

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-53935; File No. SR-CBOE-2003-41)

June 2, 2006

Self-Regulatory Organizations; Chicago Board Options Exchange, Inc.; Notice of Filing of Proposed Rule Change and Amendment Nos. 1, 2, and 3 Thereto to List and Trade Options on Corporate Debt Securities

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² notice is hereby given that on September 22, 2003, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by CBOE. On March 1, 2003, CBOE filed Amendment No. 1 to the proposed rule change.³ CBOE filed Amendment No. 2 to the proposed rule change on August 24, 2005.⁴ CBOE filed Amendment No. 3 to the proposed rule change on May 26, 2006.⁵ The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ In Amendment No. 1, CBOE replaced and superseded the original Exhibit A, which contained its rule text, in its entirety. In addition, CBOE provided explanatory commentary in response to questions raised by Commission staff regarding the proposal including, but not limited to, listing and maintenance standards, strike price intervals, and margins.

⁴ Amendment No. 2 replaced and superseded the Exchange's original Form 19b-4 in its entirety.

⁵ Amendment No. 3 replaced and superseded the Exchange's original Form 19b-4 in its entirety.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

CBOE proposes to introduce for trading a new type of option, called "Corporate Debt Security Options" ("CDSOs"), which would be options based on corporate bonds. The text of the proposed rule change is available on CBOE's Web site (<http://www.cboe.com>), at the principal office of CBOE, and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, CBOE included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. CBOE has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

Over-the-counter ("OTC") transactions in corporate debt securities (*e.g.*, bonds and notes) recently have been become subject to enhanced transparency and now are reported publicly through the NASD's Trade Reporting and Compliance Engine ("TRACE") system. This enhanced transparency and price reporting has given rise to an OTC market in options on corporate debt securities over the past few years. CBOE believes that an exchange-traded alternative may provide a useful risk management and trading vehicle for member firms and their customers.

The Exchange understands that products similar to CDSOs that are proposed in this rule filing are currently traded in the OTC market by hedge funds, proprietary trading firms, and a few very large fixed income funds. These market participants have indicated that there could be room for significant growth in OTC trading of options on corporate debt securities as transparency further improves in the market for the underlying corporate debt securities and if a listed option product were introduced. CBOE expects that users of these OTC products would be among the primary users of exchange-traded CDSOs. CBOE states that its member firms have also indicated to the Exchange that the listing and trading of CDSOs would allow their customers to better manage the risk associated with the volatility of underlying bond positions. Additionally, CBOE notes that persons writing CDSOs would have the corresponding ability to earn option premium income and carefully tailor their own risk exposure. Further, CBOE's members have indicated that these customers desire the enhanced liquidity that an exchange-traded product would bring. CBOE believes that CDSOs listed on the Exchange would have three important advantages over the contracts that are traded in the OTC market. First, as a result of greater standardization of contract terms, exchange-listed contracts should develop more liquidity. Second, counter-party credit risk would be mitigated by the fact that the contracts are issued and guaranteed by The Options Clearing Corporation ("OCC"). Finally, the price discovery and dissemination provided by CBOE and its members would lead to more transparent markets. CBOE believes that the Exchange's ability to offer CDSOs would aid it in competing with the OTC market and at the same time expand the universe of listed products available to interested market participants.

Accordingly, the Exchange proposes to list and trade CDSOs that are designed to offer investors exposure to actively traded OTC corporate bonds that have initial amounts outstanding over \$250 million. The face value of a corporate debt security underlying a CDSO would be \$100,000. Proposed CBOE Rule 28.7 would provide that there would be up to five expiration months, none further out than 15 months, but the Exchange could list additional expiration months further out than 15 months where a reasonable active secondary market exists.

Series with strike prices in, at, and out-of-the-money initially would be listed (up to ten per month initially). The Exchange represents that it would delist CDSO series for which there is no open interest. In addition, the Exchange proposes to limit the strike price intervals that it could list for CDSO series, which, as proposed, would be fixed at a percentage of principal amounts (based on a par quote basis of \$100) as follows:

- 0.5% (\$0.50) or greater, provided that the series to be listed is no more than 5% above or below the current market price of a corporate debt security either reported on TRACE during TRACE system hours or effected through on or through the facilities of a national securities exchange, as applicable, on the day prior to the day the series is first listed for trading;
- 1.0% (\$1.00) or greater, provided that the series to be listed is no more than 10% above or below the current market price of a corporate debt security either reported on TRACE during TRACE system hours or effected on or through the facilities of a national securities exchange, as applicable, on the day prior to the day the series is first listed for trading; and

- 2.5% (\$2.50) or greater, provided that the series to be listed is greater than 10% above or below the current market price of a corporate debt security either reported on TRACE during TRACE system hours or effected on or through facilities of a national securities exchange, as applicable, on the day prior to the day the series is first listed for trading.

