

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-55871; File No. SR-CBOE-2006-84)

June 6, 2007

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of Amendment No. 5 to a Proposed Rule Change to List and Trade Credit Default Options; and Order Granting Accelerated Approval of the Proposed Rule Change, as Modified by Amendment Nos. 3, 4, and 5, and Designating Credit Default Options as Standardized Options under Rule 9b-1 of the Securities Exchange Act of 1934

I. Introduction

On October 26, 2006, the Chicago Board Options Exchange, Incorporated (“CBOE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) a proposed rule change, pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² to permit CBOE to list and trade cash-settled, binary call options based on credit events in one or more debt securities of an issuer, referred to as credit default options.

On December 21, 2006, CBOE filed Amendment No. 1 to the proposed rule change; on January 16, 2007, CBOE filed Amendment No. 2 to the proposed rule change; on February 2, 2007, CBOE filed Amendment No. 3 to the proposed rule change;³ and on February 7, 2007, CBOE filed Amendment No. 4 to the proposed rule change. The proposed rule change, as amended, was published for comment in the Federal Register on February 14, 2007.⁴ The Commission received no comments on the proposal. On March 28, 2007, CBOE filed Amendment No. 5 to the proposed rule change (“Amendment No. 5”). This notice and order notices Amendment No. 5; solicits comments from interested persons on Amendment No. 5; approves the proposed rule

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Amendment No. 3 replaced the original filing, as modified by Amendment Nos. 1 and 2, in its entirety.

⁴ See Securities Exchange Act Release No. 55251 (February 7, 2007) (SR-CBOE-2006-84), 72 FR 7091 (“CBOE Proposal”).

change, as amended, on an accelerated basis; and designates credit default options as “standardized options” pursuant to Rule 9b-1 under the Act.⁵

II. Description of the CBOE Proposal

A. Generally

CBOE proposes to list and trade credit default options, which are cash-settled, binary options⁶ that are automatically exercised upon the occurrence of specified credit events or expire worthless. A credit default option would be referenced to the debt securities issued by a specified public company (“Reference Entity”)⁷ and would either have a fixed payout or expire worthless, depending upon whether or not a credit event (as described below) occurs during the life of the option. Upon confirmation of a credit event prior to the last day of trading of a credit default option series,⁸ the options positions existing as of that time would be automatically exercised and the holders of long options positions would receive a fixed cash payment of

⁵ See 17 CFR 240.9b-1. Pursuant to Rule 9b-1(a)(4) under the Act, the Commission may, by order, designate as “standardized options” securities that do not otherwise meet the definition for “standardized options.” Standardized options are defined in Rule 9b-1(a)(4) as: “[O]ptions contracts trading on a national securities exchange, an automated quotations system of a registered securities association, or a foreign securities exchange which relate to options classes the terms of which are limited to specific expiration dates and exercise prices, or such other securities as the Commission may, by order, designate.” 17 CFR 240.9b-1(a)(4).

⁶ A binary option is a style of option having only two possible payoff outcomes: either a fixed amount or nothing at all.

⁷ Proposed CBOE Rule 29.1(f) also includes as a “Reference Entity” the guarantor of the debt security underlying the credit default option.

⁸ Proposed CBOE Rule 29.9 requires that CBOE confirm the occurrence of a credit event through at least two sources, which may include announcements published via newswire services or information service companies, the names of which would be announced to the membership via a CBOE regulatory circular, or information contained in any order, decree, or notice of filing, however described, of or filed with the courts, the Commission, an exchange, an association, the Options Clearing Corporation (“OCC”), or another regulatory agency or similar authority.

\$100,000 per contract.⁹ If no credit event is confirmed during the life of the option, the final settlement price would be \$0.

Credit events that would trigger automatic exercise include a failure to make payment pursuant to the terms of the underlying debt security and any other event of default specified by CBOE at the time the Exchange initially lists a particular class of credit default options. The events of default that CBOE may specify must be defined in accordance with the terms of the debt security underlying the credit default option (“Reference Obligation”) or any other debt security of the Reference Entity (collectively with the Reference Obligation, “Relevant Obligations”).¹⁰

B. Listing Standards

A credit default option must conform to the initial and continued listing standards under proposed CBOE Chapter XXIX. CBOE may list and trade a credit default option that overlies a debt security of a Reference Entity, provided that such issuer or guarantor, or its parent if a wholly owned subsidiary, has at least one class of securities that is registered under the Act and is an “NMS stock”¹¹ as defined in Rule 600 of Regulation NMS under the Act.¹² The registered equity securities issued by the Reference Entity also would have to satisfy the requirements of CBOE Rule 5.4 for continued options trading, which requires, among other things, that an equity

⁹ The settlement amount would be \$100,000 per contract unless adjusted pursuant to proposed CBOE Rule 29.4, as discussed below.

