

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-56471; File No. SR-OCC-2007-08)

September 19, 2007

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing of a Proposed Rule Change Relating to Binary Options

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> notice is hereby given that on June 28, 2007, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which items have been prepared primarily by OCC. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The proposed rule change would amend OCC's By-Laws and Rules to permit OCC to clear and settle various types of binary options, including "fixed return options" to be listed by the American Stock Exchange ("Amex") and binary options on broad-based securities indexes proposed to be listed by the Chicago Board Options Exchange ("CBOE").

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

In its filing with the Commission, OCC 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. OCC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of such statements.<sup>2</sup>

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

<sup>2</sup> The Commission has modified parts of these statements.

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

The purpose of the proposed rule change is to permit OCC to clear and settle binary options, including fixed return options (“FROs”) to be listed and traded by Amex<sup>3</sup> and binary options on broad-based indexes proposed to be listed and traded by CBOE.<sup>4</sup> Binary options (sometimes referred to as “digital” options) are all-or-nothing options that pay a fixed amount if exercised in the money and otherwise pay nothing. Until recently, OCC did not clear any binary options other than credit default options (“CDOs”) traded on CBOE. CBOE and OCC recently were granted approval for CBOE to trade and for OCC to clear related products called credit default basket options (“CDBOs”).<sup>5</sup> General characteristics of binary options, excluding features unique to CDOs and/or CDBOs that were already described in OCC’s prior rule changes, are described below, followed by an explanation of the specific rule changes being proposed by OCC.

**Description of Binary Options.** Binary options are cash-settled options that have only two possible payoff outcomes, either a fixed exercise settlement amount or nothing at all. They are subject to automatic exercise. The underlying interest of a binary option may be one or more securities, an index of securities, or some other measure; however, OCC presently intends to clear only binary options that are within the definition of a “security” as determined by the Commission. In its capacity as a “derivatives clearing organization” regulated by the

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<sup>3</sup> Securities Exchange Act Release No. 56251 (August 14, 2007), 72 FR 46523 (August 20, 2007) (File No. SR-Amex-2004-27).

<sup>4</sup> File No. SR-CBOE-2006-105.

<sup>5</sup> Securities Exchange Act Release Nos. 56275 (August 17, 2007), 72 FR 47097 (August 22, 2007) (File No. SR-CBOE-2007-026) and 56288 (August 20, 2007), 72 FR 49034 (August 27, 2007) (File No. SR-OCC-2007-06).

Commodity Futures Trading Commission (“CFTC”), OCC may in the future propose to clear binary options that are commodity options subject to the jurisdiction of the CFTC.

A binary option, other than a CDO or CDBO, is in the money and will be automatically exercised if its underlying interest value, when measured against its exercise price, is determined to meet the criteria for automatic exercise as specified in the Exchange Rules of the listing Exchange.<sup>6</sup> For example, in the case of a “finish high fixed return option,” such option will be automatically exercised and settled for a fixed amount of cash if its underlying interest value is above its exercise price at expiration. In the case of a “finish low fixed return option,” such option will be automatically exercised and settled for a fixed amount of cash if its underlying interest value is below its exercise price at expiration. The rules proposed in this current filing for binary options are intended to be sufficiently generic to be the basis for clearing binary options proposed to be listed by Amex and CBOE as well as other binary options in the future.

**By-Law and Rule Amendments Applicable to Binary Options.** In order to provide a framework of rules that can accommodate clearance and settlement of various kinds of binary option products, OCC proposes to broaden the By-Law Article and Rule Chapter covering CDOs and CDBOs.

(1) Terminology—Article I, Section 1 and Article XIV, Section 1

“Binary option” would be defined in Article XIV, Section 1 of the By-Laws, and the definition would be cross-referenced in Article I of the By-Laws.

The definitions of “option contract” and “type of option” in Article I of the By-Laws would be amended to include a binary option.

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<sup>6</sup> CDOs and CDBOs, on the other hand, do not have exercise prices. A CDO or CDBO will be deemed to be in the money and will be automatically exercised if a credit event occurs at any time prior to the last day of trading.

