

CBOE anticipates that its reports will assess the impact of the changes to the minimum increments during the specific time period being analyzed, including, among other things, effects on (i) Market participants and customers; (ii) market performance and quality, such as quoted spreads, effective spreads, and the displayed size in the Pilot classes; and (iii) OPRA, vendor and exchange capacity. CBOE's reports should be submitted within one month following the end of the period being analyzed.

## 2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Act,<sup>6</sup> in general, and furthers the objectives of Section 6(b)(5) of the Act,<sup>7</sup> in particular, in that the proposed rule change is designed to promote just and equitable principles of trade, serve 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.

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

The Exchange does not believe that the proposed rule change will result in 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*

Written comments on the proposed rule change were neither solicited nor received.

## 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 the Exchange consents, the Commission will:

(A) By order approve such 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. The Commission also requests and encourages interested persons to submit comments on the following specific questions:

- Whether there are circumstances under which options classes included in the Penny Pilot should be removed from the Pilot?

- If so, what factors should be considered in making the determination to remove an option class from the Penny Pilot?

- Should an objective standard be used? For instance, should an option class come out of the Penny Pilot if its trading volume drops below a threshold amount? If so, what should that threshold be? Or, should an option class come out of the Penny Pilot if it is no longer among the most actively-traded options? If so, what should be considered the most-actively traded options? What statistics or analysis should be used to support a determination to remove an options class?

- Should a more subjective analysis be allowed? If so, what factors should be taken into account?

- What concerns might arise by removing an option from the Penny Pilot? How could such concerns be ameliorated?

- How frequently should the analysis be undertaken (e.g., annually, bi-annually, quarterly), or should the evaluation be an automated process?

- If a determination is made that an option should be removed from the Penny Pilot, how much notice should be given to market participants that the quoting increment will change?

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-CBOE-2007-98 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-2007-98. 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, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. Copies of such filing also will be available for inspection and copying at the principal office of the 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-2007-98 and should be submitted on or before September 12, 2007.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>8</sup>

**Florence E. Harmon,**  
Deputy Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-56275; File No. SR-CBOE-2007-26]

**Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Order Granting Approval of a Proposed Rule Change To List and Trade Credit Default Basket Options, as Modified by Amendment No. 3, and Designating Credit Default Basket Options as Standardized Options Under Rule 9b-1 of the Securities Exchange Act of 1934**

August 17, 2007.

### I. Introduction

On April 5, 2007, 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

<sup>6</sup> 15 U.S.C. 78f(b).

<sup>7</sup> 15 U.S.C. 78f(b)(5).

<sup>8</sup> 17 CFR 200.30-3(a)(12).

the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> to permit CBOE to list and trade cash-settled, binary options<sup>3</sup> based on the occurrence of credit events in the debt securities of one or more issuers, referred to as credit default basket options. On June 15, 2007, CBOE filed Amendment No. 1 to the proposed rule change; on June 19, 2007, CBOE withdrew Amendment No. 1 and filed Amendment No. 2 to the proposed rule change; and on June 21, 2007, CBOE withdrew Amendment No. 2 and filed Amendment No. 3 to the proposed rule change.<sup>4</sup> The proposed rule change, as modified by Amendment No. 3, was published for comment in the **Federal Register** on June 28, 2007 for a 15-day comment period.<sup>5</sup> The Commission received no comments on the proposal. This order approves the proposed rule change, as modified by Amendment No. 3, and designates credit default basket options as "standardized options" pursuant to Rule 9b-1 under the Act.<sup>6</sup>

## II. Description of the CBOE Proposal

### A. Generally

On June 6, 2007, the Commission approved a proposal by CBOE to list and trade credit default options, which are cash-settled binary options that are automatically exercised upon the occurrence of specified credit events or expire worthless.<sup>7</sup> CBOE now proposes to list and trade credit default basket options, which are cash-settled binary options based on a basket of at least two Reference Entities (described below). This proposal would add new rules

applicable to credit default basket options and amend certain existing rules applicable to credit default options to make them applicable to credit default basket options.