¹⁰ See proposed CBOE Rule 29.1(c).

¹¹ “NMS stock” means any security, or class of securities, other than an option for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transaction in listed options. See 17 CFR 242.600(b)(46) and (47).

¹² See proposed CBOE Rule 5.3.11.

security underlying an option be itself widely held and actively traded.¹³ The requirement that the equity securities of an issuer of a debt security underlying a credit default option meet the criteria of Rule 5.4 is designed to ensure that the issuer's securities enjoy widespread investor interest. The requirement that the Reference Entity be an issuer of a registered NMS stock will help ensure that investors have access to comprehensive public information about the issuer, including the registration statement filed under the Securities Act of 1933 ("Securities Act") and other periodic reports.¹⁴

A credit default option could not be exercised at the discretion of the investor, but instead would have an automatic payout only upon the occurrence of a credit event. The expiration date would be the fourth business day after the last day of trading of the series, which would be the third Friday of the expiration month.¹⁵ A credit default option generally would expire up to 123 months from the time it is listed, and the Exchange usually would open one to four series for each year up to 10.25 years from the current expiration.¹⁶

¹³ CBOE Rule 5.4 provides that, absent exceptional circumstances, an underlying security will not be deemed to meet the Exchange's requirements for continued approval when: (a) there are fewer than 6,300,000 shares of the underlying security held by persons other than those who are required to report their security holdings under Section 16(a) of the Act (15 U.S.C. 78p); (b) there are fewer than 1,600 holders of the underlying security; (c) the trading volume (in all markets in which the underlying security is traded) was less than 1,800,000 shares in the preceding twelve months; (d) the market price per share of the underlying security closed below \$3 on the previous trading day as measured by the closing price reported in the primary market in which the underlying security traded; or (e) the underlying security ceases to be an NMS stock.

¹⁴ Section 13 of the Act, 15 U.S.C. 78m, requires that any issuer of a security registered pursuant to Section 12 of the Act, 15 U.S.C. 78l, would file with the Commission annual reports and information and documents necessary to keep reasonably current the information in its Section 12 registration statement.

¹⁵ If a credit event is confirmed, the expiration date would be the second business day after the confirmation of a credit event. See proposed CBOE Rule 29.1(d) and (e).

¹⁶ See proposed CBOE Rule 29.2(b)(1) and (2).

C. Trading

Credit default options will trade on CBOE’s Hybrid Trading System from 8:30 a.m. to 3:00 p.m. (Central Time)¹⁷ in a manner similar to the trading of equity options. With limited distinctions, as described more fully in the proposal, CBOE’s equity option trading rules will apply to credit default options.¹⁸ Also, credit default options will be eligible for trading as Flexible Exchange Options (“FLEX Options”). A FLEX Option that is a credit default option would be cash-settled and the exercise-by-exception provisions of OCC Rule 805¹⁹ would not apply. Market-makers shall be appointed to credit default options pursuant to CBOE’s existing requirements,²⁰ as supplemented by proposed CBOE Rule 29.17. Additionally, CBOE represents that there will be a maximum of one series per quarterly expiration in a given credit default option class, and that it, and the Options Price Reporting Authority (“OPRA”), have the necessary systems capacity to handle the additional quote volume anticipated to be associated with credit default options.

Once a particular credit default option class has been approved for listing and trading, the Exchange would, from time to time, open for trading a series of that class. If a credit default option initially approved for trading no longer meets the Exchange’s requirements for continued approval, the Exchange would not open for trading any additional series of options and, as provided in CBOE Rule 5.4, could prohibit any opening purchase transactions in such series. The proposed trading rules for credit default options are designed to create an environment that takes into account the small number of transactions likely to occur, while providing price

¹⁷ See proposed CBOE Rule 29.11.

¹⁸ See proposed CBOE Rules 29.11-29.17 and 29.19.

¹⁹ OCC Rule 805 sets forth the expiration date exercise procedures for options cleared and settled by the OCC.

²⁰ See Chapter VIII of CBOE’s Rules.

improvement and the transparency benefits of competitive Exchange floor bidding, as compared to the over-the-counter (“OTC”) market.

