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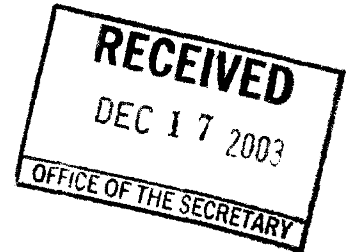

December 17, 2003

VIA OVERNIGHT MAIL

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: **File No. SR—CBOE—2003—40; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the Chicago Board Options Exchange, Inc. Relating to Options on Certain CBOE Volatility Indexes**

Dear Mr. Katz:

The Chicago Mercantile Exchange Inc. ("CME") welcomes the opportunity to comment upon the Chicago Board Options Exchange's (the "CBOE') proposed rule change concerning the listing and trading of options on the CBOE Volatility Index ("VIX"), the CBOE Nasdaq 100 Volatility Index ("VXN") and the CBOE Dow Jones Industrial Average Volatility Index ("VXD") (collectively, the "Volatility Indexes").

Introduction

We understand that the purpose of the proposed rule change is to permit the CBOE to list and trade cash-settled, European style options on the Volatility Indexes. We further understand that the calculation of each index is based upon a methodology that averages the prices of a group of security index options based on the respective underlying stock price index.

CBOE's proposed rule change implicitly requests the Securities and Exchange Commission ("SEC") to acknowledge that the Volatility Indexes should be classified as "broad-based' security indexes. The classification is significant because it will determine whether the Volatility Indexes are entitled to the relaxed treatment afforded to broad-based security indexes with respect to position limits, exercise limits and margin requirements.

CBOE's submission states that each volatility index "will be classified as a 'broad-based index.'" CBOE also states that such limits will be based upon CBOE Rule 24.4 ("Position

[1] See Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the Chicago Board Options Exchange, Inc. Relating to Options on Certain CBOE Volatility Indexes, 68 Fed. Reg. 66516 at 66518 (Nov. 26, 2003).

Limits for Broad-Based Index Options").[2] Finally, with respect to margin treatment, the CBOE states that the Volatility Indexes will be treated as broad-based indexes pursuant to CBOE Rule 12.3(c)(5)(A).[3] The CBOE's justification for broad-based index treatment is as follows:

> The underlying index options themselves are securities and are based on an index of the broader number of underlying securities. Thus, the pricing components underlying the Index options will include the SPX, NDX, or DJX options and, by extension, the component stocks of each index. These pricing components will provide a measure of the volatility of price movements of the SPX, **NDX,** or DJX stock indexes. This structure is similar to the approach used by CBOE for its interest rate options. Those products use the quotes of debt securities to derive an interest rate yield, which is converted into a measure that serves as the underlying for options. Similarly, quotes from index options securities, which reflect a measure of price movements of the SPX, **NDX,** and DJX stocks, will be used to derive a measure of volatility that will be the underlying for the respective volatility index options.[4]

We do not believe that CBOE's proposed classification of the Volatility Indexes is consistent with the definition of non-narrow-based security indexes, as set forth in the Securities Exchange Act of 1934 (the "Exchange Act") and the Commodity Exchange Act (the "CEA"), both of which were amended by the Commodity Futures Modernization Act of 2000 (the "CFMA") to include such definitions in the context of security futures products.

Analysis

The Exchange Act and the **CEA** each define the term "narrow-based security index" as an index:

(i) that has nine or fewer component securities;
(ii) in which a component security comprises. more than 30 percent of the index's weighting;
(iii) in which the five highest weighted component securities in the aggregate comprise more than 60 percent of the index's weighting; or
(iv) in which the lowest weighted component securities comprising an aggregate of 25 percent of the index's weighting have less than specified aggregate dollar values of average daily trading volume.[5]

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[2] Id.

[3] Id.

[4] Id. at 66517.

[5] See Section 3(a)(55)(B) of the Exchange Act and Section 1a(25) of the **CEA**

Conversely, the Exchange Act and the CEA each define a non-narrow-based security index (presumably a broad-based security index) as an index that has:

(i) ten or more securities;
(ii) no single component constitutes more than 30% of the weighting;
(iii) the five largest components by weight collectively constitutes no more than 60% of the weighting; and
(iv) the bottom quartile of component stocks has a combined average daily dollar trading volume of more than $50 million, or $30 million if the index includes at least 15 securities.[6]

To our knowledge, the SEC has not formally determined that the definition of non-narrow-based security index in Section 3(a)(55)(C) of the Exchange Act applies to broad-based security indexes, and we would welcome such a determination by the SEC.[7] However, to the extent that the statutory definition does apply, the Volatility Indexes do not appear to satisfy the criteria set forth in the definition.

Based upon our review of a CBOE white paper that describes in detail the calculation methodology of the Volatility Indexes,' the Volatility Indexes do not presently satisfy the trading volume requirements with respect to the bottom quartile criterion established in a joint rulemaking by the SEC and the Commodity Futures Trading Commission ("CFTC").[9] More specifically, each of the Volatility Indexes fails the dollar value of daily trading volume test. The VXN and VDX indexes rarely exceed the thirty million dollar hurdle for an index with fifteen or more components.

