

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-55938; File No. SR-CBOE-2007-26]

### Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of a Proposed Rule Change, and Amendment No. 3 Thereto, to List and Trade Credit Default Basket Options

June 21, 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 April 5, 2007, the Chicago Board Options Exchange, Incorporated ("Exchange" or "CBOE") filed with the Securities and Exchange Commission ("Commission") a proposed rule change to list and trade 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.<sup>3</sup> The proposed rule change is described in Items I, II, and III below, which Items have been prepared substantially by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

The Exchange proposes to amend its rules to provide for the listing and trading of Credit Default Basket Options, which are cash-settled call options based on the occurrence of a Credit Event in one, some or all of the Basket Components, as specified by the Exchange at listing.<sup>4</sup> The text of the

proposed rule change is available at the Exchange's Web site (<http://www.cboe.org/legal>), the principal office of CBOE, and the Commission's Public Reference Room.

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

In its filing with the Commission, the Exchange 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 those statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

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

###### 1. Purpose

The Commission recently approved the Exchange's proposal to list and trade Credit Default Options, which are cash-settled, binary call options that pay a fixed cash settlement amount based on the confirmation of a credit event in a Reference Entity (*i.e.*, debt security issuer or guarantor).<sup>5</sup> To provide investors with different and varied hedging and risk-shifting vehicles to manage investments in debt securities, the Exchange anticipates introducing additional types of Credit Options linked to debt securities. The purpose of the proposed rule change is to enable the Exchange to list and trade the second in a series of Credit Options the Exchange anticipates introducing: Credit Default Basket Options.

##### Structure of a Credit Default Basket

Credit Default Basket Options are cash-settled call options based on a basket of at least two Reference Entities ("Basket Components"). After the Basket Components have been identified, the Exchange would specify a debt security as the Reference Obligation of each Basket Component (*e.g.*, Corporation XYZ 8.375% July 2033 bond). The Exchange would also specify the Notional Face Value of the underlying Credit Default Basket (*e.g.*, \$100,000) and the weight allocated to each Basket Component (representing the fraction of the Basket Notional Face

Value allocated to the particular Basket Component). Additionally, the Exchange would specify the recovery rate for each Basket Component and the applicable Credit Event(s) for each Basket Component. Further, Basket Components would remain fixed from the time of listing to the expiration date of the option, except that Basket Components could be replaced by Successor Basket Components following a Succession Event and would be removed from the Credit Default Basket after a Credit Event or Redemption Event is confirmed by the Exchange.

The underlying Credit Default Basket could be reconstituted periodically and new option series on the reconstituted Credit Default Basket would be listed as new option classes. Existing options based on the original Credit Default Basket would continue to trade until expiration.

##### Cash Settlement Types: Multiple and Single Payout Credit Default Basket Options

The Exchange proposes to list and trade two settlement types of Credit Default Basket Options. The first settlement type would be a Multiple Payout Credit Default Basket Option that would automatically pay out a cash settlement amount each time a Credit Event is confirmed in a Basket Component during the life of the option. A cash settlement amount would be paid only once in connection with a particular Basket Component that has a confirmed Credit Event, after which time that Basket Component would be removed from the Credit Default Basket. If a Credit Event is confirmed in every Basket Component prior to expiration, the Multiple Payout Credit Default Basket Option would cease to trade; or, if no Credit Event is confirmed in any Basket Component prior to expiration, the Multiple Payout Credit Default Basket Option would expire worthless. The second settlement type would be a Single Payout Credit Default Basket Option that would be automatically exercised and pay a single cash settlement amount as soon as the first Credit Event is confirmed in any one of the Basket Components. If no Credit Event is confirmed in any Basket Component prior to expiration, the Single Payout Credit Default Basket Option would expire worthless.

Both settlement types of Credit Default Basket Options would have a cash settlement amount equal to one minus the Basket Component recovery rate as specified by the Exchange at listing multiplied by the Notional Face Value of the Basket Component. The Notional Face Value of the Basket

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

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

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

<sup>4</sup> This filing proposes new rules and amendments to existing Chapter XXIX, which was recently added to the Exchange's rulebook. See Securities Exchange Act Release No. 55871 (June 6, 2007), 72 FR 32372 (June 12, 2007) (SR-CBOE-2006-84) (approving proposal to list and trade Credit Default Options and designating Credit Default Options as standardized options). This filing also assumes that proposed amendments, deletions, and additions to existing Chapter XXIX set forth in a separate rule filing are effective. See Securities Exchange Act Release No. 55919 (June 18, 2007) (SR-CBOE-2007-62). In addition, the changes to existing Rules 5.3, 5.4, 6.1, and 29.19 and to the introduction to Chapter XXIX assume that unrelated changes proposed in two other separate rule filings are effective. See Securities Exchange Act Release No. 53935 (June 2, 2006), 71 FR 34174 (June 13, 2006) (SR-CBOE-2003-41) (notice of proposal to list and

trade Options on Corporate Bonds); SR-CBOE-2006-99 (proposal to adopt rules related to FLEX Hybrid Trading System).