Upon the confirmation of a credit event or the redemption of all Relevant Obligations, the applicable credit default option class would cease trading and all outstanding contracts in that class would be subject to automatic exercise. In addition, the CBOE’s trading halt procedures applicable to equity options shall apply to credit default options.²¹ When determining whether to institute a trading halt in credit default options, CBOE floor officials would consider whether current quotations for the Relevant Obligation(s) or other securities of the Reference Entity are unavailable or have become unreliable. The Exchange’s board of directors shall also have the power to impose restrictions on transactions or exercises in one or more series of credit default options as the board, in its judgment, determines advisable in the interests of maintaining a fair and orderly market or otherwise deems advisable in the public interest or for the protection of investors.²²

D. Clearance and Settlement

Because credit default options do not have an exercise price, they do not, by their terms, meet the definition of “standardized options” for purposes of Rule 9b-1 under the Act.²³ However, as discussed herein, the Commission today is using its authority pursuant to Rule 9b-1 to designate credit default options as “standardized options” under Rule 9b-1. Consequently, credit default option transactions would be eligible for clearance and settlement by the OCC in

²¹ See CBOE Rules 6.3 and 6.3B; proposed CBOE Rule 29.13.

²² See proposed CBOE Rule 29.8.

²³ See 17 CFR 240.9b-1.

accordance with procedures that are substantially similar to existing systems and procedures for the clearance and settlement of exchange-traded options.²⁴

E. Adjustments

Credit default options will be subject to adjustments in two circumstances.²⁵ First, if the original Reference Entity is succeeded by another entity in accordance with the terms of the underlying debt security, the related credit default options would be replaced by one or more credit default options derived from the debt securities of the successor entity or entities. To the extent necessary and appropriate for the protection of investors and the public interest, all other terms and conditions of the successor options would be the same as the original credit default options.

Second, if the specific debt security (the Reference Obligation) is redeemed during the life of the credit default option, another debt security of the Reference Entity would be specified as the new Reference Obligation. In the event that all debt securities of the Reference Entity (*i.e.*, all Relevant Obligations) are redeemed during the life of the credit default option, the option would cease trading and, assuming that CBOE has not confirmed a credit event, the contract payout would be \$0.

²⁴ On February 13, 2007, the OCC filed with the Commission pursuant to Section 19(b)(1) of the Act, 15 U.S.C. 78s(b)(1), and Rule 19b-4 thereunder, 17 CFR 240.19b-4, a proposed rule change to enable it to clear and settle credit default options proposed to be listed by CBOE. The proposed rule change was published for comment in the Federal Register on February 27, 2007. Securities Exchange Act Release No. 55362, 72 FR 9826 (March 5, 2007). On March 7, 2007, the OCC filed Amendment No. 1 to the proposed rule change. See SR-OCC-2007-01 (as amended, the “OCC Proposal”). The Commission has not yet taken action on the OCC proposal.

²⁵ See CBOE Proposed Rule 29.4.

F. Position Limits

Pursuant to proposed CBOE Rule 29.5, credit default options will be subject to a position limit equal to 5,000 contracts on the same side of the market. Credit default options shall not be aggregated with option contracts on the same underlying security and will not be subject to the hedge exemption to CBOE's standard position limits. Instead, the following hedge exemption strategies and positions shall be exempt from CBOE's position limits: (i) a credit default option position "hedged" or "covered" by an appropriate amount of cash to meet the cash settlement amount obligation (e.g., \$100,000 for a credit default option with an exercise settlement value of \$100 multiplied by a contract multiplier of 1,000); and (ii) a credit default option position "hedged" or "covered" by an amount of an underlying debt security(ies) that serves as a Relevant Obligation(s) or other securities, instruments, or interests related to the Reference Entity that is sufficient to meet the cash settlement amount obligation.²⁶ Also, CBOE's market-maker and firm facilitation exemptions to position limits will apply.²⁷

G. Margin

The margin (both initial and maintenance) required for writing short and long positions in credit default options will be as follows:²⁸

- For a qualified customer²⁹ carrying a long position in credit default options, the margin requirement will be 20% of the current market value of the credit default option.

²⁶ See proposed CBOE Rule 29.5.

²⁷ Proposed CBOE Rule 29.5 requires that for purposes of its market-maker hedge exemption (CBOE Rule 4.11.05) the position must be within 20% of the applicable limit before and exemption would be granted. With respect to CBOE's firm facilitation exemption (CBOE Rule 4.11.06), proposed CBOE Rule 29.5 provides that the aggregate exemption position could not exceed three times the standard limit of 5,000 contracts.

²⁸ See proposed CBOE Rule 12.3(l); Amendment No. 5.

