlement Date of Futures and Options on Volatility Indexes

June 3, 2004.

I. Introduction

On April 21, 2004, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),[1] and Rule 19b–4 thereunder,[2] a proposed rule change to permanently approve its modified Rapid Opening System ("ROS") opening procedure, which was approved by the Commission on a pilot basis through November 17, 2004.[3] On April 23, 2004, CBOE filed Amendment No. 1 to the proposed rule change.[4] The proposed rule change, as amended, was published for comment in the **Federal Register** on April 30, 2004.[5] The Commission received no comment letters on the proposed rule change. On May 13, 2004, CBOE filed Amendment No. 2 to the

proposed rule change.[6] This order approves the proposed rule change, as amended.

II. Description of the Proposal

On March 24, 2004, the Commission approved the implementation of a modified ROS procedure on a pilot basis through November 17, 2004.[7] CBOE now proposes that the modified ROS opening procedure pilot program be approved on a permanent basis. According to CBOE, the modified ROS opening procedure pilot program facilitates the trading of options and futures on volatility indexes ("Volatility Indexes") by modifying certain of the CBOE rules that govern ROS for index option series whose prices are used to derive the Volatility Indexes on which options and futures are traded.

According to CBOE, in general, Volatility Indexes 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 quotes of the nearby and second nearby index puts and calls on established broad-based market indexes, referred to herein as a "Market Index." 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 ("Settlement Date"). Generally, the modified ROS opening procedure allows, in part, broker-dealer orders, other than contingency orders, to be incorporated into the electronic book for purposes of the ROS opening for any index options series with respect to which a Volatility Index is calculated. The modified ROS opening procedure is 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.[8]

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 thereunder applicable to a national securities exchange.[9] In particular, the Commission believes that the proposed rule change is consistent with the requirements of Section 6(b)(5) of the Act[10] that the rules of a national securities exchange, in part, promote just and equitable principles of trade, remove impediments to and perfect the mechanism of a free and open market and a national market system and, in general, protect investors and the public interest.

The Commission notes that futures and options on Volatility Indexes with contract months that expire beyond November 2004 are currently being traded.[11] Therefore, the Commission believes that permanent approval of the modified ROS opening procedure pilot program should provide market participants with greater certainty as to the settlement process for those futures and options. The Commission also continues to believe that the modified ROS opening should ensure that broker-dealer orders are fairly incorporated into the opening,[12] and thereby enable market participants that hedge Volatility Index futures or options contract positions against option positions in the

[14] 17 CFR 200.30–3(a)(12).

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

[2] 17 CFR 240.19b–4.

[3] *See* Securities Exchange Act Release No. 49468 (March 24, 2004), 69 FR 17000 (March 31, 2004) (SR–CBOE–2004–11) ("Modified ROS Opening Procedure Pilot Program Approval Order").

[4] *See* letter from David Doherty, Attorney, Legal Division, CBOE, to Terri Evans, Assistant Director, Division of Market Regulation ("Division"), Commission, dated April 23, 2004 ("Amendment No. 1").

[5] *See* Securities Exchange Act Release No. 49614 (April 26, 2004), 69 FR 23837 ("Notice").

[6] *See* letter from David Doherty, Attorney, Legal Division, CBOE, to Terri Evans, Assistant Director, Division, Commission, dated May 12, 2004 ("Amendment No. 2"). In Amendment No. 2, CBOE amended the proposed rule text to reflect the immediate effectiveness of SR–CBOE–2004–27, which amended the modified ROS opening procedure pilot program to change the cut-off time for the submission of orders to the electronic book from 8:25 am to 8:28 am. *See* Securities Exchange Act Release No. 49679 (May 11, 2004), 69 FR 27957 (May 17, 2004) (Notice of Filing and Immediate Effectiveness of SR–CBOE–2004–27). The Commission notes that this is a technical, non-substantive amendment and not subject to notice and comment.

[7] *See* Modified ROS Opening Procedure Pilot Program Approval Order, *supra* note 3.

[8] For a detailed description on how the modified ROS opening procedure operates, *see* Notice, *supra* note 5.

[9] 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).

[10] 15 U.S.C. 78f(b)(5).

[11] Telephone conversation between David Doherty, Attorney, CBOE, and Christopher Solgan, Attorney, Division, Commission, on May 24, 2004.

[12] The Commission notes that it had previously required that CBOE develop a workable plan for the electronic incorporation of non-bookable orders in ROS. This requirement was waived in light of the limited number of non-bookable orders that are present at the open and CBOE's forthcoming ability to record information on non-bookable orders under the Consolidated Options Audit Trail ("COATS") Plan when Phase V of COATS is implemented. CBOE has represented as part of this filing that it is still unable to incorporate non-bookable orders on a daily basis because of certain technological limitations with respect to index products. Telephone conversation between David Doherty, Attorney, CBOE, and Christopher Solgan, Attorney, Division, Commission, on March 24, 2004. The Commission expects that CBOE will continue to actively monitor the quality of executions received by non-bookable orders that are not incorporated into the modified ROS opening and that CBOE will continue to explore methods to electronically incorporate non-bookable orders in the standard ROS opening in the event that non-bookable orders are more actively represented in the opening.

related Market Index to ensure convergence of the value of those two positions at the time of settlement. The ROS modified opening procedure should allow this convergence by allowing market participants to close out their open Market Index option positions and obtain the exact price (*i.e.,* the opening price) for those series that will be used to calculate the Volatility Index settlement value. The Commission notes that the modified ROS opening procedure was used on May 19, 2004 and that CBOE represented that generally no problems or issues arose regarding its use.[13]

The Commission notes that CBOE has also submitted supplemental surveillance procedures 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 and that identify whether any accounts have engaged in manipulative or violative activity.[14]

IV. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and rules and regulations thereunder.