<sup>5</sup> See *supra* note 4.

Component would represent the weight that a particular Basket Component would be given relative to the Credit Default Basket in which it is included. As discussed above, the Credit Default Basket would have a specified Notional Face Value (e.g., \$100,000) and each Basket Component would have a specified recovery rate, as set at listing. For example, assume that a Credit Default Basket Option has a Notional Face Value of \$100,000 and is comprised of ten Basket Components. Assume also that each Basket Component is equally weighted (or has the same Notional Face Value of Basket Component). This would equate to each Basket Component having a Notional Face Value of \$10,000. If a Credit Event is confirmed for a Basket Component with a specified recovery rate of 40% (or 0.40), the cash settlement amount would be \$6,000 (or  $\$10,000 \times (1 - 0.40)$ ).

The distinction between the two settlement types is that a Multiple Payout Credit Default Basket Option would automatically pay holders a cash settlement amount for each Basket Component that has a confirmed Credit Event during the life of the option. A cash settlement amount would be paid only once in connection with a particular Basket Component that has a confirmed Credit Event, after which time that Basket Component would be removed from the Credit Default Basket. In contrast, a Single Payout Credit Default Basket Option would automatically exercise and pay holders a single cash settlement amount for the first Basket Component that has a confirmed Credit Event, at which point the option would cease trading and expire.

#### *Credit Events*

Circumstances giving rise to a "Credit Event" for Credit Default Basket Options would be defined identically to those giving rise to a Credit Event for Credit Default Options, as defined in Rule 29.1. For Credit Default Basket Options, a "Credit Event" would occur when a Reference Entity:

(i) Has a Failure-to-Pay Default on a specific debt security obligation (the "Reference Obligation") or any other debt security obligations other than non-recourse indebtedness (the set of these obligations and the Reference Obligation are referred to as the "Relevant Obligations"). The term "Failure-to-Pay Default" would be defined in accordance with the terms of the Relevant Obligations, provided that the minimum failure to pay amount, individually or in the aggregate, shall be the greater of \$750,000 or the amount

specified in accordance with the terms of the Relevant Obligation(s); and/or

(ii) Has any other Event of Default on the Relevant Obligations. Each such "Event(s) of Default" would be specified by the Exchange at the time the option class is initially listed in accordance with the procedures of proposed Rule 29.2A and, if so specified, would be defined in accordance with the terms of the Relevant Obligations; provided that the default amount relates to a principal amount of the Relevant Obligation(s), individually or in the aggregate, that is the greater of \$7.5 million or the amount specified in accordance with the terms of the Relevant Obligation(s); and/or

(iii) Has a change in the terms of the Relevant Obligations (a "Restructuring"). The terms of such a Restructuring would be specified by the Exchange in accordance with proposed Rule 29.2A and, if so specified, would be defined in accordance with the terms of the Relevant Obligations; provided that the restructuring relates to a principal amount of the Relevant Obligation(s), individually or in the aggregate, that is the greater of \$7.5 million or the amount specified in the terms of the Relevant Obligation(s).

Similar to Credit Default Options, the particular Credit Events applicable to a Credit Default Basket Option would be designated by the Exchange on a class-by-class basis. However, the applicable Credit Events for Basket Components of a given Credit Default Basket Option class may not be the same. The Exchange would select from among the Credit Event terms in the underlying instruments of the Relevant Obligations of the particular Reference Entity (i.e., Basket Component) for the given Credit Default Basket Option class.

Again, similar to Credit Default Options, the Exchange would confirm a Credit Event for a Credit Default Basket Option through at least two sources, which may include announcements published via newswire services or information services companies, the names of which would be announced to the membership via Regulatory Circular, and/or information contained in any order, decree, notice of filing, however described, of or filed with the courts, the Commission, an exchange or association, the Options Clearing Corporation ("OCC"), or another regulatory agency or similar authority. Every determination of a Credit Event would be within the Exchange's sole discretion and would be conclusive and binding on all holders and sellers of Credit Default Basket Options and not subject to review.