- For a non-qualified customer carrying a long position in a credit default option, the margin requirement will be 100% of the current market value of the credit default option.
- For a non-qualified customer carrying a short position in a credit default option, the margin requirement will be the cash settlement amount, i.e., \$100,000 per contract.
- For a qualified customer carrying a short position in a credit default option, the margin requirement will be the lesser of the current market value plus 20% of the cash settlement amount or the cash settlement amount.

These requirements may be satisfied by a deposit of cash or marginable securities. These requirements may not be satisfied by presentation to the member organization carrying the customer's account of a letter of credit meeting the requirements of proposed CBOE Rule

12.3(l)(1)(iii).³⁰

A credit default option carried short in a customer's account will be deemed a covered position, and eligible for the cash account, provided any one of the following is either held in the account at the time the option is written or is received into the account promptly thereafter: (i) cash or cash equivalents equal to 100% of the cash settlement amount or (ii) an escrow agreement. The Exchange believes that these requirements strike the appropriate balance and adequately address concerns that a member or its customer may try to maintain an inordinately large unhedged position in credit default options. In addition, in Amendment No. 5, the

²⁹ Proposed CBOE Rule 12.3(l)(1)(i) defines "qualified customer" as a person or entity that owns and invests on a discretionary basis no less than \$5,000,000 in investments.

³⁰ In Amendment No. 5, CBOE deletes from proposed rule 12.3(l)(1)(iii) the option of using a letter of credit to satisfy margin requirements applicable to credit default options and makes non-substantive corrections to the formatting of proposed CBOE Rule 12.3(l)(1)(iii) and the "Interpretations and Policies" heading that accompanies CBOE Rule 12.3.

Exchange notes that, in accordance with CBOE Rule 12.3(a)(3), an escrow agreement must be issued in a form acceptable to the Exchange, and that it has traditionally recognized as acceptable the escrow agreement forms of the OCC and the New York Stock Exchange.

In Amendment No. 5, the Exchange also represents the following:

“As part of its regulatory oversight of member organizations, the Exchange generally reviews member organizations’ compliance with margin requirements applicable to customer accounts. In the future, the Exchange will include [c]redit [d]efault [o]ption margin requirements as part of this review. Additionally, the Exchange will review member organizations’ internal procedures for managing credit risk associated with extending margin to customers trading [c]redit [d]efault [o]ptions. The Exchange also notes that, pursuant to CBOE Rule 12.10, the Exchange may at any time impose higher margin requirements when it deems such higher margin requirements advisable.”

Lastly, in Amendment No. 5, the Exchange makes non-substantive changes to the text of CBOE Rule 12.5, to clarify that a credit default option that is carried for the account of a qualified investor may be deemed to have market value for the purposes of CBOE Rule 12.3(c).

H. Surveillance

The Exchange has represented that it will have in place adequate surveillance procedures to monitor trading in credit default options prior to listing and trading such options.

III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 5, including whether Amendment No. 5 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-2006-84 on the subject line.

Paper comments:

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

All submissions should refer to Amendment No. 5 to File Number SR-CBOE-2006-84. 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 such filing also will be available for inspection and copying at the principal office of the Exchange. 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 Amendment No. 5 of File Number SR-CBOE-2006-84 and should be submitted on or before [insert date 21 days from publication in the [Federal Register](#)].

IV. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.³¹ In particular, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,³² which requires, among other things, that the rules of an exchange be designed to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; to foster cooperation and coordination with persons engaged in regulating, clearing, processing information with respect to, and facilitating transactions in securities; to remove impediments to and perfect the mechanism of a free and open market and a national market system; and, in general to protect investors and the public interest. The CBOE's proposal, by enabling CBOE to offer a security that will be listed and traded on the Exchange, as opposed to the OTC market, would extend to investors the benefits of a listed exchange market, which include: a centralized market center; an auction market with posted, transparent market quotations and transaction reporting; standardized contract specifications; and the guarantee of the OCC.

As a threshold matter, the Commission finds that the credit default options proposed by CBOE are securities. Section 3(a)(10) of the Act³³ defines security to include, in part, "any put, call, straddle, option or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof)." After careful analysis, the

³¹ In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

³² 15 U.S.C. 78f(b)(5).

³³ 15 U.S.C. 78c(a)(10).