Credit default options are referenced to debt securities issued by a specified public company ("Reference Entity")<sup>8</sup> and either have a fixed payout or expire worthless, depending upon whether a credit event 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,<sup>9</sup> the options positions existing as of that time are automatically exercised and the holders of long options positions receive a fixed cash payment of \$100,000 per contract.<sup>10</sup> If no credit event is confirmed during the life of the option, the final settlement price is \$0.

Credit default basket options are like credit default options, but instead of being based on the debt securities of one Reference Entity, they are based on the debt securities of two or more Reference Entities, or Basket Components. There would be two types of credit default basket options: (i) Multiple payout credit default basket options that automatically pay holders a cash settlement amount each time a credit event is confirmed in a Basket Component during the life of the option, after which the applicable Basket Component would be removed from the basket, or expire worthless if no credit events are confirmed during the life of the option; and (ii) single payout credit default basket options that automatically pay holders a single cash settlement amount when the first credit event is confirmed in any Basket Component, or expire worthless if no credit event for any Basket Component is confirmed during the life of the option.<sup>11</sup> Unlike a multiple payout

credit default basket option, a single payout credit default basket option ceases trading after confirmation of the first credit event.

The cash payout for credit default basket options is calculated differently than for credit default options. For both types of credit default basket options, each time a credit event is confirmed during the life of the option, the holder of the option would receive a cash payment per contract that is equal to one minus the Basket Component recovery rate specified by the Exchange at listing, multiplied by the notional face value of the applicable Basket Component.<sup>12</sup> For example, if there is a credit event in a Basket Component with notional face value of \$10,000 and a recovery rate of 40%, the cash payment per contract would be \$6,000.<sup>13</sup> As with credit default options, if no credit event is confirmed during the life of the option, the final settlement price would be \$0.

### B. Listing Standards

Like credit default options, credit default basket options must conform to the initial and continued listing standards under proposed CBOE Chapter XXIX.<sup>14</sup> CBOE is proposing to list and trade only credit default basket options overlying debt securities of multiple Reference Entities each having at least one class of securities that is registered under the Act and is an "NMS stock"<sup>15</sup> as defined in Rule 600 of Regulation NMS under the Act.<sup>16</sup> Any registered equity security issued by the Reference Entity also would have to satisfy the requirements of CBOE Rule

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

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> A binary option is a style of option having only two possible payoff outcomes: either a fixed amount or nothing at all.

<sup>4</sup> Amendment No. 3 replaced the original filing in its entirety.

<sup>5</sup> See Securities Exchange Act Release No. 55938 (June 21, 2007), 72 FR 35523 ("CBOE Proposal").

<sup>6</sup> 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 of "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).

<sup>7</sup> See Securities Exchange Act Release No. 55871, 72 FR 32372 (June 12, 2007) (SR-CBOE-2006-84) (approving CBOE's proposal to list and trade credit default options) ("Credit Default Option Approval Order"). See also Securities Exchange Act Release No. 55919 (June 18, 2007), 72 FR 34498 (June 22, 2007) (SR-CBOE-2007-62) (making various technical changes to CBOE's credit default option rules).

<sup>8</sup> Proposed CBOE Rule 29.1(f) also includes as a "Reference Entity" the guarantor of the debt security underlying the credit default option. For purposes of credit default basket options, Reference Entities are referred to as "Basket Components." See proposed CBOE Rule 29.1(h).

<sup>9</sup> CBOE Rule 29.9(c) (to be relettered CBOE Rule 29.9(d)) 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, or of filed with the courts, the Commission, an exchange, an association, the Options Clearing Corporation ("OCC"), or another regulatory agency or similar authority.

<sup>10</sup> However, the settlement amount could be adjusted pursuant to proposed CBOE Rule 29.4.

<sup>11</sup> Credit events that trigger an automatic pay out include a failure to make payment pursuant to the terms of an underlying debt security and any other event of default specified by CBOE at the time it

initially lists a particular class of credit default basket options. For each Basket Component, the events of default that CBOE may specify must be defined in accordance with the terms of the specific debt security underlying the Basket Component (each a "Reference Obligation") or any other debt securities of the Basket Component other than non-recourse indebtedness (collectively with the Reference Obligation, "Relevant Obligations"). See proposed CBOE Rules 29.1(c) and 29.2A.

