

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-55872; File No. SR-OCC-2007-01)

June 6, 2007

Self-Regulatory Organizations; The Options Clearing Corporation; Order Granting Approval of a Proposed Rule Change Relating to Credit Default Options

I. Introduction

On February 13, 2007, The Options Clearing Corporation (“OCC”) filed with the Securities and Exchange Commission (“Commission”) proposed rule change File No. SR-OCC-2007-01 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”).¹ On March 7, 2007, OCC filed an amendment to the proposed rule change.² Notice of the proposal was published in the Federal Register on March 5, 2007.³ No comment letters were received. This order approves the proposed rule change as amended.

II. Description

The purpose of the proposed rule change is to permit OCC to clear and settle credit default options (“CDOs”), which are options related to the creditworthiness of an issuer or guarantor (“reference entity”) of one or more specified debt securities (“reference obligation(s)”). CDOs are “binary” options that pay a fixed amount to the holder of the option

¹ 15 U.S.C. 78s(b)(1).

² The March 7, 2007, amendment reflects OCC’s determination to seek approval for the credit default option product only and not for binary options in general. Because Amendment No. 1 is technical in nature, the Commission is not republishing the notice of filing for public comment.

³ Securities Exchange Act Release No. 55362 (February 27, 2007), 72 FR 9826.

upon the occurrence of a “credit event” affecting the reference obligations.⁴ CDOs will be traded by the Chicago Board Options Exchange (“CBOE”).⁵

Description of Credit Default Options.

CDOs are structured as binary options that are automatically exercised and the exercise settlement amount payable if a “credit event” occurs at any time prior to the last day of trading. A “credit event” is generally defined as any failure to pay on any of the reference obligations or any other occurrence that would constitute an “event of default” or “restructuring” under the terms of any of the reference obligations and that the listing exchange has determined would be a credit event for purposes of the CDO. The payout or settlement amount for a single exercised option CBOE CDO will be \$100,000.

By-Law and Rule Amendments Applicable to CDOs.

In order to accommodate trading in CDOs, OCC is adding a new By-Law Article and a new Chapter to its Rules to incorporate several new defined terms and procedures for clearing and settling CDOs.

1. Terminology—Article I, Section 1 and Article XIV, Section 1 of the By-Laws

The definition of “expiration time” in Article I of the By-Laws is modified to be a default provision to permit the expiration time to be defined differently for different classes of options. The definition of “option contract” in Article I of the By-Laws is amended to include a credit default option and to provide a more generic definition of “cash-settled option.”

⁴ “Binary” options (also sometimes referred to as “digital” options) are “all-or-nothing” options that pay a fixed amount if automatically exercised and otherwise pay nothing.

⁵ Securities Exchange Act Release Nos. 55251 (February 7, 2007), 72 FR 7091 (February 14, 2007) (notice of filing of proposed rule change); 55871 (June 6, 2007) (order approving proposed rule change) [File No. SR-CBOE-2006-84].

“Adjustment event” is defined in Article XIV by reference to the rules of the listing exchange. Similarly, “credit event” is defined by reference to exchange rules. The terms “credit event confirmation” and “credit event confirmation deadline” are used, respectively, to refer to the notice that must be provided by the listing exchange or other reporting authority to OCC that a credit event has occurred (and that a CDO will therefore automatically be exercised) and to the deadline for receipt of such notice if it is to be treated as having been received on the business day on which it is submitted. Credit event confirmations received after the deadline on the expiration date but before the expiration time will be given effect but may result in delayed exercise settlement.

OCC is also defining the term “exercise settlement amount” in Article XIV for purposes of credit default options. The exercise settlement amount of a credit default option is the amount specified by the exchange on which the option is traded that will be paid in settlement of an automatically exercised option. CBOE has specified the exercise settlement amount for a single CDO as \$100,000. OCC’s proposed definition would permit an exchange to specify a different exercise settlement amount. The exercise settlement amount will be determined by the exchange at the time of listing when the exchange fixes the other variable terms for the options of a particular class or series.

OCC is replacing the definitions of “variable terms,” “premium,” and “multiplier” in Article I with revised definitions in Article XIV, Section 1 that are applicable to credit default options. The term “class” is also redefined in Article XIV, Section 1. To be within the same class, CDOs must have the same reporting authority, which OCC anticipates will ordinarily be the listing exchange. This is necessary because of the degree of discretion that the reporting authority will have in determining whether a credit event has occurred.