#### *Automatic Payout and Exercise*

Upon the confirmation of a Credit Event, a Credit Default Basket Option would either automatically pay out (for Multiple Payout Credit Default Basket Options) or be automatically exercised (for Single Payout Credit Default Basket Options). To trigger an automatic payout or automatic exercise, a Credit Event would need to have (i) Occurred between the option's listing date and 10:59 p.m. (CT) on the option's last trading day which, subject to certain exceptions, would generally be the third Friday of the expiration month; and (ii) been confirmed by the Exchange no later than the option's expiration date which, subject to certain exceptions, would generally be the fourth business day after the third Friday of the expiration month.

If the Exchange confirms a Credit Event, the holder of a Multiple Payout Credit Default Basket Option would receive an automatic payout for each Basket Component that has a confirmed Credit Event during the life of the option. A cash settlement amount would be paid only once in connection with a particular Basket Component that has a confirmed Credit Event, after which time that Basket Component would be removed from the Credit Default Basket. (If a Credit Event were confirmed for every Basket Component during the life of the option, the Multiple Payout Credit Default Basket Option would cease trading and expire.) For a Single Payout Credit Default Basket Option, once the Exchange confirms a Credit Event, the option would be automatically exercised and pay holders a single cash settlement for the first Basket Component that has a confirmed Credit Event, at which point the option would cease trading and expire. For both types of Credit Default Basket Options, if no Credit Event is confirmed in any Basket Component prior to the expiration date, the cash settlement amount would be \$0.

#### *Description of Rules Proposed*

The proposed new rules and amendments for the listing and trading of Credit Default Basket Options are layered into existing Chapter XXIX and are premised on the assumption that certain amendments, deletions, and additions to existing Chapter XXIX are effective.<sup>6</sup> Below, the Exchange specifies and describes the new rules and amendments currently being proposed for Credit Default Basket Options. Such new rules and amendments include, but are not

<sup>6</sup> See *supra* note 5.

limited to, new definitions, new margin requirements, and new settlement procedures. The Exchange also notes where it is proposing amendments to rules in Chapter XXIX so that Chapter XXIX would generally apply to Credit Options (*i.e.*, Credit Default Options and Credit Default Basket Options).<sup>7</sup>

a. Definitions (Changes to Rule 29.1)

The Exchange is proposing to supplement Rule 29.1 to include new definitions applicable to Credit Default Basket Options and to add and expand upon existing definitions. In particular, the Exchange is proposing new definitions for "Credit Option," "Credit Default Basket Option," "Notional Face Value of Basket," and "Notional Face Value of Basket Component."

The term "Credit Option" would be defined as an option that is subject to the rules in Chapter XXIX.

The term "Credit Default Basket Option" would be defined to mean a call option based on a basket comprised of at least two Reference Entities ("Basket Component(s)"), which would settle in cash in one of two manners. A Multiple Payout Credit Default Basket Option would automatically pay a cash settlement amount each time a Credit Event is confirmed in a Basket Component during the life of the option. A cash settlement amount would be paid only once in connection with a particular Basket Component that has a confirmed Credit Event, after which time that Basket Component would be removed from the Credit Default Basket. If a Credit Event is confirmed in every Basket Component prior to expiration, the option would cease to trade. A Single Payout Credit Default Basket Option would be automatically exercised and pay a single cash settlement amount as soon as the first Credit Event is confirmed in any one of the Basket Components. If no Credit Event is confirmed in any Basket Component prior to expiration, the option would expire worthless.

The term "Notional Face Value of Basket" would be defined as the total face value for the Credit Default Basket as specified by the Exchange at listing.

The term "Notional Face Value of Basket Component" would be defined as the weight of the Basket Component multiplied by the Notional Face Value of Basket as specified by the Exchange at listing.

The Exchange is also proposing to amend the existing definitions of "Cash

Settlement Amount," "Expiration Date," and "Last Trading Date" so that those terms would be applicable to Credit Default Basket Options. The term "Cash Settlement Amount" would be amended to include two sub-paragraphs so that the term would be defined separately for Credit Default Options and for Credit Default Basket Options. For Credit Default Options, the Exchange is proposing that the existing definition of "Cash Settlement Amount" would be codified as new subparagraph (a). For Credit Default Basket Options, the Exchange is proposing that a new definition of the term "Cash Settlement Amount" be codified as new subparagraph (b) and would be defined in terms of the amount paid for a Basket Component that has a confirmed Credit Event. That amount would be equal to one minus the Basket Component recovery rate specified by the Exchange at listing multiplied by the Notional Face Value of the Basket Component. The exercise settlement value would be equal to the cash settlement amount divided by the contract multiplier specified by the Exchange.