OCC proposes to redefine the term “class” in Article XIV, Section 1 so that it will apply to binary options generally. To be within the same class, binary options other than CDOs or CDBOs must cover the same underlying interest and have otherwise identical terms except for exercise price (if any) and expiration date.

The definition of “exercise price” in Article I would be replaced with respect to binary options with a revised definition in Article XIV, Section 1 which would recognize that binary options will be settled by a fixed cash payment. The exercise price of a binary option is neither an amount that is paid in exchange for an underlying interest nor is it used to determine the exercise settlement amount as in the case of other cash-settled options. In the case of a binary option other than a CDO or CDBO, the exercise price of a binary option is simply a defined value or range of values for the underlying interest. If the underlying interest value falls within the defined range at expiration of such binary option, the option will be automatically exercised; otherwise, the option will expire unexercised. A CDO or CDBO is said to have no exercise price.

OCC proposes to redefine the term “underlying interest” in Article XIV, Section 1 so that it will apply to binary options generally. In the case of a binary option other than a CDO or CDBO, the underlying interest is the underlying security, securities, index, basket, or measure whose value is compared to such option’s exercise price to determine whether the option is in the money and will be automatically exercised. In conjunction with the revised definitions of “exercise price” and “underlying interest,” OCC also proposes to add a new defined term, “underlying interest value,” to Article XIV, Section 1. When used with respect to a binary option other than a CDO or CDBO, underlying interest value means the value or level of the unit of trading of the underlying interest at any point in time as reported by the reporting authority. A new definition for the term

“unit of trading” would state “unit of trading” when used with respect to a binary option means the quantity of the underlying interest on which the underlying interest value is based and is ordinarily a single share in the case of binary options on individual equity securities or one (1) in the case of binary index options. The terms “unit of trading” and “underlying interest value” would not be applicable to CDOs and CDBOs.

Other terms that were created or amended for CDOs and CDBOs will be modified to apply to binary options generally.

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

Paragraph (e) of Article VI, Section 10 would be further amended to apply to binary options generally.

(3) General Rights and Obligations—Article XIV, Section 2B

Article XIV, Section 2B would define the general rights and obligations of holders and writers of binary options other than CDOs or CDBOs. As noted above, the holder of a binary option that is automatically exercised would have the right to receive the fixed exercise settlement amount from OCC, and the assigned writer would have the obligation to pay that amount to OCC.

(4) Adjustments of Binary Options Other than CDOs or CDBOs—Article XIV, Section 3A; Unavailability or Inaccuracy of Final Underlying Interest Value—Article XIV, Section 5; Determination of Final Underlying Interest Value—Article XIV, Section 6

Article XIV, Section 3A would describe the methods by which binary options other than CDOs or CDBOs generally will be adjusted if adjustments are deemed to be necessary. Special adjustment rules are needed because of the fixed, cash-settlement feature of binary options. For instance, under Article VI, Section 11A(d), which governs adjustment of other equity options, if there is a stock dividend, distribution, or split

whereby a whole number of shares of the underlying security is issued for each outstanding share, the exercise price is proportionately reduced, and the number of option contracts is increased by the number of shares issued with respect to each share of the underlying security. This adjustment would be inappropriate for binary options for which the underlying interest is an equity security. For example, an XYZ option with an exercise price of \$50 would be adjusted to become two XYZ options, each with an exercise price of \$25. Because the fixed exercise settlement amount of a binary option is intended to remain at \$100, this adjustment would increase the total payout upon exercise to \$200. To avoid this result, Article XIV, Section 3A(a)(4) would provide that the number of option contracts would not proportionally increase and only the exercise price would be adjusted. The other provisions of Article XIV, Section 3A are similar to Article VI, Section 11A, with appropriate modifications for binary options. In order to maintain consistency with adjustment policies for physically settled stock options where such consistency is appropriate, certain changes in the treatment of dividends that were proposed in SR-OCC-2006-01 to become effective at a future date, will become effective on the same date for binary options on single stocks.