<sup>12</sup> At the time of listing, the Exchange will designate the notional face value and recovery rate of each Basket Component. See proposed CBOE Rule 29.2A (setting forth the requirements for the designation and terms of credit default basket options); and proposed CBOE Rules 29.1(a)(ii) and (j) (setting forth the definitions for "cash settlement amount" for credit default basket options and "Notional Face Value of Basket Component," respectively).

<sup>13</sup>  $\$10,000 \times (1 - 0.40) = \$6,000$ .

<sup>14</sup> CBOE is amending Chapter XXIX to make it applicable to all "Credit Options," which would include credit default options and credit default basket options.

<sup>15</sup> "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. See 17 CFR 242.600(b)(46) and (47).

<sup>16</sup> See proposed CBOE Rule 5.3.11.

5.4, which requires, among other things, that an equity security underlying an option be itself widely held and actively traded.<sup>17</sup> This requirement is designed to ensure that the issuer's securities enjoy widespread investor interest. The requirement that each Reference Entity be an issuer or guarantor of registered NMS stock will help ensure that investors have access to comprehensive public information about the Reference Entity, including the registration statement filed under the Securities Act of 1933 ("Securities Act") and other periodic reports.<sup>18</sup>

Also, as with credit default options, a credit default basket 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.<sup>19</sup> The Exchange usually would open one to four series for each year up to 10.25 years from the current expiration.<sup>20</sup>

### C. Trading

The trading rules for credit default basket options would be consistent with those applicable to credit default options. Specifically, credit default basket options would trade on CBOE's

Hybrid Trading System from 8:30 a.m. to 3 p.m. (Central Time)<sup>21</sup> 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 would apply to credit default options.<sup>22</sup> Also, credit default basket options would be eligible for trading as Flexible Exchange Options ("FLEX Options"). A FLEX Option that is a credit default basket option would be cash-settled and the exercise-by-exception provisions of OCC Rule 805<sup>23</sup> would not apply. Market-makers would be appointed to credit default options pursuant to CBOE's existing requirements,<sup>24</sup> as supplemented by proposed CBOE Rule 29.17. Additionally, CBOE represents 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 basket options.

Once a particular credit default basket 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 class 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 class. The proposed trading rules for credit default basket options are designed to create an environment that takes into account the small number of transactions likely to occur, while providing price improvement and the transparency benefits of competitive floor bidding, as compared to the over-the-counter ("OTC") market.

Upon the confirmation of the first credit event (in the case of a single payout credit default basket option), a credit event in every Basket Component (in the case of a multiple payout credit default basket option), or the redemption of all Relevant Obligations (in the case of either type of credit default basket option), the applicable credit default basket option class would cease trading. In addition, CBOE's trading halt procedures applicable to equity options would apply to credit

default basket options.<sup>25</sup> When determining whether to institute a trading halt in credit default basket options, CBOE floor officials would consider whether current quotations for a Relevant Obligation or other securities of a Reference Entity are unavailable or have become unreliable.<sup>26</sup> The Exchange's board of directors would also have the power to impose restrictions on transactions or exercises in one or more series of credit default basket 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.<sup>27</sup>

### D. Clearance and Settlement

Like credit default options, credit default basket options do not have an exercise price, and thus by their terms, do not meet the definition of "standardized options" for purposes of Rule 9b-1 under the Act.<sup>28</sup> However, as discussed herein, the Commission today is using its authority pursuant to Rule 9b-1 to designate credit default basket options as "standardized options" under Rule 9b-1. Consequently, credit default basket option transactions will be eligible for clearance and settlement by the OCC in accordance with procedures that are substantially similar to existing systems and procedures for the clearance and settlement of exchange-traded options.<sup>29</sup>

### E. Adjustments

Like credit default options, both types of credit default basket options would be subject to adjustments in two circumstances.<sup>30</sup> First, if a Basket Component is succeeded by another entity in accordance with the terms of the underlying debt securities, the Exchange will specify a new recovery

<sup>17</sup> 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: (i) 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); (ii) there are fewer than 1,600 holders of the underlying security; (iii) the trading volume (in all markets in which the underlying security is traded) was less than 1,800,000 shares in the preceding 12 months; (iv) 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 (v) the underlying security ceases to be an NMS stock.