For example, if the Notional Face Value of the Basket Component is \$10,000 and the Exchange specifies a recovery rate of 40% (or 0.40) for the particular Basket Component in which a Credit Event is confirmed, the cash settlement amount would be \$6,000 (or  $\$10,000 * (1 - 0.40)$ ). For holders of a long Single Payout Credit Default Basket Option, the cash settlement amount, based on this equation, would be paid a single time when the first Credit Event is confirmed during the life of the option. In either type of Credit Default Basket Options, if no Credit Event is confirmed in any Basket Component, the cash settlement value would be \$0.

The term "Expiration Date" would be amended to include two sub-paragraphs so that the term would be defined separately for Credit Default Options and for Credit Default Basket Options.<sup>8</sup> As for Credit Default Basket Options, the term "Expiration Date" would be defined as the fourth business day after the third Friday of the expiration month (or, if that day is not a business day, the fourth business day after the preceding business day); provided, however, if a Credit Event is confirmed by the Exchange to members and the Clearing Corporation before that day in (i) Every Basket Component for a Multiple Payout Credit Default Basket Option; or (ii) the first Credit Event in any one of the

Basket Components for a Single Payout Credit Default Basket Option; or a Redemption Event, as provided for in Rule 29.4, has been confirmed in the last Basket Component prior to that day, the expiration date would be accelerated to the second business day immediately following the last confirmation date.

The term "Last Trading Date" would be amended to include two sub-paragraphs so that the term would be defined separately for Credit Default Options and for Credit Default Basket Options.<sup>9</sup> As for Credit Default Basket Options, the term "Last Trading Date" would be defined as the third Friday of the contract month (or if that day is not a business day, the preceding business day); provided, however, if a Credit Event has been confirmed by the Exchange to members and the OCC prior to that day in (i) Every Basket Component for a Multiple Payout Credit Default Basket Option; or (ii) the first Credit Event in any one of the Basket Components for a Single Payout Credit Default Basket Option; or a Redemption Event, as provided for in Rule 29.4, has been confirmed in the last Basket Component prior to that day, the series would cease trading at the time of the confirmation and the last trading day would be changed to the confirmation date.

The Exchange proposes to amend the existing definition of "Credit Event" so that it would apply to "Credit Default Basket Options." The change would include reference to Rules 29.2, *Designation of Credit Default Option Contracts*, and 29.2A, *Designation and Terms of Credit Default Basket Option Contracts*.

The Exchange proposes to amend the existing definition of "Reference Entity" so that it would apply to "Credit Default Basket Options." The Exchange also proposes to replace the word "underlying" with "underlies."

b. Initial and Maintenance Listing Criteria, Designation and Terms of Credit Default Basket Options, and Adjustment (Changes to Rule 5.3 and 5.4, Proposed Rule 29.2A, and Rule 29.4)

The Exchange proposes amending Rule 5.3.11, *Criteria for Underlying Securities*, so that it would apply to all Credit Options. Under the proposed criteria, the Exchange may list and trade a Credit Option that overlies a Reference Obligation of a Reference Entity,

<sup>7</sup> The Exchange is proposing changing all references to "Credit Default Options" in the Title and Introduction to Chapter XXIX to "Credit Options."

<sup>8</sup> The Exchange also proposes to make a conforming amendment to the definition of "Expiration Date" for Credit Default Options by replacing the phrase "the third Friday of the expiration month" with the phrase "that day."

<sup>9</sup> The Exchange also proposes to amend the definition of "Last Trading Day" for Credit Default Options by including the phrase "of a Redemption Event, as provided for in Rule 29.4, has been confirmed prior to that day." The Exchange also proposes to change the word "would" to "will."

provided that the Reference Entity satisfies the following: First, the Reference Entity or the Reference Entity's parent, if the Reference Entity is a wholly-owned subsidiary, must have at least one class of securities that is duly registered and is an "NMS stock" as defined in Rule 600 of Regulation NMS.<sup>10</sup> Second, the registered equity securities issued by the Reference Entity must also satisfy the requirements for continued options trading on CBOE pursuant to existing Exchange Rule 5.4.<sup>11</sup>

The Exchange also proposes amending Rule 5.4.15, *Withdrawal of Approval of Underlying Securities*, so that it would apply to all Credit Options. Rule 5.4.15 would similarly provide that Credit Options initially approved for options trading shall be deemed not to meet the Exchange's requirements for continued approval, and the Exchange would not open for trading any additional series of the class covering such options and may prohibit any opening purchases transactions in such series as provided in existing Rule 5.4, at any time the Exchange determines on the basis of information made publicly available that any of the listing requirements identified above are not satisfied.

