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August 25, 2006



Ms. Nancy M. Morris  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-9303

**Re: File No. SR-CBOE-2003-41 -- Proposed Rule Change to List and Trade Options on Corporate Debt Securities**

Dear Ms. Morris:

The Bond Market Association (the "Association")<sup>1</sup> appreciates this opportunity to comment on the above-referenced proposed rule changes filed by the Chicago Board Options Exchange, Inc. (the "CBOE") with the Securities and Exchange Commission (the "Commission"). The proposed rule changes (the "CBOE Proposal")<sup>2</sup> would permit the listing and trading of options on corporate bonds, referred to by the CBOE as "corporate debt security options" ("CDSOs").

Currently, options on corporate bonds are traded only over-the-counter ("OTC"). The CBOE stated in its filing that users of OTC options on corporate bonds are expected to be among the primary users of CDSOs. The potential benefits of CDSOs identified by the CBOE include providing a tool to manage risks associated with the volatility of underlying bonds, providing an opportunity for option writers to earn premium income, enhancing liquidity by offering a standardized exchange-traded product, and contributing to more transparent markets through the price discovery and

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<sup>1</sup> The Association is a trade association that represents approximately 200 securities firms, banks and asset managers that underwrite, trade and invest in fixed-income securities in the United States and in international markets. Fixed income securities include U.S. government and federal agency securities, municipal bonds, corporate bonds, mortgage-backed and asset-backed securities, money market instruments and funding instruments such as repurchase agreements. The Association is expected to merge with the Securities Industry Association in November 2006. More information about the Association and its members and activities is available on its website [www.bondmarkets.com](http://www.bondmarkets.com), and information regarding the Securities Industry Association is available on its website at [www.sia.com](http://www.sia.com).

<sup>2</sup> Release No. 34-53935 (June 2, 2006), 71 Fed. Reg. 34174 (June 13, 2006).

dissemination provided by CBOE and its members. The CBOE also noted that offering CDSOs would aid it in competing with the OTC market.

The Association fully supports initiatives that will offer the corporate bond markets additional risk management tools and enhanced liquidity. We note, however, that the CBOE Proposal in its current form may not fully achieve the objectives of the CBOE described above, and therefore, we provide some suggestions we believe will help achieve such goals.

As a general matter, we note that the structure of the corporate debt market, which is primarily an OTC market without a centralized exchange-style price discovery process, presents a number of potential challenges for a listed option product. In particular, there are limitations on using TRACE information as the appropriate pricing mechanism for options on corporate bonds, and there are potential liquidity constraints in certain bonds at certain times. These factors may make it difficult for market participants trading standardized options to be certain they can effectively execute hedges or strategies, or acquire or sell bonds upon exercise of an option, at anticipated prices. In addition, option writers may face uncertainty as to whether their options will be exercised (*i.e.*, whether the buyers will view the options as in-the-money).<sup>3</sup>

Nevertheless, we believe that the potential challenges for CDSOs can be mitigated, particularly if their underlying corporate bonds have adequate liquidity and trading volume. We offer below comments that are intended to facilitate the viability of CDSOs and increase the likelihood that they will improve liquidity and risk management in the corporate debt markets.

#### I. Listing Criteria for Underlying Securities

The CBOE Proposal establishes both initial and continuing listing criteria applicable to bonds underlying CDSOs. As noted above, in our view it is important that these criteria generally identify bonds that are sufficiently liquid to support the trading and settlement of listed options and avoid any risk that either the options or the underlying cash markets would be susceptible to price distortions or liquidity pressures.

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<sup>3</sup> Although to some extent these factors also present challenges for OTC options on corporate bonds, the nature of the OTC options market – with the opportunity for direct negotiation between counterparties – may provide market participants with greater flexibility to negotiate and adjust trade execution and settlement to reflect current market conditions. For instance, many OTC options are traded only if the underlying bond can be obtained by the market maker at a certain price within a certain period of time. If the market maker is unable to obtain the underlying bonds at the price the market maker referenced for such bonds, the quote for the option is revised to reflect the updated price of the underlying bonds. The investor then has the choice to trade or decline to trade the options with the revised terms, or alternatively, to deliver the underlying bonds at the previously referenced price and trade on the original quote.

On the other hand, it is also important that the continuing listing requirements not be set so high as to risk frequent delisting, which can be disruptive to the markets.

As an initial matter, we note that corporate bonds underlying OTC options usually are issued in at least \$500 million in initial principal amount in order to ensure that there is sufficient liquidity to accommodate delivery of bonds upon exercise of options. As such, we would recommend that the CBOE Proposal similarly require that the initial principal amount for bonds underlying CDSOs be at least \$500 million.