<sup>18</sup> Section 13 of the Act, 15 U.S.C. 78m, provides that any issuer of a security registered pursuant to Section 12 of the Act, 15 U.S.C. 78l, must file with the Commission annual reports and information and documents necessary to keep reasonably current the information in its Section 12 registration statement.

<sup>19</sup> For a single payout credit default basket option, if a credit event is confirmed, the expiration date would be the second business day after the confirmation of the first credit event. For a multiple payout credit default basket option, if a credit event is confirmed in every Basket Component, the expiration date would be the second business day after the confirmation of the last credit event. For either type of credit default basket options, if a Redemption Event is confirmed in all Basket Components, the expiration date would be the second business day after the last confirmation date. See proposed CBOE Rules 29.1(d)(ii) and (e)(ii). See also proposed CBOE Rule 29.4.

<sup>20</sup> See proposed CBOE Rule 29.2A(b)(1) and (2).

<sup>21</sup> See proposed CBOE Rule 29.11.

<sup>22</sup> See proposed CBOE Rules 29.11–29.15, 29.16, and 29.19.

<sup>23</sup> OCC Rule 805 sets forth the expiration date exercise procedures for options cleared and settled by the OCC.

<sup>24</sup> See Chapter VIII of CBOE's rules.

<sup>25</sup> See CBOE Rules 6.3 and 6.3B; proposed CBOE Rule 29.13.

<sup>26</sup> See *id.*

<sup>27</sup> See proposed CBOE Rule 29.8.

<sup>28</sup> 17 CFR 240.9b-1.

<sup>29</sup> On April 20, 2007, the OCC filed with the Commission, a proposed rule change to enable it to clear and settle credit default basket options proposed to be listed by CBOE. On June 14, 2007, the OCC filed Amendment No. 1 to the proposal. The proposed rule change, as amended, was published for comment in the *Federal Register* on June 27, 2007. Securities Exchange Act Release No. 55939 (June 21, 2007), 72 FR 35291 (SR-OCC-2007-06) (the "OCC Proposal"). The Commission has not yet taken action on the OCC proposal. The Commission also notes that the Options Disclosure Document ("ODD") was recently amended to incorporate disclosure related to both credit default options and credit default basket options. See Securities Exchange Act Release No. 55921 (June 18, 2007), 72 FR 34495 (June 22, 2007) (SR-ODD-2007-03).

<sup>30</sup> See CBOE proposed Rule 29.4.

rate and basket weight for each successor Basket Component. The newly specified weights would equal the weight of the original Basket Component. To the extent necessary and appropriate for the protection of investors and the public interest, all other terms and conditions of the options would be the same as the original credit default basket options.

Second, if the Reference Obligation of a Basket Component is redeemed or matures during the life of the credit default basket option, the Exchange would specify another debt security of the Reference Entity as the new Reference Obligation for that Basket Component. If all debt securities of a Basket Component (*i.e.*, all Relevant Obligations) are redeemed during the life of the credit default basket option, that Basket Component would be removed from the basket.

#### *F. Position Limits*

Pursuant to proposed CBOE Rule 29.5, credit default basket options would be subject to a position limit equal to 50,000 contracts on the same side of the market. Credit default basket options would not be aggregated with option contracts on the same underlying security and would not be subject to the hedge exemption to CBOE's standard position limits. Instead, the following hedge strategies and positions would be exempt from CBOE's position limits: (i) A credit default basket option position "hedged" or "covered" by an appropriate amount of cash to meet the cash settlement amount obligation; and (ii) a credit default basket option position "hedged" or "covered" by an amount of any of the Basket Component's debt securities, instruments, or interests sufficient to meet: (A) In the case of a single payout credit default option, the cash settlement amount obligation that would be the greatest if any of the Basket Components of that option were to experience a credit event; or (B) in the case of a multiple payout credit default option, the sum of the sum of each Basket Component's cash settlement amount.<sup>31</sup> Also, CBOE's market-maker and firm facilitation exemptions to position limits would apply.<sup>32</sup>

<sup>31</sup> See proposed CBOE Rule 29.5.