Commission finds that credit default options are options³⁴ based on the value of a security or securities and, therefore, securities under Section 3(a)(10) of the Act;³⁵ in addition, the Commission finds that credit default options are options on an interest in, or based on the value of an interest in, a security or securities and, therefore, are securities under Section 3(a)(10) of the Act.³⁶

The Commission interprets “based on the value [of a security or securities]” in Section 3(a)(10) of the Act³⁷ to include options whose pricing in the secondary market moves in relation to the value of the underlying security or securities of the option in question. Thus the fact that the payout of a cash-settled option will not increase or decrease based on the price movement of the underlying security of that option is not dispositive.³⁸

³⁴ Although credit default options do not share every feature of a classic option, the Commission nonetheless finds that credit default options are option contracts. In particular, the Commission notes that the buyer of a credit default option pays to the seller a nonrefundable premium, has rights but no further obligations under the contract, and has no further risk exposure because the seller bears all the risk of the credit event occurring. See United States v. Bein, 728 F.2d 107, 112 (2d Cir. 1984) (highlighting characteristics that distinguish options from futures contracts).

³⁵ 15 U.S.C. 78c(a)(10).

³⁶ 15 U.S.C. 78c(a)(10). In determining whether a derivative is a security, the Commission and the courts have looked to the economic reality of the product. See Caiola v. Citibank, N.A., New York, 295 F.3d 312, 325 (2d Cir. 2002), quoting United Housing Foundation v. Foreman, 421 U.S. 837, 848 (1975) (“In searching for the meaning and scope of the word ‘security’ . . . the emphasis should be on economic reality”). Construing the definition of a security in this manner permits the Commission and the courts “sufficient flexibility to ensure that those who market investments are not able to escape the coverage of the Securities Acts by creating new instruments that would not be covered by a more determinate definition.” Reves v. Ernst & Young, 494 U.S. 56, 63 n.2 (1990).

³⁷ Id.

³⁸ In addressing whether a “digital option” or a “binary option” with a fixed payout is an option based on the value of a security or securities, the court in Stechler v. Sidley, Austin Brown & Wood, L.L.P., 382 F.Supp.2d 580, 596-97 (S.D.N.Y. 2005), held that the issue ultimately turned on questions of fact and declined to decide the issue on a motion to dismiss. However, the court’s analysis made clear that the existence of a fixed payout that is not tied in a proportionate manner to the price of an underlying security is not a determining factor in deciding whether an instrument is an option on a security.

Because credit default options are not currently traded, there is no empirical data regarding their pricing in the secondary market. However, credit default options are essentially exchange-traded equivalents of single-name, OTC credit default swaps.³⁹ A single-name credit default swap is an agreement between a protection buyer and a protection seller whereby the buyer pays a periodic fee in return for a contingent payment by the seller upon the occurrence of a credit event with respect to one or more reference obligations of a reference entity. Credit events typically include one or more of the following: (1) bankruptcy, (2) obligation acceleration, (3) obligation default, (4) a failure to pay, (5) repudiation or moratorium, or (6) restructuring. Similarly, as explained above, each credit default option shall specify (a) the Reference Entity, (b) the specific debt security or securities that serve as its Reference Obligation or other Relevant Obligations, and

Rather, the court accepted that, in evaluating the economic reality of an instrument, it is appropriate to consider whether the resale value of the instrument moves in relation to the movement of an underlying reference.

³⁹ Despite the similarities between credit default options and OTC credit default swaps, the Commission wishes to make two things clear. First, because credit default options will be exchange-traded and not individually negotiated (and not necessarily between eligible contract participants), they are not qualifying swap agreements under Section 206A of the Gramm-Leach-Bliley Act (“GLBA”), 15 U.S.C. 78c note, and, therefore, not excluded from the definition of security by Section 3A of the Act, 15 U.S.C. 78c-1. Second, certain OTC credit default swaps are not securities. The finding that credit default options are securities because they are options based on the value of a security might suggest that OTC credit default swaps are also options based on the value of a security or securities and, therefore, excluded from the definition of swap agreement because Section 206A(b)(1) of the GLBA, 15 U.S.C. 78c note, excludes from the definition of swap agreement “any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities, including any interest therein or based on the value thereof.” However, Congress specifically enumerated “credit default swaps” (without defining the term) as one example of a qualifying swap agreement. See Section 206A(a)(3) of the GLBA, 15 U.S.C. 78c note. The Commission views the specific enumeration of “credit default swaps” as reflecting the intention of Congress to exclude certain OTC credit default swaps from the definition of security pursuant to Sections 206B & C of the GLBA, 15 U.S.C. 78c note. Credit default swaps that involve terms similar to credit default options, but that are otherwise excluded from the definition of security because they are qualifying swap agreements, remain subject to the Commission’s antifraud jurisdiction (including authority over insider trading) as “security-based swap agreements” under Section 206B of the GLBA, 15 U.S.C. 78c note.

