

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-63819; File No. SR-CBOE-2010-106)

February 2, 2011

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Approving a Proposed Rule Change, as Modified by Amendment No. 1, to Amend Margin Requirements for Credit Options

I. Introduction

On December 1, 2010, the Chicago Board Options Exchange, Incorporated (“Exchange” or “CBOE”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change as described below. On December 14, 2010, the Exchange filed Amendment No. 1 to the proposed rule change.<sup>3</sup> The proposed rule change was published for comment in the Federal Register on December 21, 2010.<sup>4</sup> The Commission received no comment letters on the proposed rule change. This order approves the proposed rule change.

II. Description of the Proposal

The Exchange proposes to amend Rule 12.3(1), Margin Requirements, to make CBOE’s margin requirements for Credit Options consistent with FINRA Rule 4240, Margin Requirements for Credit Default Swaps. CBOE’s Credit Options consist of two variations – Credit Default Options and Credit Default Basket Options. Credit Default Options and Credit

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> Amendment No. 1 to SR-CBOE-2010-106 replaced and superseded the original rule filing in its entirety.

<sup>4</sup> See Securities Exchange Act Release No. 63546 (December 15, 2010), 75 FR 80099 (December 21, 2010) (“Notice”).

Default Basket Options are also referred to as “Credit Event Binary Options.” Effectively, both contracts operate in the same manner as credit default swap contracts.

As with a credit default swap contract, the buyer of a Credit Option contract is buying protection from the seller of the Credit Option. This protection is in the form of a monetary payment from the Credit Option seller to the Credit Option buyer in the event that the issuer of debt securities, or Reference Entity, specified as underlying the Credit Option contract has a Credit Event,<sup>5</sup> consequently defaulting on the payment of principal and interest on its debt securities. When a Credit Option buyer and seller initially open their positions via a transaction consummated on the Exchange, the Credit Option buyer’s account is charged (debited) for the cost of the protection. The Credit Option seller’s account is credited. For the protection, there is only a one-time debit and credit to the buyer and seller, respectively. If, prior to expiration of the Credit Option, a Credit Event<sup>6</sup> occurs, the Credit Option contract is settled with a credit to the Credit Option buyer’s account for a predetermined payout amount (e.g., \$1,000), based on the Exchange’s contract specifications. The Credit Option seller’s account is debited (charged) for the payout amount.

Credit Default Options have a single Reference Entity. Credit Default Basket Options have multiple Reference Entities. If a Credit Default Basket Option is specified as having a single payout, settlement is triggered when any one of the component Reference Entities has a Credit Event and thereafter the option ceases to exist. The payout is the settlement amount attached to that one Reference Entity. If a Credit Default Basket Option is specified as having

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<sup>5</sup> See Securities Exchange Act Release No. 63352 (November 19, 2010), 75 FR 73155 (November 29, 2010) (order approving SR-CBOE-2010-046). CBOE amended its rules to permit it to, among other things, list credit options designating a single credit event, such as failure-to-pay default, another event of default, or a restructuring. See also CBOE Rules 29.2 and 29.2A.

<sup>6</sup> Id.

multiple payouts, a settlement is triggered when any one of the component Reference Entities has a Credit Event,<sup>7</sup> but the option continues to exist until its expiration. Therefore, additional settlements would be triggered if, and as, any Credit Events occur in respect of the remaining Reference Entity components. The payout is the settlement amount attached to each particular Reference Entity.

CBOE notes that the current Exchange margin requirements for Credit Options were established before FINRA implemented margin requirements for credit default swaps (FINRA Rule 4240). In order to be consistent with FINRA margin requirements and establish a level playing field for similar instruments, CBOE's proposed amendments adopt the FINRA requirements to a large extent. For Credit Default Options, which overlie a single Reference Entity, CBOE proposes to adopt FINRA's margin percentage table for credit default swaps. With respect to Credit Default Basket Options, CBOE is adopting the margin percentage table that FINRA requires for CDX indices because, like an index, a Credit Default Basket Option involves multiple component Reference Entities. CBOE proposes to revise the FINRA column headings to fit Credit Options. FINRA Rule 4240 requires the percentage to be applied to the notional amount of a credit default swap. CBOE's proposed rules would require that the percentage be applied to the settlement value of a Credit Option to arrive at a margin requirement because the settlement value of a Credit Option is analogous to the notional amount of a credit default swap. CBOE's proposed rules incorporate all other relevant aspects of FINRA 4240, such as risk monitoring procedures and guidelines, and concentration charge (net capital) requirements.

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<sup>7</sup> Id.

CBOE's proposed rules would require no margin in the case of a spread (i.e., long and short Credit Options with the same underlying Reference Entity or Entities.) This differs from FINRA Rule 4240, which requires margin of 50% of the margin required on the long or short (credit default swap), whichever is greater. CBOE is proposing no margin because the long and short are required to have the same underlying Reference Entity. Moreover, Credit Options are standardized and are settled through The Options Clearing Corp.

CBOE's proposed rules would also require no margin on a short Credit Default Option that is offset with a short position in a debt security issued by the Reference Entity underlying the option. This language differs from the debt security offset allowed under FINRA Rule 4240. However, applicable margin must still be collected on the short position in a debt security as prescribed pursuant to applicable margin rules. Rule 4240 requires no margin for a long credit default swap contract that is paired with a long position in the underlying debt security. However, CBOE believes this type of offset does not appear to be workable in respect of a Credit Default Option.

The proposal will become effective on a pilot basis to run a parallel track with FINRA Rule 4240. FINRA Rule 4240 operates on an interim pilot basis which is currently scheduled to expire on July 16, 2011.<sup>8</sup> If the Exchange were to propose an extension of the Credit Option Margin Pilot Program or should the Exchange propose to make the Pilot Program permanent, then the Exchange would submit a filing proposing such amendments to the Pilot Program.

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<sup>8</sup> See Securities Exchange Act Release No. 63391 (November 30, 2010), 75 FR 75718 (December 6, 2010) (notice of filing for immediate effectiveness extending FINRA Rule 4240 margin interim pilot program to July 16, 2011).

### III. Discussion and Commission's Findings

After careful consideration, the Commission finds that the proposed rule change, as modified by Amendment No. 1, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.<sup>9</sup> In particular, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,<sup>10</sup> which requires, among other things, that the rules of an exchange be designed to 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. In the Commission's view, because it is consistent with FINRA Rule 4240, the proposed rule change will provide for a more uniform application of margin requirements for similar products.

The Commission further believes that it is appropriate to approve the proposal on a pilot basis to expire on July 16, 2011. In particular, the Commission notes that CBOE's proposed pilot program will parallel FINRA's pilot program. This will allow the Commission and CBOE to monitor the effects of the pilot on the markets and investors and consider appropriate adjustments, as necessary.

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<sup>9</sup> In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>10</sup> 15 U.S.C. 78f(b)(5).

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>11</sup> that the proposed rule change (SR-CBOE-2010-106), as modified by Amendment No. 1, is approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>12</sup>

Elizabeth M. Murphy  
Secretary

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<sup>11</sup> 15 U.S.C. 78s(b)(2).

<sup>12</sup> 17 CFR 200.30-3(a)(12).