<sup>32</sup> Proposed CBOE Rule 29.5 would require 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 an exemption would be granted. With respect to CBOE's firm facilitation exemption (CBOE Rule 4.11.06), proposed CBOE Rule 29.5 would provide that the aggregate exemption position could not exceed three times the standard limit of 50,000 contracts.

#### *G. Margin*

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

- For a qualified customer carrying a long position in a credit default basket option, the margin requirement would be 15% of the current market value of the credit default basket option.
- For a non-qualified customer carrying a long position in a credit default basket option, the margin requirement would be 100% of the current market value of the credit default basket option.
- For a qualified customer carrying a short position in a multiple payout credit default basket option, the margin requirement would be the lesser of the current market value of the credit default basket option plus 15% of the sum of each Basket Component's cash settlement amount, or the sum of each Basket Component's cash settlement amount.
- For a non-qualified customer carrying a short position in a multiple payout credit default basket option, the margin requirement would be the sum of each Basket Component's cash settlement amount.
- For a qualified customer carrying a short position in a single payout credit default basket option, the margin requirement would be the lesser of the current market value of the credit default basket option plus 15% of the cash settlement amount of the Basket Component that would be the greatest if any of the Basket Components were to experience a credit event, or the cash settlement amount of the Basket Component that would be the greatest if any of the Basket Components were to experience a credit event.
- For a non-qualified customer carrying a short position in a single payout credit default basket option, the margin requirement would be the cash settlement amount of the Basket Component that would be the greatest if any of the Basket Components were to experience a credit event.

These requirements may be satisfied by a deposit of cash or marginable securities.

A credit default option carried short in a customer's account would be deemed a covered position, and eligible for the cash account, provided any one of the following is held in the account at the time the option is written or is received into the account promptly thereafter: (i) For multiple payout credit default basket options, cash or cash equivalents equal to 100% of the sum of each Basket Component's cash

settlement amount; (ii) for single payout credit default basket options, cash or cash equivalents equal to 100% of the cash settlement amount of the Basket Component that would be the greatest if any of the Basket Components were to experience a credit event; or (iii) 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. The Exchange represents that, in accordance with proposed CBOE Rule 12.3(a)(4), 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.

Lastly, pursuant to proposed CBOE Rule 12.5, a credit default basket option that is carried for the account of a qualified customer 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 basket options prior to listing and trading such options.

### **III. 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.<sup>33</sup> In particular, the Commission finds that the proposal is consistent with section 6(b)(5) of the Act,<sup>34</sup> 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. CBOE's proposal, by enabling it to list and trade securities heretofore existing only in the OTC market, would extend to investors the benefits of a listed exchange market,

<sup>33</sup> 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).

<sup>34</sup> 15 U.S.C. 78f(b)(5).

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.

In connection with its earlier approval of credit default options, the Commission found that the credit default options proposed by CBOE are securities because they are options based on the value of a security or securities and because they are options on an interest in, or based on the value of an interest in, a security or securities.<sup>35</sup> Under an analysis similar to that applied to credit default options, and after careful consideration of the terms of the two types of credit default basket options, the Commission finds that the credit default basket options proposed by CBOE are securities. Specifically, the Commission finds that credit default basket options are options based on the value of securities or a group or index of securities and are options on an interest in or based on the value of an interest in, securities or a group or index of securities and, therefore, are securities under section 3(a)(10) of the Act.<sup>36</sup>