Proposed Rule 29.2A would be added to provide the terms by which the Exchange would designate each Credit Default Basket Option class.<sup>12</sup> Under the proposed rule, the Exchange would designate each Credit Default Basket Option class by reference to: (i) The

Notional Face Value of Basket (e.g., \$100,000); (ii) the Basket Components; (iii) the weight of each Basket Component, which would represent the fraction of the Notional Face Value of the Basket allocated to each Basket Component; (iv) the recovery rate of each Basket Component; (v) the specified debt security that defines the Reference Obligation of each Basket Component (e.g., Corporation XYZ 8.375% July 2033 bond); and (vi) the applicable Credit Event(s). The applicable Credit Event(s) would include a Failure-to-Pay Default and may include any other Event(s) of Default or Restructuring that is specified by the Exchange.<sup>13</sup>

After a particular Credit Default Basket Option class has been approved for listing and trading on the Exchange, the Exchange would from time to time open for trading series of options on that class. Only Credit Default Basket Option contracts approved by the Exchange and currently open for trading on the Exchange would be eligible to be purchased or written on the Exchange. Prior to the opening of trading in a particular Credit Default Basket Options series in a given class, the Exchange would fix the expiration month and year. To the extent possible, CBOE intends to have Credit Default Basket Options recognized and treated like existing standardized options. Standardized systems for listing, trading, transmitting, clearing, and settling options, including systems used by OCC, would be employed in connection with Credit Default Basket Options. Credit Default Basket Options would also have a symbology based on the current system.

A Credit Default Basket Option series would generally be listed up to 123 months ahead of its expiration date and could expire in the months of March, June, September, and December. The Exchange usually would open one to four series for each year up to 10.25 years from the current expiration. Additional series of options on the same Credit Default Basket Option class could be opened for trading on the Exchange when the Exchange deems it necessary to maintain an orderly market or to meet customer demand. The opening of a new series of Credit Default Basket Options on the Exchange would not affect any other series of options of the same class previously opened.

The proposed amendment to Rule 29.4, *Adjustments*, which for purposes

of Credit Options would replace existing Rule 5.7, *Adjustments*, contains information about adjustments to Credit Default Basket Options due to succession or redemption events in the Reference Entity.

With respect to adjustments related to a succession, the proposed rule provides that a Basket Component may be replaced by one or more Basket Components ("Successor Basket Components") that would consist of the Successor Reference Entity(ies). For purposes of the proposed rule, a "Successor Reference Entity" and a "Succession Event" would be defined in accordance with the terms of the Relevant Obligations of the Basket Component that is subject to adjustment for succession. For each Successor Basket Component, the Exchange would specify the Reference Obligation (e.g., XYZ 8.375% December 2033 bond), recovery rate, and basket weight of each Successor Basket Component(s).

In respect of each Successor Basket Component, the newly specified weight(s) would equal the weight of the predecessor Basket Component replaced by the Successor Basket Component(s). For example, if two Successor Basket Components replaced one Basket Component, the Exchange would specify each of their recovery rates and the basket weight of each Successor Basket Component. The recovery rates of the Successor Basket Components could differ from the specified recovery rate of the predecessor Basket Component and the recovery rates of the two Successor Basket Components could differ from one another. However, the sum basket weights of the two Successor Basket Components (however apportioned by the Exchange) would equal the basket weight of the predecessor Basket Component.

All other terms and conditions of each Credit Default Basket Option containing a Successor Basket Component would be the same as the original Credit Default Basket Option unless the Exchange determines, in its sole discretion, that a modification is necessary and appropriate for the protection of investors and the public interest, including but not limited to the maintenance of fair and orderly markets, consistency of interpretation and practice, and the efficiency of settlement procedures.

With respect to adjustments related to a redemption, the proposed amendment provides that, once the Exchange has confirmed a Redemption Event in a Basket Component, that Basket Component will be removed from the Credit Default Basket. If a Credit Event has been confirmed to have occurred

<sup>10</sup> This criterion is designed to ensure that there is adequate information publicly available regarding the issuer of a debt security that serves as a Reference Obligation underlying a Credit Option. The market for debt securities serving as Reference Obligations is largely an over-the-counter market and many debt securities, including those among the most actively traded, are not themselves registered under Section 12 of the Act, 15 U.S.C. 78f. The issuers of many unregistered debt securities, however, have equity securities that are duly registered and are "NMS stocks" as defined in Rule 600 of Regulation NMS, 17 CFR 242.600. These issuers are required to provide periodic reports to the public due to the equity registration, and the fact that their debt securities are unregistered does not diminish in practical terms the information provided by their periodic reports. Thus, the requirements enable a wide array of Credit Options to be listed while ensuring sufficient public disclosure of information about any debt securities that serve as Reference Obligations underlying the exchange-traded Credit Options.

