



March 25, 2004

**Via Electronic Mail**

Ms. Jean A. Webb  
Secretary  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21st Street, N.W.  
Washington, D.C. 20581

Re: CBOE Futures Exchange, LLC  
Certification of Futures Contracts on CBOE Volatility Index  
Submission Number CFE-2004-10


Dear Ms. Webb:

Pursuant to Section 5c(c)(1) of the Commodity Exchange Act, as amended ("Act"), and §40.2 of the regulations promulgated by the Commodity Futures Trading Commission under the Act, CBOE Futures Exchange, LLC ("CFE") hereby submits rules and terms and conditions for a new product to be traded on CFE, which are attached hereto along with a summary description of the product. The new product is a futures contract on the CBOE Volatility Index, and the product will be listed for trading on CFE commencing on March 26, 2004.

CFE certifies that the futures contract on the CBOE Volatility Index complies with the Act and the rules thereunder.

Questions regarding this submission may be directed to David Doherty at (312) 786-7466. Please reference our submission number CFE-2004-10 in any related correspondence.

CBOE Futures Exchange, LLC

By:   
Edward J. Joyce  
President

Cc: Mark Baumgardner (OCC)

## **Summary Description of CBOE Volatility Index Futures**

CBOE Futures Exchange, LLC ("CFE") intends to list futures on the CBOE Volatility Index ("VIX"), which is a broad-based security index that measures stock market expectations of near term volatility as conveyed by certain stock index option prices. The VIX qualifies as a broad-based security index pursuant to the Joint Order issued by the Securities and Exchange Commission and the Commodity Futures Trading Commission dated March 25, 2004 (Release No. 34-49469).

The calculation of VIX is derived from the quotes of certain S&P 500 Composite Stock Price Index ("S&P 500") option series ("SPX option series") to derive a measure of the volatility of the United States equities market. VIX provides investors with up-to-the-minute market estimates of expected volatility by extracting implied volatilities from real-time SPX bid/ask quotes. VIX is quoted in percentage points per annum. For example, an index level of 16.5 represents an annualized volatility of 16.5%.

VIX will be calculated using real-time quotes of nearby and second nearby index puts and calls on the SPX. For each contract month, Chicago Board Options Exchange, Incorporated ("CBOE") will determine the at-the-money strike prices for the SPX. It will then select the at-the-money and out-of-the money SPX option series with non-zero bid prices 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 first calculate a volatility measure for the nearby options followed by 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 thirty-day measure of volatility.

As described above, the VIX futures contract will be structured as a future on a group of securities, namely option prices on the S&P 500. These pricing components will provide a

measure of the volatility of price movements of the SPX. CBOE will use the actual quotes of options on the S&P 500 to derive the corresponding measure of VIX.

CBOE will compute the VIX on a real-time basis throughout each trading day, from 8:30 AM until 3:15 PM (CST). In addition, CBOE will compute an "Increased-Value" VIX equal to ten times the VIX value on a real-time basis throughout each trading day, from 8:30 AM until 3:15 PM (CST). This Increased-Value VIX (Symbol: "VBI"), which will be the underlying for VIX futures, will be disseminated at fifteen-second intervals via the CBOE Financial Network during regular trading hours from 8:30 AM until 3:15 PM (CST).

The final settlement date for the VIX futures contract shall be 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. For example, May 2004 VIX futures would expire on Wednesday, May 19, 2004, which is the Wednesday immediately prior to the third Friday of May, which is the month preceding the expiration of the June 2004 SPX options. Trading in the expiring contract month will normally cease at 3:15 PM (CST) on the business day immediately preceding the final settlement date of the futures contract. When the last trading day is moved because of a CFE holiday, the last trading day for expiring VIX futures contracts will be the day immediately preceding the last regularly-scheduled trading day.

Settlement of VIX futures contracts will result in the delivery of a cash settlement amount on the business day immediately following the settlement date. The cash settlement amount on the final settlement date shall be the final mark to market amount against the final settlement price of the VIX futures multiplied by \$100.00. The final settlement price for VIX futures will be calculated based on the opening prices of the SPX option series used to calculate VIX on the settlement date. The procedures used to determine the opening prices of the SPX options are governed by CBOE rules. The opening price for any series in which there is no trade shall be the average of that option's bid price and ask price as determined at the opening of trading. The final settlement price of the VIX futures contract will be rounded to the nearest \$0.01.

## Rule Chapter Setting Forth Contract Specifications for CBOE Volatility Index Futures

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### CHAPTER 12 CBOE VOLATILITY INDEX FUTURES CONTRACT SPECIFICATIONS

#### 1201. Scope of Chapter

This chapter applies to trading in futures on the CBOE Volatility Index ("VIX"). The procedures for trading, clearing, settlement, and any other matters not specifically covered herein shall be governed by the generally applicable rules of the Exchange. The VIX futures contract was first listed for trading on the Exchange on March 26, 2004.

#### 1202. Contract Specifications

(a) *Multiplier.* Each VIX futures contract is valued at \$100.00 times an underlying value that will be disseminated by the Exchange to market vendors. This underlying value ("Increased-Value VIX") is valued at ten times the VIX value. Therefore, the Increased-Value VIX will be disseminated at 165 if the VIX value is 16.5.

(b) *Schedule.* The Exchange shall list for trading no more than two near-term contract months and two contract months on the February quarterly cycle (February, May, August, November) at the same time. The final settlement date for a VIX futures contract shall be 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.