As a threshold matter, the Commission finds that credit default basket options are options, not futures contracts. Generally speaking an option grants the holder the right, but not the obligation, to buy or sell a specific quantity, at a specific price, on or before a specified future date.<sup>37</sup> Courts have highlighted three characteristics in particular that distinguish options from futures contracts: (i) An options-buyer pays to the seller a nonrefundable premium; (ii) an options-buyer has rights but no further obligations under the contract; and (iii) an options-seller bears all the risk exposure.<sup>38</sup> Examining credit default basket options in light of these characteristics, it is clear that credit default basket options are options. First, the buyer of a credit default basket option pays to the seller a nonrefundable premium. Second, the buyer of a credit default basket option has rights but no further obligations under the contract. Third, the buyer of a credit default basket option has no further risk exposure under the contract and the seller bears all the risk of the credit event occurring.

Although credit default basket options differ from classic options in certain respects, these differences do not affect the economic substance of the contract. First, credit default basket options are cash-settled and do not allow for physical delivery. It is well established, however, that cash-settled options based on prices of securities are options “on” such securities.<sup>39</sup> Second, credit default basket options are automatically exercised, unlike a classic option that generally gives the option-holder the right but not the obligation to exercise if the option is in the money. In the case of cash-settled options, such as credit default basket options, however, giving the option-holder the right to decline to accept the cash upon the occurrence of an event of default would be economically meaningless.<sup>40</sup> For this reason, under OCC rules, index option contracts are automatically exercised if they are in-the-money at expiration, and equity options contracts are automatically exercised if they are in-the-money by specified amounts. Third, the payout for a credit default basket option is fixed in advance and binary in nature, while in a classic option the payout can increase or decrease continuously in direct correlation with the price movement of the underlying instrument. The same is true, of course, of the payout of a futures contract. Thus, the fixed payout of credit default basket options does not weigh in favor of classifying them as either futures or options.

In short, even though the potential payout of a credit default basket option is cash-settled, automatically exercised, and fixed in advance, the buyer of a credit default basket option still pays a fixed premium for the possibility of receiving a greater amount—which is the essence of optionality.<sup>41</sup>

Furthermore, the Commission finds that credit default basket options are securities under section 3(a)(10) of the Act.<sup>42</sup> Specifically, credit default basket

options are options based on the value of securities or a group or index of securities and are options on an interest in, or based on the value of an interest in, securities or a group or index of securities. In coming to these conclusions, the Commission carefully considered the terms of the credit default basket options, using an analytical approach similar to that which the Commission applied to credit default options.

The Commission also believes that the listing and trading rules proposed by CBOE for credit default basket options are substantially similar to the listing and trading rules for credit default options, and are likewise reasonable and consistent with the Act. As with a credit default option, a credit default basket option must be based on Reference Obligations issued by entities that issue or guarantee 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 Entities that may be necessary to price a credit default basket option appropriately.

The Commission believes that the proposed position limits and margin rules for credit default basket options are reasonable and consistent with the Act. The proposed position limit of 50,000 contracts in any credit default basket 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

finding that credit default basket options are securities because they are options based on the value of securities or a group or index of securities might suggest that single-name or basket OTC credit default swaps are also options based on the value of a security or group or index of 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. Of course, OTC credit default swaps that involve terms similar to credit default basket 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.

<sup>35</sup> See Credit Default Option Approval Order, *supra* note 7.

<sup>36</sup> 15 U.S.C. 78c(a)(10).

<sup>37</sup> See *British American Commodity Options v. Bagley*, 552 F.2d 482, 484–85 (2d Cir. 1977).

<sup>38</sup> See *CFTC v. U.S. Metals Depository Co.*, 468 F.Supp. 1149, 1154 (S.D.N.Y. 1979); and *United States v. Bein*, 728 F.2d 107, 112 (2d Cir. 1984).

<sup>39</sup> See *Caiola v. Citibank, N.A.*, New York, 295 F.3d 312, 326 (2d Cir. 2002).

<sup>40</sup> See *Stechler v. Sidley, Austin Brown & Wood, L.L.P.*, 382 F.Supp.2d 580, 595–97 (S.D.N.Y. 2005).