(c) the applicable events of default that trigger payout (as determined in accordance with the terms of the Reference Obligation or other Relevant Obligations), which could include such events as a failure to pay, obligation acceleration or default, and restructuring. Hence, credit default options have essentially the same structure as credit default swaps.

In the case of a credit default swap, the amount the buyer pays for protection is based on a quoted spread expressed in basis points on a notional amount specified in the swap agreement. This quoted spread is often referred to as a “CDS spread” and is principally based on the probability that the Reference Entity will default (*i.e.*, its creditworthiness). More specifically, the CDS spread represents the price required by a swap counterparty to compensate it for the credit risk associated with the potential default on a particular reference obligation or obligations of an issuer. Similarly, the value of a debt security is a function of the issuer’s creditworthiness, which is expressed in terms of a “yield spread” (sometimes called “credit spread”). The yield (or credit) spread is the difference between the yield on the debt instrument and the yield on a debt security of similar maturity whose yield represents pure interest rate risk, such as U.S. Treasuries,⁴⁰ and represents the additional yield required by an investor to compensate it for the credit risk associated with the potential default on the particular debt instrument of an issuer.⁴¹ As a consequence of this relationship between debt securities and credit default swaps, the credit default swap market enables more wide-spread trading in an issuer’s creditworthiness than was previously possible.

⁴⁰ Some academics have hypothesized that there may be some deviation between the yield on U.S. Treasuries and pure interest rate risk because bond interest is subject to state tax but U.S. Treasuries are not. See, e.g., Haibin Zhu, An Empirical Comparison of Credit Spreads between the Bond Market and the Credit Default Swap Market, BIS Working Papers No. 160 (August 2004) (also noting that transparency and the widespread use of U.S. Treasuries as collateral could explain apparent deviations).

⁴¹ While the terms of both corporate securities and credit default swaps are established when parties enter into the respective contracts, the fair market value of these contracts can vary over the life of the contracts in response to changing perceptions of the creditworthiness of an issuer.

There is a close empirical correlation between the price of a credit default swap (as expressed in the CDS spread) and the yield (or credit) spread of the specific reference obligation or obligations of that credit default swap.⁴² This correlation is to be expected because the valuation of credit default swaps and debt securities are each based on credit risk, and because of the potential for arbitrage between the secondary bond market and the credit default swap market.⁴³ Similarly, because credit default options are exchange-traded equivalents of credit default swaps, the Commission expects that there will be a close empirical correlation between the pricing of a specific credit default option during the life of the contract and the yield spread of the Reference Obligation or other Relevant Obligations of that credit default option.

We further note, more generally, that credit default options expressly reference in their payout conditions a term of an underlying security that is material to the value of that security. A credit default option will pay out if there is a failure to pay or other default event under the terms of the underlying debt security.

For these reasons, credit default options are options “based on the value [of a security or securities]” and, therefore, securities.

In addition, the Commission has determined that credit default options are options on an “interest in,” or based on the value of an interest in, a security or securities within the meaning of Section 3(a)(10) of the Act.⁴⁴ A security is a collection of rights (and obligations) running between the issuer and the holder of the security. The concept of an “interest in” a security

⁴² See, e.g., Roberto Blanco, Simon Brennan, and Ian W. Marsh, An Empirical Analysis of the Dynamic Relation between Investment-Grade Bonds and Credit Default Swaps, The Journal of Economics, Volume LX, No. 5 (Oct. 2005) (finding credit default swap spreads to be quite close to bond yield spreads).

⁴³ See Zhu, An Empirical Comparison of Credit Spreads between the Bond Market and the Credit Default Swap Market, supra note 40.

⁴⁴ 15 U.S.C. 78c(a)(10).

plainly includes rights generating a pecuniary interest in a security, such as the right to a dividend payment or bond (coupon) payment. One relevant “interest in” a debt security underlying a credit default option is the right to receive (coupon) payments under the terms of that debt security. When a (coupon) payment is not made, impairing the value of that interest, the protection seller must make a payment to the protection buyer. Similarly, a specified default event may trigger other rights of a holder of the debt security. The default events that trigger exercise and payment under the credit default option are meaningful only because they are material terms of a security, essential to the debt holder’s rights and interests in that security.⁴⁵ The credit default option payout is contingent on these security-dependent events. For these reasons, credit default options are options on an interest in, or based on the value of an interest in, a security or securities.⁴⁶