Similarly, the float and trading volume requirements should also be considered in the context of avoiding potential liquidity issues upon settlement of CDSOs. As proposed, the initial trading volume requirement is \$100 million in notional value over the preceding six months, and the continuing trading volume requirement is \$75 million in notional value over the preceding six months. The initial and continuing “float” requirement is \$200 million. The CBOE should consider whether these requirements are sufficiently high. We note that corporate bonds generally trade far more infrequently than listed equities (although obviously different bonds have very different trading characteristics).<sup>4</sup> It is also important to take into account changes in trading levels that may occur over time in some corporate debt securities, as certain bonds are more likely to experience peaks in trading volume near issuance, during certain seasons or upon the occurrence of credit-related events.

It would also be helpful if the CBOE would clarify how the initial and continuing trading volume requirements will be applied, and how the float will be calculated. For example, what sources will be used to measure trading volume, and will volume be aggregated over the six month period, or will the CBOE look to the average trading volume per day/week/month for the preceding six month period? Similarly, what sources will be used to determine the “float” of the underlying security, and with what frequency will that determination be made?

## II. Margin Requirements

The CBOE Proposal establishes initial and maintenance margin requirements for short uncovered puts and calls. We note that corresponding changes to the margin requirements of other self-regulatory organizations (“SROs”), such as the New York Stock Exchange, Inc. (the “NYSE”), will be necessary to clarify margin levels applicable to those firms that are subject to the option margin requirements of these other SROs.

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<sup>4</sup> Approximately 12% of TRACE-eligible securities trade daily, while in contrast at least 90% of NYSE-listed equity securities trade daily. In addition, while only approximately 60% of all TRACE-eligible securities traded in 2005, at least 90% of equity securities traded in 2005. Source: NYSE, MarketAxess Corporate Bond Ticker and NASD.

In addition, the Association notes that the CBOE Proposal would introduce a new definition of “Investment Grade” for margin purposes that is different from the existing definition of “investment grade debt securities” in the margin rules of the NYSE and other SROs. Although the CBOE’s proposed definition would be consistent with the definition set forth in the TRACE rules, it may be more appropriate and avoid confusion if the CBOE’s definitions under its margin requirements were consistent with the definitions set forth in other SRO margin rules.

We also note that the CBOE and the NYSE have proposed amendments to their margin rules that would permit a broader range of equity products to be eligible for “portfolio margining”.<sup>5</sup> We support the eventual inclusion of fixed income products in these “portfolio margining” regimes, and believe that the development of CDSOs provides an additional justification for such expansion.

### III. Position Limit Requirements

The CBOE Proposal establishes tiered position limits intended to cap positions at 10% of the total float of the underlying corporate debt security. In determining the total float for these purposes, the CBOE proposes to exclude amounts held by holders of 10% or more of the underlying corporate debt security. It would be useful to market participants if the CBOE would clarify how it will determine if any investors hold 10% or more of a corporate bond, since it is our understanding that such information may not be publicly available.

### IV. Trading Halts

The CBOE Proposal establishes additional factors (beyond those set forth in its existing rules) that floor officials may consider in determining whether to halt trading in CDSOs. One such factor is whether the TRACE reporting system is inoperative or is not available for viewing by market participants because of systems problems occurring on the TRACE reporting system.

We note that there may be instances in which only a portion of the TRACE system is inoperative, but transaction reporting in other areas of TRACE is functioning normally (*e.g.*, if CTCI MQ is down, but FICC is still running). In addition, for bonds traded through the NYSE ABS, a failure of TRACE may not warrant a trading halt in options on such bonds. The CBOE and its floor officials will need to determine which of the various possible types of TRACE-related systems failures require a trading halt.

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<sup>5</sup> See Release No. 34-54125 (July 11, 2006), 71 Fed. Reg. 40766 (July 18, 2006); Release No. 34-53577 (Mar. 30, 1976), 71 Fed. Reg. 17539 (Apr. 6, 2006); and Release No. 34-53576 (Mar. 30, 1976), 71 Fed. Reg. 17519 (Apr. 6, 2006).

V. Specific Terms of CDSOs<sup>6</sup>

As proposed, CDSOs would expire on the Saturday immediately following the third Friday of the expiration month. Although we understand this approach would be consistent with the expiration features of equity options, it would differ from general market practice with respect to OTC options on corporate bonds, which typically expire on the 20<sup>th</sup> of the relevant month. This difference in expiration dates may have implications for the manner in which CDSOs are traded and the extent to which they can be used *in lieu* of, or to hedge, OTC options positions.

