

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-56288; File No. SR-OCC-2007-06)

August 20, 2007

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

I. Introduction

On April 20, 2007, The Options Clearing Corporation (“OCC”) 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 on June 16, 2007, amended the proposed rule change. Notice of the proposal was published in the Federal Register on June 27, 2007 for a 15-day comment period.² No comment letters were received. This order approves the proposed rule change.

II. Description

The purpose of the proposed rule change is to permit OCC to clear and settle credit default basket options (“CDBOs”), which are options related to the creditworthiness of an issuer or guarantor (“reference entity”) of one or more specified debt securities (“reference obligations”). CDBOs are proposed to be traded by the Chicago Board Options Exchange (“CBOE”).³ Characteristics of CDBOs are described below, followed by an explanation of the specific rule changes being implemented by OCC in order that it may clear and settle them.

¹ 15 U.S.C. 78s(b)(1).

² Securities Exchange Act Release No. 55939 (June 21, 2007), 72 FR 35291.

³ Securities Exchange Act Release Nos. 55938 (June 21, 2007), 72 FR 35523 (June 28, 2007) (notice of filing of proposed rule change); 56275 (August 17, 2007) (order approving proposed rule change) [File No. SR-CBOE-2007-26].

Description of Credit Default Basket Options.

CDBOs are structured as binary options with an automatic exercise feature.⁴ They are very similar to Credit Default Options (“CDOs”) that were recently approved for trading by CBOE and for clearing by OCC except that CDBOs are based upon multiple reference entities instead of a single reference entity.⁵ A CDBO will be automatically exercised and an exercise settlement amount will be payable if a “credit event” occurs with respect to any one of the reference entities at any time prior to the last day of trading. As in the case of a CDO, a “credit event” is generally defined as any failure to pay on any of the reference obligations or any other occurrence that constitutes an “event of default” or a “restructuring” under the terms of any of the reference obligations of a particular reference entity and that the listing exchange has determined is a credit event for purposes of the CDBO.

CDBOs may be thought of as a bundle of CDOs in that there is a fixed exercise settlement amount that is determined for each of the reference entities included in the basket of reference entities underlying the CDBO. The exercise settlement amount may be the same for all of the reference entities or it may be different for each one.

CDBOs come in two types: multiple payout CDBOs and single payout CDBOs. A multiple payout CDBO is automatically exercised each time there is a credit event affecting any one of the reference entities. Once the CDBO has been exercised with respect to that reference entity such reference entity is removed from the basket. In the unlikely event that a CDBO is exercised with respect to all of the reference entities in the basket, the expiration of the CDBO

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 No. 55871 (June 6, 2007), 72 FR 32372 (June 12, 2007) [File No. SR-CBOE-2006-84]. See also Securities Exchange Act Release No. 55872 (June 6, 2007), 72 FR 32693 (June 13, 2007) [File No. SR-OCC-2007-01].

would be accelerated. A single payout CDBO, on the other hand, is automatically exercised only the first time that a credit event is confirmed with respect to any one of the reference entities. A single payout CDBO cannot be exercised again with respect to any other reference entity, and its expiration date would be accelerated. With either a multiple payout CDBO or a single payout CDBO, the exercise settlement amount will be the exercise settlement amount that is assigned by the listing exchange to the reference entity affected by the credit event.

By-Law and Rule Amendments Applicable to CDOs.

In order to accommodate trading in CDBOs, OCC is amending the By-Law Article and Rule Chapter that it adopted for the clearance and settlement of CDOs.

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

The definition of “option contract” in Article I of the By-Laws is amended to include CDBOs. “Adjustment event” and “credit event” are defined in Article XIV by reference to the rules of the listing exchange. 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 CDBO 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 credit event confirmation 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 CDBOs. The exercise settlement amount of a CDBO is the amount specified by the listing exchange that will be paid in settlement when a CDBO is automatically exercised as a result of a credit event affecting a particular reference entity. The exercise settlement amount for each

reference entity 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 of the By-Laws with revised definitions in Article XIV, Section 1 that are applicable to CDBOs. The term “class” is also redefined in Article XIV, Section 1. To be within the same class, CDBOs 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.

Other terms that were created or amended for CDOs will be modified to apply to CDBOs as well.

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 and expiration date for a series of CDBOs at the time the series is opened for trading. Section 10(e) also reminds the reader that CDBOs are subject to adjustment under Article XIV.

3. Rights and Obligations—Article XIV, Section 2

Article XIV, Section 2A defines the general rights and obligations of holders and writers of CDBOs. As noted above, the holder of a CDBO 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 Basket Options—Article XIV, Section 3;
Determination of Occurrence of Credit Event—Article XIV, Section 4

Article XIV, Section 3 provides for adjustment of CDBOs in accordance with the rules of the listing exchange. CBOE's rules provide for adjustment of CDBOs 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, as in the case of CDOs, OCC will have no responsibility for adjustment determinations with respect to CDBOs.

Similarly, Section 4 provides that the listing exchange for a class of CDBOs will have responsibility for determining the occurrence of a credit event that will result in the automatic exercise of the CDBOs of that class with respect to a particular reference entity. 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

CDBOs will not be subject to the exercise-by-exception procedures applicable to most other options under OCC's Rules but instead will be automatically exercised prior to or at expiration if the specified criterion for exercise is met. The procedures for the automatic exercise of CDBOs, 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

As in the case of CDOs, OCC will not initially margin CDBOs through its “STANS” system in the same way that other options are margined. Because of the fixed payout feature of CDOs and CDBOs, further systems development is needed to accommodate these options in STANS on a portfolio basis. Until such development is completed, elements of STANS will be used to determine the expected liquidating value of each class of CDBOs and CDOs by extracting certain information regarding the default probability from the listed equity options on the common stock of the reference entity and the market price of the CDBOs and CDOs. Expected liquidating values can then be derived from simulated price movements in the stock over a range of values. Thus, general principles of STANS will be applied, but each class of CDBOs and CDOs will be treated as a separate portfolio and will not be included within the entire portfolio of a particular account. An exception to this will be in the case where a firm has a net long position in CDBO or CDO contracts that is not required to be segregated and the risk computed under this methodology is less than 100% of the premium value of the net long position. In such a situation, the excess long value will be used to cover requirements associated with other cleared contracts. This margin methodology will result in a more conservative risk estimate than if the contracts were fully integrated in STANS since offsets in the risk calculation between these products and others will not be recognized except to the extent of any excess long value. Ultimately, CDBOs 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 CDBOs. Therefore, Rule 1506 states that Rule 610, which otherwise would permit such deposits, does not apply to CDBOs.

7. Acceleration of Expiration Date—Rule 1507

This provision permits OCC to accelerate the expiration date of a single payout CDBO when the option is deemed to have been automatically exercised on any day prior to the expiration date and to accelerate the expiration date of a multiple payout CDBO when the option is deemed to have been automatically exercised with respect to every reference entity underlying such option 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 basket options. The proposed rule change is also consistent with Section 17A(b)(3)(F) of the Act because it is designed 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 CDBOs take place at OCC with OCC applying substantially the same rules and procedures to CDBOs 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-2007-06) 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).