<sup>41</sup> See Brief of Amicus Curiae The Securities and Exchange Commission, at 24, *Caiola v. Citibank, N.A.*, New York, 295 F.3d 312 (2d Cir. 2002) (01–7545) (“Simply put, Caiola paid a little for the chance to get a lot”).

<sup>42</sup> The Commission wishes to make clear that because credit default basket 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. Also, certain OTC credit default swaps (whether single-name or basket) are not securities. The

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:

- The Exchange will have in place adequate surveillance procedures to monitor trading in credit default basket 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 basket options as proposed.

This approval order is based on CBOE's representations.

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

#### IV. Designation of Credit Default Basket 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 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.<sup>43</sup> 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.<sup>44</sup>

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.<sup>45</sup> The Commission

specifically reserved in Rule 9b-1 the ability to designate as standardized options other securities "that the Commission believes should be included within the options disclosure framework."<sup>46</sup>

The Commission hereby designates credit default basket options, as defined in the OCC Proposal,<sup>47</sup> as standardized options for purposes of Rule 9b-1 under the Act. Like credit default options, credit default basket options do not meet the definition of "standardized options," because they do not have an exercise price.<sup>48</sup> However, they resemble standardized options in other significant respects. Credit default basket options have underlying securities and an expiration date. Like other standardized options, credit default basket 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 basket options

offer or sale of the underlying security or securities as 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).

<sup>46</sup> *See* Securities Exchange Act Release No. 19055 and Securities Act Release No. 6426 (September 16, 1982), 47 FR 41950, 41954 (September 23, 1982).

<sup>47</sup> For purposes of its proposal, OCC would define the term "credit default basket option" as an option that is based on a basket comprised of at least two reference entities and that is either a "multiple payout credit default basket option" or a "single payout credit default basket option." A "multiple payout credit default basket option" would mean a credit default basket option that automatically pays an exercise settlement amount each time a credit event is confirmed with respect to any one of the reference entities prior to expiration of the option. A "single payout credit default basket option" would be automatically exercised and pay a single exercise settlement amount only when the first credit event is confirmed with respect to a reference entity prior to expiration of the option. *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 basket 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 any one of the issuers or guarantors of the reference obligation(s) that underlie a credit default basket option. *See* proposed Section 1.R.(1) of Article XIV of the OCC By-Laws.

"Reference obligation" would mean any debt security the terms of which are used to define the occurrence of a credit event with respect to the reference entity that is its issuer or guarantor for a class of credit default basket options, as provided in the rules of the listing exchange. *See id.*

<sup>48</sup> *See* Credit Default Options Approval Order at Section VI (designating credit default options as standardized options for purposes of Rule 9b-1 under the Act).

are designed to provide market participants with the ability to hedge their exposure to underlying securities. The fact that credit default basket options lack a specified exercise 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 basket options supports the view that adding credit default basket options to the standardized option disclosure framework is reasonable.

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

#### V. Conclusion

*It is therefore ordered*, pursuant to section 19(b)(2) of the Act,<sup>49</sup> that the proposed rule change (SR-CBOE-2007-26), as modified by Amendment No. 3, be and hereby is approved.

*It is further ordered*, pursuant to Rule 9b-1(a)(4) under the Act, that credit default basket options, as defined in proposed rule change SR-OCC-2007-06, are designated as standardized options.

By the Commission.

**Florence E. Harmon,**  
*Deputy Secretary.*

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#### SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-56265; File No. SR-FINRA-2007-002]

#### Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change To Extend a Pilot Program That Increases Position and Exercise Limits for Certain Equity Options

August 15, 2007.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on July 31, 2007, the Financial Industry Regulatory Authority, Inc. ("FINRA") (f/k/a the National Association of Securities Dealers, Inc. ("NASD")) filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and

<sup>49</sup> 15 U.S.C. 78s(b)(2).

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

<sup>2</sup> 17 CFR 240.19b-4.

<sup>43</sup> *See* 17 CFR 240.9b-1(d)(1).

<sup>44</sup> *See* 17 CFR 240.9b-1(d)(2).

<sup>45</sup> *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