



CBOE Regulatory Circular RG04-85

August 6, 2004

To: Members and Member Firms

Re: SPX Opening on VIX Futures Settlement Days

As previously announced in CBOE Regulatory Circular RG04-58, the Exchange has modified the ROS opening procedures in SPX options on the days when there is a VIX futures settlement. This circular announces enhancements to those procedures and seeks to re-emphasize certain aspects of the procedures. The Exchange strongly advises members, member firms and customers to thoroughly review RG04-58 and this circular so that they are aware of the special procedures on VIX settlement days.

Dissemination of Order Imbalances

The commonly used hedge for VIX futures involves holding a portfolio of SPX options that will be used to calculate VIX on the final settlement date. Traders holding hedged VIX futures positions to settlement can be expected to trade out of their SPX options on that date. Traders who hold short, hedged VIX futures would liquidate that hedge by selling their SPX options, while traders holding long, hedged VIX positions would liquidate their hedge by buying SPX options. In order to seek convergence with the VIX final settlement value, these traders would be expected to liquidate their hedges by submitting market orders in the appropriate SPX option series during the SPX opening on the final settlement date of the VIX contract. To the extent (1) traders who are liquidating hedges predominately are on one side of the market (e.g., seek to buy the particular SPX options) and (2) those traders' orders predominate over other orders during the SPX opening on the final settlement date for the VIX futures, trades to liquidate hedges may contribute to an order imbalance during the SPX opening on that date. In fact, these factors did occur, and did lead to this type of imbalance, during the SPX opening on the June and July VIX settlement days.

As RG04-58 noted, the Exchange has allowed all market participants to participate in the SPX order book on the opening of VIX settlement days. This change was made to solicit as much interest as possible in the event of an order imbalance in the SPX options used to calculate VIX on VIX settlement days. In order to facilitate broad awareness of the existence and size of any such order imbalance, the Exchange will publish these order imbalances on the CBOE web-site at www.cboe.com/cfe on the day of VIX settlement and will relay this information to the Options

Price Reporting Authority (OPRA) from which it will be available to market data vendors. In particular, the information will be found on the following vendor pages, among others:

Bloomberg: FLEX go
ILX: FLEX

The Exchange will publish information about order imbalances, as they exist at 8:10 a.m. on the morning of VIX settlement days. Market participants should contact their member firm for information about order imbalances existing at other times prior to 8:28 a.m. on the morning of VIX settlement. As a reminder, in order to participate in the ROS opening on the morning of VIX settlement, all orders for placement in the electronic book must be received prior to 8:28 a.m.

Submission of Market Orders that Offset VIX Positions

In order to provide for a timely and orderly dissemination of SPX option order imbalances on the morning of VIX settlement, participants submitting SPX option orders that are the result of unwinding a hedge to VIX futures are ***strongly encouraged to submit these orders prior to 8:00 a.m.***

Market Maker Requirements in the Modified ROS Opening Procedure

As noted in RG04-58, when LMMs set Autoquote values for the modified ROS opening procedure on the morning of VIX settlement, they must do so in a manner consistent with their obligation to price option contracts fairly. Among other things, that obligation requires LMMs to consider the unique circumstances that reduce risk during those openings – circumstances that are not present during the opening on other days. For instance, only LMMs may log onto ROS during the opening on those other days, and LMMs therefore must absorb the entire order imbalance during those openings. In contrast, during the modified ROS opening on the morning of a VIX futures settlement, all SPX market makers must sign onto ROS if they both have signed onto RAES at any time during the most recent expiration cycle and are present during the ROS opening. Accordingly, the risk associated with order imbalances is more widely spread during the opening on the morning of VIX settlement. In addition, proprietary orders and orders from broker/dealers are accepted into the book for participation in the modified ROS opening on the morning of VIX settlements, while such orders are not accepted into ROS for other openings. These proprietary and broker/dealer orders may partially offset the order imbalances that otherwise would exist on the day of VIX settlement, and therefore may reduce the LMMs' risk during such an opening.

Any questions regarding this circular may be directed to Steve Slawinski of the Regulatory Division at 312-786-7744 or Patrick Fay of the CBOE Futures Exchange at 312-786-7925 or Bill Speth 312-786-7141.