<sup>11</sup> The provisions of existing Rule 5.4.01 require that an equity security underlying an option be itself widely held and actively traded. The requirement that the securities of an issuer of a debt security meet the criterion of Rule 5.4.01 provides an additional assurance that such issuer's securities enjoy widespread investor interest.

<sup>12</sup> For ease of reference, the Exchange is proposing to place proposed Rule 29.2A immediately after Rule 29.2, *Designation of Credit Default Option Contracts*.

<sup>13</sup> The Exchange would specify the applicable Credit Event(s) in accordance with proposed amended Rule 29.1(c), new Rule 29.2A, and proposed amended Rule 29.4.

prior to the effective date of a Redemption Event, the cash settlement amount shall be as provided in Rule 29.1(a). The Credit Event confirmation period would begin when the Credit Default Basket Option contract is listed and would extend to 3 p.m. (CT) on the fourth Exchange business day after the effective date of the Redemption Event.

A "Redemption Event" would be defined in accordance with the terms of the Relevant Obligations and would include the redemption of the Reference Obligation and of all other Relevant Obligations. However, if the Reference Obligation is redeemed or matures but other Relevant Obligations remain, a new Reference Obligation would be specified from among the remaining Relevant Obligations and the substitution would not be deemed a Redemption Event.

As with Credit Default Options, the Exchange would confirm adjustment events affecting Credit Default Basket Options based on at least two sources, which may include announcements published via newswire services or information services companies, the names of which would be announced to the membership via Regulatory Circular, and/or information submitted to or filed with the courts, the Commission, an exchange or association, the OCC, or another regulatory agency or similar authority. Rule 29.4 would provide that every such determination made pursuant to the rule would be within the Exchange's sole discretion and be conclusive and binding on all holders and sellers and not subject to review.

c. Determination of Credit Events, Automatic Payout and Exercise, and Settlement (Amendments to Rules 29.9–29.10)

The Exchange proposes amending Rule 29.9, *Determination of Credit Event, Automatic Exercise and Settlement*, so that it would apply to Credit Default Basket Options. Specifically, the Exchange is proposing new text to Rule 29.9 that would provide that Credit Default Basket Options would be subject to automatic payouts and/or exercise upon the Exchange confirming that a Credit Event has occurred in a Basket Component between the listing date and the last trading date as follows: (i) Multiple Payout Credit Default Basket Options would be subject to automatic payouts each time a Credit Event is confirmed in a Basket Component;<sup>14</sup> and (ii) Single

Payout Credit Default Basket Options would be subject to automatic exercise as soon as a Credit Event is confirmed in any one of the Basket Components. As with Credit Default Options, the Credit Event confirmation period would begin when the Credit Default Basket Option is listed and would extend to 3 p.m. (CT) on the expiration date.

The Exchange would confirm a Credit Event based on at least two sources, which could include announcements published via newswire services or information services companies, the names of which would be announced to the membership via Regulatory Circular, or information submitted to or filed with the courts, the Commission, an exchange or association, the OCC, or another regulatory agency or similar authority. Every determination made pursuant to proposed Rule 29.9 would be within the Exchange's sole discretion and be conclusive and binding on all holders and sellers and not subject to review.

The proposed amendment to Rule 29.9 would also provide that, if the Exchange determines that a Credit Event in a Basket Component has occurred prior to 10:59 p.m. (CT) on the last trading day: (i) A Multiple Payout Credit Default Basket Option would automatically pay the cash settlement amount (*i.e.*, one minus the Basket Component recovery rate specified by the Exchange at listing multiplied by the Notional Face Value of the Basket Component); however, if a Credit Event has been confirmed by the Exchange for each Basket Component prior to the last day of trading, the Multiple Payout Credit Default Basket Option would cease trading upon confirmation of the last Credit Event; and (ii) a Single Payout Credit Default Basket Option would automatically exercise and pay the cash settlement amount (*i.e.*, one minus the Basket Component recovery rate specified by the Exchange at listing multiplied by the Notional Face Value of the Basket Component); however, if a Credit Event has been confirmed by the Exchange prior to the last day of trading, the Single Payout Credit Default Basket Option would cease trading upon confirmation of the Credit Event.