Article XIV, Section 3A(b) would govern adjustments of binary options for which the underlying interest is an index of equity securities and would be similar to Article XVII, Section 3, which governs index options, with appropriate modifications to reflect unique features of binary options. For instance, because binary options do not have an index multiplier, the Securities Committee would generally adjust the exercise price of a binary option of which the underlying interest is an index of equity securities to get the appropriate result.

Article XIV, Section 5, would give OCC the authority to fix the underlying interest value for a binary option other than a CDO or CDBO and to rely on that value for determining whether such binary option would be exercised under circumstances similar to those in which OCC may currently fix the exercise settlement amount for index options.

Article XIV, Section 6 would provide, in essence, that the underlying interest value of a series of binary options at expiration, other than CDOs or CDBOs, would be determined by the Exchange or Exchanges on which such series is traded subject to any overriding provision of OCC's By-Laws and Rules. If a series of options is traded on more than one Exchange, OCC could use the underlying interest value received from the Exchange deemed by OCC to be the principal Exchange, or OCC could employ a procedure to derive a single value based on some or all of the values received.

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

Binary options would not be subject to the exercise-by-exception procedures applicable to most other options under OCC's Rules but would instead be automatically exercised prior to or at expiration if the specified criterion for exercise is met. The procedures for the automatic exercise of binary options, as well as assignment and settlement of exercises (including provisions applicable to a suspended Clearing Member), would be set forth in Rules 1501 through 1505 of new Chapter XV and in revised Rule 801(b).

(6) Margin Requirements—Rule 601; Deposits in Lieu of Margin—Rule 1506

OCC would margin binary options through its usual "STANS" system. STANS has been modified to accommodate the particular binary options to be traded by Amex

and the binary index product currently proposed by CBOE. CDOs and CDBOs will be margined as described in the applicable rule filings cited above.

OCC is not proposing to accept escrow deposits in lieu of clearing margin for binary options. Therefore, Rule 1506 would state that Rule 610, which otherwise would permit such deposits, does not apply to binary options.

(7) Acceleration of Expiration Date—Rule 1507(d)

This new provision would accelerate the expiration date of a binary option other than a CDO or CDBO when OCC determines in its discretion that the underlying interest value of such option has become fixed prior to the expiration of the option (e.g., where the equity security underlying a binary option has been converted by a merger into the right to receive a fixed amount of cash). If the option is out of the money, it would expire unexercised. Otherwise, it would be automatically exercised.

The proposed changes to OCC's By-Laws and Rules are consistent with the purposes and requirements of Section 17A of the Act because they are designed to promote the prompt and accurate clearance and settlement of transactions in, including exercises of, binary options, and to foster cooperation and coordination with persons engaged in the clearance and settlement of such transactions, to remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of such transactions, and in general to protect investors and the public interest. The proposed rule change accomplishes this purpose by applying substantially the same rules and procedures to these transactions as OCC applies to similar transactions in other cash-settled options except to the extent that special rules and procedures are required in order to accommodate unique features of binary options.

(B) Self-Regulatory Organization's Statement on Burden on Competition



OCC does not believe that the proposed rule change would impose any burden on competition.

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

Written comments were not and are not intended to be solicited with respect to the proposed rule change and none have been received.

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

Within thirty-five 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 ninety 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 the self-regulatory organization consents, the Commission will:

- (A) by order approve the proposed rule change 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 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](mailto:rule-comments@sec.gov). Please include File Number SR-OCC-2007-08 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-OCC-2007-08. 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 Section, 100 F Street, NE, Washington, DC 20549, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. Copies of such filing also will be available for inspection

and copying at the principal office of OCC and on OCC's Web site at [www.optionsclearing.com](http://www.optionsclearing.com).

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-OCC-2007-08 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.<sup>7</sup>

Florence E. Harmon  
Deputy Secretary

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<sup>7</sup> 17 CFR 200.30-3(a)(12).