Moreover, the economic reality of credit default options supports the conclusion that credit default options are securities. Taking a short position (*i.e.*, taking on the role of a protection seller) via credit default options would be akin to purchasing the corporate bond that is the Reference Obligation or other Relevant Obligations of that credit default option with the interest rate risk fully hedged. Both give the investor the same risk exposure to creditworthiness of an issuer. Indeed, credit default options may even more closely reflect the financial condition of an SEC-registered

⁴⁵ Although certain default events trigger the exercise and payment of a credit default option, it would not be accurate to describe these options as options on “an event”. There is no event delivered upon exercise of the option, rather a payment is delivered. The crucial question is what causes the option to be in-the-money and pay out. In the case of credit default options, it is an event that is created by a security.

⁴⁶ It is important to note that merely because the option does not transfer ownership of the interest or right in a security – but instead becomes in-the-money and provides a cash payment if certain security rights are triggered – does not mean the option is not on an interest in a security. *Cf. Caiola*, 295 F.3d 312 (2d Cir. 2002) (including within the definition of “security” an option that did not deliver an actual security or interest in a security, but merely a cash payment).

issuer because, unlike corporate bonds, which reflect both an issuer's creditworthiness and general interest rate risk, credit default options would only reflect an issuer's creditworthiness. That ability to isolate and transfer credit risk, backed by the guarantee of a central counterparty and the transparency of an exchange, should provide investors with additional opportunities to gain exposure to the public debt market.

For these reasons, the Commission finds that credit default options are options based on the value of, and options on interests in or based on the value of interests in, a security or securities of the Reference Entity and, therefore, securities under Section 3(a)(10) of the Act.⁴⁷

Further, the Commission believes that the listing rules proposed by CBOE for credit default options are reasonable and consistent with the Act. The Commission notes in particular that a credit default option must be based on a Reference Obligation issued by an entity that issues registered equity securities that are NMS stocks and that meet the Exchange's standards for listing an equity option. These requirements are reasonably designed to facilitate investors' access to information about the Reference Entity that may be necessary to price a credit default option appropriately.

The Commission believes that the proposed position limits and margin rules for credit default options are reasonable and consistent with the Act. The proposed position limit of 5,000 contracts in any credit default option class appears to reasonably balance the promotion of a free and open market for these securities with minimization of incentives for market manipulation and insider trading. The proposed margin rules appear reasonably designed to deter a member or its customer from assuming an imprudent position in credit default options.

In support of this proposal, the Exchange made the following representations:

⁴⁷ 15 U.S.C. 78c(a)(10).

- The Exchange will have in place adequate surveillance procedures to monitor trading in credit default options prior to listing and trading such options, thereby helping to ensure the maintenance of a fair and orderly market for trading in credit default options.
- The Exchange and the OPRA will have the necessary systems capacity to accommodate the additional volume associated with credit default options as proposed.

This approval order is conditioned on CBOE's adherence to these representations.

For the foregoing reasons, the Commission finds that the proposed rule is consistent with the Act.

V. Accelerated Approval

The Commission finds good cause for approving the proposed rule change, as modified by Amendment No. 5, prior to the thirtieth day after publishing notice of Amendment No. 5 in the Federal Register pursuant to Section 19(b)(2) of the Act.⁴⁸ In Amendment No. 5, CBOE: (1) modified the text of the proposed margin requirements applicable to credit default options contained in proposed Rules 12.3 and 12.5; (2) made corresponding changes to the discussion sections of the Form 19b-4 and the Exhibit 1 thereto; and (3) inserted information in the discussion sections of the Form 19b-4 and the Exhibit 1 thereto regarding the form of escrow agreements and the Exchange's supervision of member organizations that extend margin to customers trading Credit Default Options.⁴⁹ The Commission believes that Amendment No. 5

⁴⁸ 15 U.S.C. 78s(b)(2). Pursuant to Section 19(b)(2) of the Act, the Commission may not approve any proposed rule change, or amendment thereto, prior to the thirtieth day after the date of publication of the notice thereof, unless the Commission finds good cause for so doing.

⁴⁹ The changes pursuant to Amendment No. 5 are discussed more fully in Section II.G,

raises no significant regulatory issues. The Commission therefore finds good cause exists to accelerate approval of the proposed change, as modified by Amendment No. 5, pursuant to Section 19(b)(2) of the Act.