Once a Credit Event is confirmed, the Exchange would provide the OCC with notice of the Credit Event and notice of the applicable cash settlement value, similar to the notification procedures that are in place for existing products trading on the Exchange. The rights and obligations of holders and sellers of Credit Default Basket Options dealt in

on the Exchange shall be set forth in the by-laws and rules of OCC.

The Exchange proposes amending Rule 29.10 so that it would apply to all Credit Options and would provide that the "reporting authority" as used in this rule refers to the Exchange or any other entity identified by the Exchange as the "reporting authority" in respect of a class of Credit Default Options for purposes of the by-laws and rules of the OCC and any affiliate of the Exchange or any such other entity. No reporting authority makes any warranty, express or implied, as to the results to be obtained by any person or entity from the use of any Credit Default Option. Any reporting authority hereby disclaims all warranties of merchantability or fitness for a particular purpose or use with respect to any Credit Default Option. Any reporting authority shall have no liability for any damages, claims, losses (including any indirect or consequential losses), expenses, or delays, whether direct or indirect, foreseen or unforeseen, suffered by any person relating to any Credit Default Option, including without limitation as a result of any error, omission, or delay in confirming, or disseminating notice of, any Credit Event, any determination to adjust or not to adjust the terms of outstanding Credit Options, or any other determination with respect to Credit Default Options for which it has responsibility under the by-laws and rules of the OCC.

d. Position Limits, Reporting Requirements, Exercise Limits, and Other Restrictions (Amendments to Rules 29.5–29.8)

The Exchange is proposing that the position limits for Credit Default Basket Option contracts be equal to 50,000 contracts on the same side of the market. The Exchange believes that position limits set at this level would inhibit market manipulation or would mitigate other possible disruptions in the market. However, over time and based on the Exchange's experience in trading Credit Default Basket Options, CBOE may seek to increase these limits. Any such increase would be reflected through a rule filing submitted pursuant to Section 19(b) of the Act.<sup>15</sup>

In determining compliance with the Exchange's position limit requirements, the proposed amendment to Rule 29.5 would provide that Credit Default Basket Options shall not be aggregated with option contracts on the same or similar underlying security. CBOE believes that the nature of Credit Default

<sup>14</sup> As provided in proposed Rule 29.1(h)(i), a cash settlement amount would be paid only once in connection with a particular Basket Component that has a confirmed Credit Event, after which time that

Basket Component would be removed from the Credit Default Basket.

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

Basket Options as well as the risk/return profile of these options provides significant differences to existing standardized options that render aggregation of such positions unnecessary. In addition, Credit Default Basket Options would not be subject to the hedge exemption to the standard position limits found in existing Rule 4.11.04.

Instead, the following qualified hedge exemption strategies and positions would be exempt from the established 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 (e.g., \$100,000 for a Credit Default Basket Option with a Notional Face Value of Basket of \$100,000); and (ii) a Credit Default Basket Option position "hedged" or "covered" by a sufficient amount of any of the Basket Component debt securities, instruments, or interests related to the Reference Entity that equals the sum of the cash settlement amounts for Basket Components for a Multiple Payout Credit Default Basket Option or equals the maximum Basket Component cash settlement amount for a Single Payout Credit Default Basket Option.

The Exchange proposes amending Rule 29.5 so that it would apply to all Credit Options. Therefore, the existing Market-Maker and firm facilitation exemptions to position limits currently available to members under existing Rules 4.11.05 and 4.11.06, respectively, would also apply. Pursuant to Rule 4.11.05 (the Market-Maker exemption), the Exchange may grant a Market-Maker an exemption from the standard position limit of 50,000 contracts for Credit Default Basket Options for the purpose of maintaining a fair and orderly market. With respect to Credit Default Basket Options, Rule 29.5 makes clear that a Market-Maker's position would have to generally be within 20% of the applicable limit of 50,000 contracts before an exemption would be granted. Pursuant to Rule 4.11.06 (the firm facilitation exemption), the Exchange may grant a member organization an exemption from the standard position limit of 50,000 contracts for Credit Default Basket Options for the purpose of facilitating a customer order. With respect to Credit Default Basket Options, Rule 29.5 makes clear that a member organization's aggregate exemption position could not exceed three times the standard limit of 50,000 contracts and would be applied consistent with the procedures described in existing Rule 4.11.06.