The increments proposed herein are designed to allow the Exchange flexibility to list strike increments at appropriate levels, while at the same time would establish reasonable limits on the number of strikes that may be listed in order to diminish any potential effect on the Exchange's quote capacity thresholds. The Exchange affirms that, as structured, it has sufficient systems capacity to support the listing of CDSOs in the strike price increments proposed herein.

According to the Exchange, the option premium would be quoted in points where each point equals \$1,000. The minimum tick would be 0.05 (\$50.00). The expiration date would be the Saturday immediately following the third Friday of the expiration month. CDSOs would be European-style options and could be exercised only on the last day of expiration. Trading in CDSOs ordinarily would cease on the business day (usually a Friday) preceding the expiration date. Trading hours would be 8:30 a.m. to 3:02 p.m. Chicago time.

Prices of CDSOs generally would be based on the prices of corporate debt securities that are reported through TRACE by members of NASD. The TRACE rules require NASD members dealing in corporate debt securities to report transactions in eligible debt securities to TRACE within 15 minutes of execution. NASD currently notifies subscribers regarding general TRACE reporting system outages via the following

electronic communications: (i) http://apps.nasdaq.com/Regulatory_Systems/trace_sub.asp; and (ii) http://www.nasdaqtrader.com/dynamic/newsindex/vendoralerts_2005.stm.

The settlement process for CDSOs would be the same as the settlement process for equity options under CBOE rules, except as necessary to take into account that the securities underlying CDSOs are debt securities.⁶ CDSOs would be physically settled and exercise notices that are properly tendered would result in delivery of the underlying corporate debt securities on the third business day following exercise. Payment of a CDSO's exercise price would be accompanied by payment of accrued interest on the underlying corporate debt security from, but not including, the last interest payment date to, and including, the exercise settlement date, as specified in OCC rules.

CBOE states that issuers generally calculate the accrued interest in one of two methods, each of which is detailed in Appendix A to the contract specifications set forth in Exhibit B. The Exchange would notify OCC of the accrued interest calculation methodology that applies to each corporate debt security prior to the listing thereof. CBOE has proposed to establish tiered position limits based upon a policy to cap position limits at 10% of the total float of the underlying bond. The "total float" of the underlying corporate debt security would exclude amounts held by 10% holders of the corporate debt security. In other words, if a person holds more than 10% of a particular corporate debt security, the amount held by such person would not be included in the "total float" for purposes of determining the applicable position and exercise limits. For example, if a person holds 14% of the total outstanding issuance of a corporate debt security, the

⁶ If the outstanding debt issuance amount of an underlying corporate debt security is insufficient to satisfy the delivery requirements under CBOE Rule 11.3, OCC rules provide for special settlement exercise procedures.

applicable position and exercise limits would only be based on the remaining 86% of the issuance that is not held by such person. The Exchange believes that the 10% threshold amount is a reasonable measure of those market participants, such as pension funds, that have purchased a corporate debt security for long-term investment versus those that have purchased a corporate debt security with a willingness to sell such security in the short-term period and thus increase the amount of liquidity in the particular issue. CBOE also believes this 10% level is sufficient to inhibit market manipulation or to mitigate other possible disruptions in the market. CBOE's proposed lowest position limit for equity options is 13,500 contracts, which, if exercised, would represent approximately 19.28% of the minimum float of an equity security eligible to underlie a CBOE equity option (seven million shares).⁷ Moreover, CBOE's proposed 13,500 equity option contract limit applies to those options having an underlying security that does not meet the requirements for a higher option contract limit. CBOE believes the proposed 10% position limit for CDSOs, which is significantly less than that for equity options, is sufficiently high to account for the differences in liquidity between the equity and debt markets. Therefore, CBOE proposes the following tiers:

Issue Float	Position Limit
\$200,000,000 - \$499,999,000	200 contracts
\$500,000,000 - \$749,999,000	500 contracts
\$750,000,000 - \$999,999,000	750 contracts
\$1,000,000,000 - \$2,499,999,000	1,000 contracts
\$2,500,000,000 and greater	2,500 contracts

⁷ See CBOE Rule 4.11 (Position Limits).