With respect to the VIX index, its dollar value of daily trading is greater than thirty million dollars on most days. However, Section 3(a)(55)(B) of the Exchange Act (and Section

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[6] Id.

[7] Prior to enactment of the CFMA, the SEC and CFTC agreed, in the context of the Shad/Johnson Accord, on a methodology to determine whether an index satisfied the narrow-based requirements of Section 2(a)(1)(B)(ii)(III) of the CEA, which was: "Such group or index of securities shall be predominately composed of the securities of unaffiliated issuers and shall be a widely published measure of, and shall reflect, the market for all publicly traded equity or debt securities or a substantial segment thereof, or shall be comparable to such measure." See 49 Fed. Reg. 16 at 2884-2886 (January 24, 1984). It is unclear whether the SEC continues to apply the 1984 methodology for determining whether a security index is broad-based or narrow-based, rather than a statutory "non-narrow-based' standard in light of the CFMA (as discussed herein).

[8] See CBOE VIX White Paper, available at: http://www.cboe.com/micro/vix/vixwhite.pdf

[9] See 66 Fed. Reg. 164 at 44490-44516 (August 23,2001)

1a(25) of the Act) stipulate that the dollar value of daily trading test be calculated over the prior six full calendar months and that the Commissions should jointly determine the methodology to be used. In addition, both sections contain an unanticipated anomaly in that, under a strict literal interpretation, even an index that has been broad-based every day for years could immediately become narrow-based if it fails the criterion on a single trading day during its first thirty days of trading.

In a joint rulemaking, the SEC and CFTC addressed this anomaly with three alternative paths to exclusion, the first two of which are applicable to a security index based on index options.[10] The VIX index appears to fail both paths to exclusion, in one case because serial options are typically listed for only three months, and therefore are not properly "seasoned," and in the other case, because of the occasional trading day with dollar volume of the bottom quartile below $30 million. The Volatility Indexes thus do not pass muster under Section 3(a)(55)(C).

Perhaps in recognition of this deficiency, the CBOE appears to suggest that it is appropriate to "look through" the options to the components of the Volatility Indexes upon which the options are based. Such an approach, however, was rejected by the SEC and CFTC when they jointly ruled that a futures contract based on a share of an exchange-traded fund ("ETF"), a trust issued receipt, or a share of a registered closed-end management investment company, would be classified as futures contracts on security futures products—not futures contracts on a broad-based index.[11] The SEC and CFTC made their determination on the basis of five criteria, none of which "looked through" the indexes to the underlying securities.[12] Consistent with the ruling, the status of the Volatility Indexes as broad-based indexes would thus be based solely upon the characteristics of the securities contained in the indexes—index options in this case. To the extent that the SEC were to determine otherwise, the CME expects that it would be afforded an equal opportunity to trade futures on ETFs, mutual funds and other security products and to treat those futures contracts implicitly as broad-based indexes because the underlying securities would properly be classified as a broad-based index.

Finally, it is important to note that the CBOE, through its affiliate, the Chicago Futures Exchange ("CFE"), plans to list and trade futures contracts that are based upon the Volatility Indexes. Because the futures are based on security indexes, in order to list and trade such futures contracts, the CFE will be required to obtain approval from, or certify to, the CFTC that the Volatility Indexes satisfy the requirements set forth in Section 2(a)(1)(C)(ii) of the CEA, which includes the requirement that the Volatility Indexes are non-narrow-based security indexes.

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[10] Id

[11] See Joint Order Granting the Modification of Listing Standards Requirements under Section 6(h) of the Securities Exchange Act of 1934 and the Criteria under Section 2(a)(1) of the Commodity Exchange Act, 67 Fed. Reg. 122 at 42760-42763 (June 25,2002).

[12] **Id.** The criteria were: i) the registration and trading status for the products; ii) the number of products outstanding; iii) the total trading volume in the previous 12 months; iv) the market price of the products over the previous three months: and v) the compliance of the issuer with the Exchange Act.

As described above, however, we do not believe that the Volatility Indexes are non-narrow-based security indexes. Indeed, if the Volatility Indexes are not narrow-based security indexes, the CFTC would have ***exclusive*** jurisdiction over any futures contracts based upon the indexes. Moreover, even if the Volatility Indexes are narrow-based indexes, and they meet certain additional requirements,[13] any fbtures contracts based upon the indexes would be deemed security fbtures products and subject to the joint regulation of the CFTC and SEC.

Conclusion

Thank you for the opportunity to comment upon the proposed rule change. If you have any questions or comments, please do not hesitate to contact me, Richard McDonald, Managing Director, Regulatory Policy, at (312) 930-4574, or Matthew F. Kluchenek, Director and Associate General Counsel, at (312) 338-2861.

Respectfully submitted,

Craig S. Donohue
Office of the CEO

cc Hon James E Newsome, Chairman of the CFTC
Hon Walter Lukken, Commissioner of the CFTC
Hon Sharon Brown-Hruska, Commissioner of the CFTC
Mr Michael Gorham, Director of Market Oversight, CFTC
Mr Thomas Leahy, Division of Economic Analysis, CFTC
Ms Joanne Moffic-Silver, General Counsel, CBOE

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[13] Specifically, since security futures must be based upon equity securities, the CFTC and SEC would have to make a joint ruling to grant an exemption from that requirement.