In addition, we note that under the CBOE Proposal each option would cover \$100,000 face value of corporate bonds. Most corporate bonds underlying OTC options are traded with institutional counterparties, generally in increments of \$1 million face value. It may be more difficult to obtain the underlying security for purposes of settling CDSOs in such smaller amounts. We encourage the CBOE to consider whether the proposed \$100,000 face value will inhibit trading or settlement of CDSOs, and whether a larger face amount may be more appropriate.

More generally, we note that in its filing the CBOE stated “[p]rices of CDSOs generally would be based on the prices of corporate debt securities that are reported through TRACE by members of NASD.”<sup>7</sup> In reviewing the CBOE Proposal, however, the only instance we have identified in which transaction prices as reported on TRACE appear to be incorporated into the CBOE’s rules is in connection with the establishment of exercise price intervals pursuant to proposed Rule 28.7(c). In light of the sentence from the CBOE Proposal quoted above, it would be useful if CBOE would clarify whether there are any other instances in which it intends to rely on TRACE-reported transaction prices for purposes of CDSOs. In addition, it would be useful if CBOE would explain in more detail how it will use TRACE data for purposes of establishing exercise price intervals – *e.g.*, what if there is limited data, or significant volatility in the reported prices? We note that TRACE is just one of a number of potential sources of information regarding the pricing of corporate bonds, and in certain circumstances (for instance in the case of illiquid bonds) there may be limitations on the use of TRACE-reported transaction prices as a definitive indicator of market price for purpose of trading and settling options.<sup>8</sup>

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<sup>6</sup> We also note that the text of the rule amendments provides that trading will be from 8:30 a.m. to 3:00 p.m. Chicago time, but the CBOE’s description of the proposed rule change states that trading will extend until 3:02 pm. Chicago time. We assume that the intended closing time is 3:00 p.m. and suggest that the CBOE clarify that is the case.

<sup>7</sup> 71 Fed. Reg. 34175.

<sup>8</sup> In addition, based on Exhibit B in the CBOE Proposal (Proposed Contract Specifications for Corporate Debt Security Options), we understand that CDSOs would not be subject to automatic exercise and would be physically-settled only (not cash-settled). If this understanding is incorrect, we believe it important that these elements of the CBOE Proposal be clarified and discussed more fully. Although a cash settlement option may alleviate some of the liquidity concerns potentially associated with the

VI. Treatment of CDSOs Under Commission and Other SRO Rules

We have not undertaken a comprehensive review of Commission and SRO rules that might be relevant to the listing or trading of CDSOs. We note, however, that since many existing requirements applicable to listed options were established with reference to options on equity securities, it is possible that modifications to, or relief from, certain such requirements may be necessary or appropriate for CDSOs.<sup>9</sup>

In addition, the CBOE Proposal notes that CBOE will work with the Options Clearing Corporation (“OCC”) to revise the Options Disclosure Document to incorporate CDSOs. Given the significant differences between equities and corporate securities, we ask that the revised Options Disclosure Document be made available for review and comment before approval of the CBOE Proposal. We further believe it would be useful if the CBOE would clarify how OCC’s rules and procedures (or amendments thereto, if any) would apply to CDSOs. For example, we request that the CBOE clarify how margin requirements for clearing firms will be assessed in connection with CDSOs, including in particular how prices (and exposures) will be calculated in light of the absence of a centralized quotation reporting system. In addition, we believe it important to understand more fully how settlement issues will be addressed, including delivery failures and buy-in requirements, particularly in light of potential liquidity concerns noted above. Procedures should also be specified for handling CDSOs on bonds whose issuers are subject to an insolvency event (*e.g.*, bankruptcy, liquidation, dissolution, etc.) or certain types of corporate reorganization (*e.g.*, merger, consolidation, sale of substantially all of assets, etc.).

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The Association thanks the Commission for affording it the opportunity to comment on the CBOE Proposal. If you have any questions concerning these comments,

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physical settlement of CDSOs, the limitations described above on the use of TRACE as an indicator of market price will present challenges for establishing the appropriate cash settlement amount (or if there is automatic exercise, to determine whether an option will be exercised).

<sup>9</sup> We also note that CDSOs apparently would include options on convertible bonds. Since convertible bonds are “equity securities” at least for purposes of the Securities Exchange Act of 1934, there may be a need to clarify the application of rules governing listed options on “equity” securities to CDSOs on convertible bonds (or provide appropriate relief from such application).

or would like to discuss our comments further, please feel free to contact me at 646-637-9220 or via email at [mkuan@bondmarkets.com](mailto:mkuan@bondmarkets.com).

Sincerely,



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