[13] Telephone conversation between David Doherty, Attorney, CBOE, and Christopher Solgan, Attorney, Division, Commission, on May 28, 2004. CBOE noted that there were two minor issues that arose regarding the May 19, 2004 opening. First, that while 138 market makers were able to log on to ROS for the modified opening, two market makers were unable to participate in the opening because they failed to log onto ROS in a timely manner. Second, CBOE is investigating whether a broker-dealer violated CBOE Rule 6.2A by failing to cancel a broker-dealer order that was not executed during the opening as explicitly required by the rule. CBOE has represented that these problems did not affect the performance of the modified ROS opening. Further, CBOE has represented that it will work with market makers to ensure their timely participation in ROS.

[14] CBOE has represented, and the Commission expects, that CBOE will work with the Commission's Office of Compliance Inspections and Examinations ("OCIE") to finalize any surveillance reports used in connection with the modified ROS opening in a manner acceptable to OCIE. The Commission also expects CBOE to assess its surveillance procedures from time to time to determine whether they are adequate to ensure that market makers do not engage in manipulative or improper trading practices. Further, the Commission expects CBOE to consider whether any additional surveillance procedures are necessary to prevent manipulative or other improper practices. In addition, CBOE stated, and the Commission expects, that it will modify 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. CBOE has also represented and the Commission expects that prior to implementation of this system change, CBOE will file a rule change with the Commission to reflect this system change. *See* Notice, *supra* note 5.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[15] that the proposed rule change (SR–CBOE–2004–23) and Amendment Nos. 1 and 2 thereto, are approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[16]

Margaret H. McFarland,
Deputy Secretary.
[FR Doc. 04–13088 Filed 6–9–04; 8:45 am]
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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–49793; File No. SR–CHX–2004–02]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Chicago Stock Exchange, Incorporated Relating to Automatic Execution of Orders

June 2, 2004.

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 February 11, 2004, the Chicago Stock Exchange, Incorporated ("CHX" or "Exchange") filed with the Securities and Exchange Commission (the "Commission") the proposed rule change as described in Items I, II and III 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

The Exchange proposes to amend Article XX, Rule 37 of the CHX Rules, which governs, among other things, automatic execution of market and marketable limit orders, to eliminate the existing 100-share minimum automatic execution threshold. The text of the proposed rule change is available from the Office of the Secretary of the CHX or 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, the Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed

[15] 15 U.S.C. 78s(b)(2).
[16] 17 CFR 200.30–3(a)(12).
[1] 15 U.S.C. 78s(b)(1).
[2] 17 CFR 240.19b–4.

any comments it received regarding 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 Exchange proposes to amend Article XX, Rule 37 and Rule 43 of the CHX Rules, which governs, among other things, automatic execution of market and marketable limit orders, to eliminate the existing 100-share minimum automatic execution threshold.

Background

The vast majority of orders received by a CHX specialist are routed from order-sending firms via the Exchange's MAX" system, which provides for the electronic routing and automatic execution of orders. CHX rules require that the MAX system automatically execute orders at the national best bid or offer ("NBBO") if certain conditions are met.[3] In order to manage his position and prudently limit his auto-execution exposure, each CHX specialist designates an "auto-execution threshold" for each issue.[4] The auto-execution threshold is the number of shares that the specialist is willing to execute automatically. Under the current rule, the minimum auto-execution threshold is 100 shares.[5]

[3] See CHX Article XX, Rule 37(b)(6)(automatic execution of orders in listed securities); CHX Article XX, Rule 37(b)(7)(automatic execution of orders in OTC securities).

[4] Article XX, Rule 37(b)(1).

[5] The CHX believes that it is important to note that under the current version of the CHX rules governing automatic execution, a CHX specialist is required to permit MAX system execution of an unlimited number of orders at the then-prevailing NBBO price, until the consolidated quotation stream reflects a change in the NBBO price. As a consequence, if a large number of orders are routed to the CHX specialist simultaneously, before the consolidated quotation is updated, the CHX specialist would be obligated to fill all of the orders at the NBBO price, despite the fact that the aggregate number of shares vastly exceeded the NBBO size. The CHX represents that this virtually unlimited liability is an unintended, and unwarranted, consequence of automatic execution guarantees like the Exchange's current rule.

For example, if the national best bid ("NBB") was 50 x 1000 shares, the CHX specialist would be obligated to execute an unlimited number of customer sell orders at 50, as long as each order was 1000 shares or less in size, until the consolidated quotation information indicated a change in the NBB. Continuing this hypothetical example, assume