The trading days for VIX futures contracts shall be the same trading days of options on the S&P 500 Composite Stock Price Index, as those days are determined by CBOE.

The trading hours for VIX futures contracts are from 8:30 a.m. (CST) to 3:15 p.m. (CST).

(c) *Minimum Increments.* The minimum fluctuation of the VIX futures contract is \$0.10, which has a value of \$10.00. For example, if the price of the VIX futures contract increases from 165.00 to 165.10, that fluctuation equates to a \$10.00 increase in the value of the VIX futures contract.

(d) *Position Limits.* A person may not own or control more than 5,000 contracts net long or net short.

For the purposes of this rule, the positions of all accounts directly or indirectly owned or controlled by a person or persons, and the positions of all accounts of a person or persons acting pursuant to an expressed or implied agreement or understanding shall be cumulated.

The foregoing position limit shall not apply to bona fide hedge positions meeting the requirements of Commission Regulation §1.3(z)(1) and the rules of the Exchange.

(e) *Termination of Trading.* Trading on the VIX futures contract terminates on the business day immediately preceding the final settlement date of VIX for the relevant spot month.

(f) *Contract Modifications.* Specifications are fixed as of the first day of trading of a contract. If any U.S. government agency or body issues an order, ruling, directive or law that conflicts with the requirements of these rules, such order, ruling, directive or law shall be construed to take precedence and become part of these rules, and all open and new contracts shall be subject to such government orders.

(g) *Execution Priorities.* Pursuant to Rule 406(a)(i), the base allocation method of price-time priority shall apply to trading in VIX futures contracts. Pursuant to Rule 406(b)(iii), a DPM trade participation right priority shall overlay the price-time priority base allocation method.

(h) *Crossing Two Original Orders.* The eligible size for an original Order that may be entered for a cross trade with another original Order pursuant to Rule 407 is one Contract. The request for quote response period under Rule 407(a) for the request for quote required to be sent before the initiation of a cross trade under Rule 407 is five seconds. Following the request for quote response period, the Trading Privilege Holder or Authorized Trader, as applicable, must expose to the market for at least five seconds under Rule 407(b) at least one of the original Orders that it intends to cross.

(i) *Price Limits.* Pursuant to Rule 413, VIX futures contracts are not subject to price limits.

(j) *Exchange of Future for Physical.* Exchange of Future for Physical transactions, as set forth in Rule 414, may not be entered into with respect to VIX futures contracts.

(k) *Block Trades.* Pursuant to Rule 415(a)(i), the minimum Block Trade quantity for the VIX futures contract is 100 contracts. If the Block Trade is executed as a spread or a combination, one leg must meet the minimum Block Trade quantity for the VIX futures contract and the other leg(s) must have a contract size that is reasonably related to the leg meeting the minimum Block Trade quantity. Pursuant to Rule 415(f), the seller is obligated to call the Help Desk without delay, but no later than ten minutes after a Block Trade is negotiated, to notify the Exchange of the terms of the trade, including information identifying the relevant Contract, contract month, price or premium, quantity, time of execution, counterparty Clearing Member for each Block Trade and, if applicable, the underlying commodity, whether the transaction involved a put or a call and the strike price and any other information that is required to be set forth in the prescribed Block Trade Reporting Form.

(l) *No-Bust Range.* Pursuant to Rule 416, the CFE error trade policy may only be invoked for a trade price that is greater than 10% on either side of the market price of the applicable VIX futures contract. In accordance with Policy and Procedure III, the Help Desk will determine what the true market price for the relevant Contract was immediately before the potential error trade occurred. In making that determination, the Help Desk may consider all relevant factors, including the last trade price for such Contract, a better bid or offer price, a more recent price in a different contract month and the prices of related contracts trading in other markets.

(m) *Pre-execution Discussions.* Pursuant to Policy and Procedure IV, the time period a Trading Privilege Holder or Authorized Trader must wait after engaging in pre-execution discussions with the other side of an Order is five seconds after that Order has been entered into the CBOE System.

(n) *Reportable Position.* Pursuant to Commission Regulation §15.03 and Commission Regulation Part 17, the position level that is required to be reported to the Commission is any open position in VIX futures contracts at the close of trading on any trading day equal to or in excess of twenty-five contracts on either side of the market.

#### **1203. Settlement**

Settlement of VIX futures contracts will result in the delivery of a cash settlement amount on the business day immediately following the settlement date. The cash settlement amount on the final settlement date shall be the final mark to market amount against the final settlement price of the VIX futures multiplied by \$100.00. The final settlement price of the VIX futures contract will be rounded to the nearest \$0.01.

Clearing Members holding open positions in VIX futures contracts at the termination of trading in that Contract shall make payment to or receive payment from the Clearing Corporation in accordance with normal variation and performance bond procedures based on the final settlement amount.

If the settlement value is not available or the normal settlement procedure cannot be utilized due to a trading disruption or other unusual circumstance, the settlement value will be determined in accordance with the Rules and By-Laws of The Options Clearing Corporation.

#### **1204. DPM Participation Rights and Obligations**

(a) *DPM Appointment.* A Trading Privilege Holder will be appointed to act as a DPM for VIX futures contracts pursuant to Rule 515.

(b) *DPM Participation Right.* The DPM participation right percentage under Rule 406(b)(iii) for VIX futures contracts is 30%.

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