The Exchange is proposing comprehensive initial listing and ongoing maintenance requirements for CDSOs, which are set forth in proposed CBOE Rules 5.3.10 and 5.4.14. In addition to standards such as the required amount of underlying security holders and outstanding float amounts, the Exchange is also proposing as a criterion for listing a particular corporate debt security for options trading that the issuer of the corporate debt security or the issuer's parent, if the issuer is a wholly-owned subsidiary, has at least one class of common or preferred equity securities registered under Section 12(b) of the Act.⁸ This criterion is designed to ensure that there is adequate information publicly available regarding the issuer of a corporate debt security underlying an option traded on the Exchange. The corporate debt security market is largely an OTC market and many corporate debt securities, including those among the most actively traded, are not themselves registered under Section 12 of the Act. The issuers of many unregistered corporate debt securities, however, have equity securities registered under Section 12 of the Act. These issuers are required to provide periodic reports to the public due to the equity registration, and the Exchange believes that the fact that their corporate debt securities are unregistered does not diminish in practical terms the information provided by their periodic reports. Thus, CBOE believes that the proposed requirement would enable a wide array of actively traded corporate debt securities to be eligible for options trading while ensuring sufficient public disclosure of information about any corporate debt securities underlying exchange-traded options.⁹

⁸ 15 U.S.C. 781(b).

⁹ Proposed CBOE Rule 5.3.10 was amended to also include the requirement that the issuer of a corporate debt security has registered the offer and sale of the security under the Securities Act of 1933.

The Exchange is proposing as another listing criterion that the stock of an issuer of a corporate debt security be eligible for options trading under CBOE Rule 5.4. The provisions of CBOE Rule 5.4 would require that an equity security underlying an option be itself widely held and actively traded. The Exchange believes that a requirement that the stock of an issuer of a corporate debt security meet the criterion of CBOE Rule 5.4 would provide additional indicia that such issuer's securities are subject to widespread investor interest. Moreover, the Exchange believes that this requirement would ensure that a corporate debt securities option is not used as a proxy for equity options trading of an issuer whose stock does not meet the criterion of CBOE Rule 5.4.

With respect to credit ratings of corporate debt securities, the initial listing standards would provide that corporate debt securities on which options transactions are listed must have credit ratings issued by Moody's Investors Service ("Moody's") that are Caa¹⁰ or higher and credit ratings issued by Standard & Poor's that are CC¹¹ or higher. The proposed maintenance standards require that the corporate debt securities maintain

¹⁰ Under Moody's rating definitions, "obligations rated Caa are judged to be of poor standing and are subject to very high credit risk." Moody's has two ratings lower than Caa: Ca and C. Moody's defines Ca-rated obligations as "highly speculative and are likely in, or very near, default, with some prospect of recovery of principal and interest." Moody's defines C-rated obligations as "the lowest rated class of bonds and are typically in default, with little prospect for recovery of principal or interest."

¹¹ Under Standard & Poor's rating definitions, "an obligation rated CC is currently highly vulnerable to nonpayment." Standard & Poor's has two ratings lower than CC: C and D. Under Standard & Poor's definitions, C-rated obligations "may be used to cover a situation where a bankruptcy petition has been filed or similar action has been taken, but payments on this obligation are being continued." Under Standard & Poor's definitions, "an obligation rated 'D' is in payment default. The 'D' rating category is used when payments on an obligation are not made on the date due even if the applicable grace period has not expired, unless Standard & Poor's believes that such payments will be made during such grace period. The 'D' rating also will be used upon the filing of a bankruptcy petition or the taking of a similar action if payments on an obligation are jeopardized."

the ratings set forth in the initial listing standards. CBOE believes that these initial and maintenance standards are appropriate because they provide a measure of certainty with respect to the satisfaction of regularly scheduled interest payments on the corporate debt security, which triggers the corresponding requirement to pay the accrued interest under proposed CBOE Rule 28.15. The Exchange also believes that market participants investing in corporate debt securities should have the opportunity to use CDSOs to mitigate risk when the underlying corporate debt security is subject to credit downgrades and potentially price declines.

The proposed margin (both initial and maintenance) for writing uncovered puts or calls would be as follows.¹² An option writer would be required to deposit and maintain 100% of the current market value of the option plus 10% of the aggregate contract value minus the amount by which the option is out-of-the-money, if any, subject to a minimum for calls equal to 100% of the current market value of the option plus 5% of the aggregate contract value for any corporate debt security that is rated investment-grade.¹³ For non-

¹² Pursuant to a telephone conversation between Angelo Evangelou, Assistant General Counsel, and Dennis O'Callahan, Director Research and Product Development, CBOE, and Bonnie Gauch, Special Counsel, Marc McKayle, Special Counsel, and Ronsha Butler, Special Counsel, Division of Market Regulation, Commission, on June 1, 2006, the description contained in this paragraph was conformed to reflect the provisions contained in proposed CBOE Rule 12.3.