CDOs will be a category of options where exercise is triggered by a discrete event such as a “credit event” affecting the “reference obligations” issued by a “reference entity,” which terms are defined to have the meanings given to them in the rules of the listing exchange. The term “underlying interest” is defined to be the reference obligation(s) with respect to which the credit event will or will not occur.

2. Terms of Cleared Contracts—Article VI, Section 10(e)

A new paragraph (e) is added to Article VI, Section 10 so that an exchange is required to designate the exercise settlement amount, expiration date, and exercise price for a series of credit default options at the time the series is opened for trading. Section 10(e) also reminds the reader that credit default options are subject to adjustment under Article XIV.

3. Rights and Obligations—Article XIV, Section 2

Article XIV, Section 2 defines the general rights and obligations of holders and writers of credit default options. As noted above, the holder of a credit default option that is automatically exercised has the right to receive the fixed exercise settlement amount from OCC, and the assigned writer has the obligation to pay that amount to OCC.

4. Adjustments of Credit Default Options—Article XIV, Section 3; Determination of Occurrence of Credit Event—Article XIV, Section 4

Article XIV, Section 3 provides for adjustment of CDOs in accordance with the rules of the listing exchange. CBOE’s rules provide for adjustment of CDOs in the case of certain corporate events affecting the reference obligations, and OCC proposes simply to defer to the rules and to the determinations of the listing exchange pursuant to its rules. Accordingly, OCC will have no responsibility for adjustment determinations with respect to CDOs.

Similarly, Section 4 provides that the listing exchange for a class of CDOs will have responsibility for determining the occurrence of a credit event that will result in automatic exercise of the options of that class. The listing exchange has the obligation to provide a credit event confirmation to OCC in order to trigger the automatic exercise.

5. Exercise and Settlement—Chapter XV of the Rules and Rule 801

Credit default options will not be subject to the exercise-by-exception procedures applicable to most other options under OCC's Rules but would instead be automatically exercised at expiration if the specified criterion for exercise is met. The procedures for the automatic exercise of credit default options, as well as their assignment and settlement (including during periods when a clearing member is suspended), are set forth in Rules 1501 through 1505 of new Chapter XV and in revised Rule 801(b).

6. Special Margin Requirements—Rule 601; Deposits in Lieu of Margin—Rule 1506

OCC will not initially margin CDOs through its usual "STANS" system. Because of CDOs' fixed payout feature, further systems development is needed to accommodate these options in STANS. Until such development is completed, OCC has initially determined to require that writers of such options post margin in a fixed amount that will be set at 100% of the fixed exercise settlement amount applicable to each series of CDOs. OCC would have discretion to reduce the requirement to something less than 100% if research, analysis, and experience suggest that a lower percentage is sufficient. Initially, long positions in CDOs will be valued at zero and will provide no offset against margin requirements on shorts. Again, based on research, analysis, and experience, OCC may determine to give some value to the longs. Ultimately,

CDOs will be incorporated into the STANS system and will be valued and margined on a risk basis.

OCC does not propose to accept escrow deposits in lieu of clearing margin for credit default options. Therefore, Rule 1506 states that Rule 610, which otherwise would permit such deposits, does not apply to credit default options.

7. Acceleration of Expiration Date—Rule 1507

This provision permits OCC to accelerate the expiration date of a credit default option when the option is deemed to have been exercised on any day prior to the expiration date.

III. Discussion

Section 17A(b)(3)(F) of the Act requires that the rules of a clearing agency be designed to promote the prompt and accurate clearance and settlement of securities transactions.⁶ The Commission finds the proposed rule change to be consistent with Section 17A(b)(3)(F) of the Act because it is designed to promote the prompt and accurate clearance and settlement of transactions in, including exercises of, credit default options and to remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of such transactions.⁷ These purposes are accomplished by having the clearance and settlement of CDOs take place at OCC and by OCC applying substantially the same rules and procedures to CDOs as it applies to similar transactions in other cash-settled options.

⁶ 15 U.S.C. 78q-1(b)(3)(F).

⁷ In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

IV. Conclusion

On the basis of the foregoing, the Commission finds that the proposed rule change is consistent with the requirements of the Act and in particular Section 17A of the Act and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (File No. SR-OCC-2007-01) as modified by Amendment No. 1 be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.⁸

Florence E. Harmon
Deputy Secretary

⁸ 17 CFR 200.30-3(a)(12).