VI. Designation of Credit Default Options Pursuant to Rule 9b-1

Rule 9b-1 establishes a disclosure framework for standardized options that are traded on a national securities exchange and cleared through a registered clearing agency. Under this framework, the exchange on which a standardized option is listed and traded must prepare an Options Disclosure Document (“ODD”) that, among other things, identifies the issuer and describes the uses, mechanics, and risks of options trading, in language that can be easily understood by the general investing public. The ODD is treated as a substitute for the traditional prospectus. A broker-dealer must provide a copy of the ODD to each customer at or before approving of the customer’s account for trading any standardized option.⁵⁰ Any amendment to the ODD must be distributed to each customer whose account is approved for trading the options class for which the ODD relates.⁵¹

Under Rule 9b-1, use of the ODD is limited to “standardized options” for which there is an effective registration statement on Form S-20 under the Securities Act or that are exempt from registration.⁵² The Commission specifically reserved in Rule 9b-1 the ability to designate as

supra.

⁵⁰ See 17 CFR 240.9b-1(d)(1).

⁵¹ See 17 CFR 240.9b-1(d)(2).

⁵² See 17 CFR 240.9b-1(b)(1) and (c)(8). See also 17 CFR 230.238. Rule 238 under the Securities Act provides an exemption from the Securities Act for any standardized option, as defined by Rule 9b-1(a)(4) under the Act, with limited exceptions. Rule 238 does not exempt standardized options from the antifraud provisions of Section 17 of the Securities Act, 15 U.S.C. 77q. Also, offers and sales of standardized options by or on behalf of the issuer of the underlying security or securities, an affiliate of the issuer, or an underwriter, will constitute an offer or sale of the underlying security or securities as

standardized options other securities “that the Commission believes should be included within the options disclosure framework.”⁵³

The Commission hereby designates credit default options, as defined in the OCC Proposal,⁵⁴ as standardized options for purposes of Rule 9b-1 under the Act. Credit default options do not meet the definition of “standardized options,” because they do not have an exercise price. However, they resemble standardized options in other significant respects. Credit default options have an underlying security and an expiration date. Like other standardized options, credit default options have standardized terms relating to exercise procedures, contract adjustments, time of issuance, effect of closing transactions, restrictions, and other matters pertaining to the rights and obligations of holders and writers. Further, credit default options are designed to provide market participants with the ability to hedge their exposure to an underlying security. The fact that credit default options lack a specified exercise

defined in Section 2(a)(3) of the Securities Act, 15 U.S.C. 77b(a)(3). See also Securities Act Release No. 8171 (December 23, 2002), 68 FR 188 (January 2, 2003) (Exemption for Standardized Options From Provisions of the Securities Act of 1933 and From Registration Requirements of the Exchange Act of 1934).

⁵³ See Securities Exchange Act Release No. 19055 and Securities Act Release No. 6426 (September 16, 1982), 47 FR 41950, 41954 (September 23, 1982).

⁵⁴ For purposes of its proposal, OCC would define the term “credit default option” as an option that is automatically exercised upon receipt by the OCC of a credit event confirmation with respect to the reference obligation(s) of a reference entity. Credit default options have only two possible payoff outcomes: either a fixed automatic exercise settlement amount or nothing at all. See proposed Section 1.C.(2) of Article XIV of the OCC By-Laws.

“Credit event” would be as defined in the rules of the exchange on which the credit default options are listed, with respect to a reference obligation for such option. See proposed Section 1.C.(3) of Article XIV of the OCC By-Laws.

“Reference entity” would mean the issuer or guarantor of the reference obligation(s). See proposed Section 1.R.(1) of Article XIV of the OCC By-Laws.

“Reference obligations” would mean one or more debt securities the terms of which define a credit event for a class of credit default options, as provided in the rules of the listing exchange. See id.

price does not detract from this option-like benefit. The Commission believes that the fact that the OCC, the clearing agency for all standardized options, is willing to serve as issuer of credit default options supports the view that adding credit default options to the standardized option disclosure framework is reasonable.

Therefore, the Commission hereby designates credit default options, such as those proposed by CBOE, as standardized options for purposes of Rule 9b-1 under the Act.

VII. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,⁵⁵ that the proposed rule change (SR-CBOE-2006-84) as modified by Amendment Nos. 3, 4, and 5, be, and hereby is approved on an accelerated basis.

IT IS FURTHER ORDERED, pursuant to Rule 9b-1(a)(4) under the Act, the credit default options, as defined in proposed rule change (SR-OCC-2007-01) are designated as standardized options.

By the Commission.

Florence E. Harmon
Deputy Secretary

⁵⁵ 15 U.S.C. 78s(b)(2).