¹³ The definition of an investment-grade corporate debt security is set forth in proposed CBOE Rule 12.3(a)(15). The proposed definition mirrors the definition set forth in NASD rules pertaining to TRACE. For purposes of CBOE Rule 12.3, the Exchange would interpret the lowest of the four highest generic rated categories referenced in the proposed definition for "Investment Grade" to be, for example, Baa in the case of Moody's Investors Services and BBB in the case of Standard and Poor's.

investment-grade¹⁴ corporate debt securities, the margin requirement would be 100% of the current market value of the option plus 15% of the aggregate contract value minus the amount by which the option is out-of-the-money, if any, subject to a minimum for calls equal to 100% of the current market value of the option plus 10% of the aggregate contract value. Writers of options on convertible corporate debt securities would be required to deposit and maintain 100% of the current market value of the option plus 20% of the aggregate contract value minus the amount by which the option is out-of-the-money, if any, subject to a minimum for calls equal to 100% of the current market value of the option plus 10% of the aggregate contract value. In the case of puts for each of investment-grade, non-investment-grade, and convertible corporate debt securities, the minimum margin required would be 100% of the current market value of the option plus 5%, 10%, and 10%, respectively of the put exercise price. This methodology incorporates the same formula in CBOE Chapter 12 that the Exchange applies to all other option classes, but with percentages that consider the specific market factors pertaining to debt rating and type of the corporate debt security. For example, the Exchange requires a deposit of 100% of the current market value of the option plus a 20% Initial/Maintenance Margin and a 10% Minimum Margin. This same level would apply to convertible corporate debt securities that are the underlying for options listed under the proposed CBOE Chapter 28 rules. For investment-grade corporate debt securities that underlie

¹⁴ The proposed definition of a non-investment-grade corporate debt security is set forth in proposed CBOE Rule 12.3(a)(16). The proposed definition mirrors the definition set forth in the NASD rules pertaining to TRACE. The Exchange would interpret the lowest of the four highest generic rated categories referenced in the proposed definition for "Non-Investment Grade" to be, for example, Baa in the case of Moody's Investors Services and BBB in the case of Standard and Poor's.

options listed under the proposed CBOE Chapter 28 rules, the Exchange is proposing a 10% Initial/Maintenance Margin and a 5% Minimum Margin because investment grade corporate debt securities generally experience lower price movements and lower volatility levels than stocks. CBOE states that, since non-investment-grade corporate debt securities exhibit price movements that are higher than investment-grade corporate debt securities, it is proposing a 15% Initial/Maintenance Margin and a 5% Minimum Margin for those securities. The Exchange believes that these proposed margin levels also are consistent with the Commission's Net Capital Rule for the underlying corporate debt securities.¹⁵

CBOE believes that the operational capacity used to accommodate the trading of CDSOs on the Exchange would have a negligible effect on the total capacity used by the Exchange to trade its products on a daily basis.

To the extent that features of CDSOs differ from other security options, CBOE would issue a circular to its members before the initiation of trading in CDSOs that would specify the special characteristics of CDSOs. This circular would highlight the exercise methodology of the series, explain the cash adjustment procedures, identify the new symbols for the CDSO series, and identify the initial expiration months and strike prices available for trading. The Exchange notes that these procedures are similar to the procedures used when the Exchange listed both A.M.- and P.M.-settled SPX Index options in 1992.

The Exchange would monitor the media for rating downgrades and other corporate actions to ensure the Exchange's maintenance standards are fulfilled, and

¹⁵ 17 CFR 240.15c3-1.

monitor for any corporate actions that may influence the pricing of corporate debt securities and CDSOs. In addition, the Exchange would work with OCC to revise the Options Disclosure Document to incorporate CDSOs in a manner that is satisfactory to both the Exchange and the Commission.

The Exchange believes that the introduction of CDSOs would increase the variety of listed options to investors and expand the risk management choices for debt securities participants.

2. Statutory Basis

The Exchange believes that its proposal, as amended, is consistent with the requirements of Section 6(b) of the Act,¹⁶ in general, and Section 6(b)(5) of the Act¹⁷ in particular, in that it is designed to promote just and equitable principles of trade as well as to protect investors and the public interest. The Exchange states that the introduction of CDSOs would increase the variety of listed options to investors and expand the risk management choices for debt securities participants.

B. Self-Regulatory Organization's Statement on Burden on Competition

CBOE does not believe that the proposed rule change, as amended, would impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

No written comments were either solicited or received.

¹⁶ 15 U.S.C. 78f(b).

¹⁷ 15 U.S.C. 78f(b)(5).

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which CBOE consents, the Commission will:

- (A) by order approve such proposed rule change, as amended, or
- (B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-CBOE-2003-41 on the subject line.

Paper comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-CBOE-2003-41. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site

<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of the filing also will be available for inspection and copying at the principal office of CBOE. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-CBOE-2003-41 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁸

Nancy M. Morris
Secretary

¹⁸ 17 CFR 200.30-3(a)(12).