The Exchange proposes amending Rule 29.6, *Reports Related to Position*

*Limits and Liquidation of Positions*, so that it would apply to all Credit Options. Therefore, the standard equity reporting requirements described in existing Rule 4.13, *Reports Related to Position Limits*, would be applicable to Credit Options. As such, in accordance with Rule 4.13(a), positions in Credit Options would be reported to the Exchange via the Large Option Positions Report when an account establishes an aggregate same side of the market position of 200 or more Credit Options. In computing reportable Credit Options under existing Rule 4.13, Credit Options could not be aggregated with non-Credit Option contracts. In addition, Credit Options on a given class shall not be aggregated with any other class of Credit Options. Rule 4.13(b) imposes additional reporting requirements for positions in excess of 10,000 contracts. The reporting requirements in Rule 4.13(b) would also apply to Credit Options, except that the reporting requirement would be triggered for a Credit Option position on behalf of a member's account or for the account of a customer in excess of 1,000 contracts on the same side of the market, instead of the normal 10,000 contract trigger amount. The data to be reported would include, but would not be limited to, the Credit Option positions, whether such positions are hedged, and documentation as to how such contracts are hedged. The Exchange believes that the reporting requirements and the surveillance procedures for hedged positions would enable the Exchange to closely monitor sizable positions and corresponding hedges.

The Exchange proposes amending Rule 29.7, so that it would apply to all Credit Options and, as a result, there would be no exercise limits for Credit Options.

The Exchange proposes amending Rule 29.8, so that it would apply to all Credit Options. Rule 29.8 would provide that Credit Options shall also be subject to existing Rule 4.16, *Other Restrictions on Options Transactions and Exercises*, which provides the Exchange's Board with the power to impose restrictions on transactions or exercises in one or more series of options of any class dealt in on the Exchange 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.

CBOE believes the proposed safeguards would serve sufficiently to help monitor open interest in Credit Option series and significantly reduce any risks.

e. Margin Requirements (Amendment to Rules 12.3 and 12.5)

The Exchange is proposing to amend Rule 12.3(I), *Margin Requirements*, so that it would apply to all Credit Options. Rule 12.3(I) would also be amended to include sub-paragraphs so that margin account and cash account requirements would be defined separately for Credit Default Options and for Credit Default Basket Options.

In addition, the Exchange is also proposing to supplement Rule 12.3(I), to include requirements applicable to the initial and maintenance margin required on any Credit Default Basket Options carried in a customer's account. The requirements would be as follows: The initial and maintenance margin required on any Credit Default Basket Option carried long in a customer's account would be 100% of the current market value; provided, however, for the account of a qualified customer, the margin would be 15% of the current market value.

The initial and maintenance margin required on any Credit Default Basket Option carried short in a customer's account would be as follows: (i) For Multiple Payout Credit Default Basket Options, the sum of each Basket Component's cash settlement amount as defined in Rule 29.1; provided, however, for the account of a qualified customer (as defined in Rule 12.3(I)(1)(i)), the margin would be the lesser of the current market value plus 15% of the sum of each Basket Component's cash settlement amount as defined in Rule 29.1 or of the sum of each Basket Component's cash settlement amount; or (ii) for Single Payout Credit Default Basket Options, the Basket Component cash settlement amount as defined in Rule 29.1 that is highest; provided, however, for the account of a qualified customer (as defined in Rule 12.3(I)(1)(i)), the margin would be the lesser of the current market value plus 15% of the Basket Component cash settlement defined in Rule 29.1 that is the highest or the Basket Component cash settlement amount that is the highest.

The Exchange proposes amending Rule 12.5, *Determination of Value for Margin Purposes*, so that it would apply to all Credit Options. Rule 12.5 would provide that Credit Options carried for the account of a qualified customer may be deemed to have market value for the purposes of the customer margin account provisions provided in existing Rule 12.3(c). For purposes of these proposed provisions, the term "qualified customer" would be defined as a person or entity that owns and

invests on a discretionary basis no less than \$5,000,000 in investments.

Under the proposal, a deposit of cash or marginable securities could satisfy Credit Default Basket Option margin requirements.

The proposed margin provisions also would provide that a Credit Default Basket Option carried short in a customer's account be deemed a covered position, and eligible for the cash account, provided any one of the following either 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 as defined in Rule 29.1; (ii) For Single Payout Credit Default Basket Options, cash or cash equivalents equal to 100% of the Basket Component cash settlement amount as defined in Rule 29.1 that is the highest; or (iii) an escrow agreement.

Under the proposal, the escrow agreement must certify that the bank holds for the account of the customer as security for the agreement (i) Cash, (ii) cash equivalents, (iii) one or more qualified equity securities, or (iv) a combination thereof having an aggregate market value of not less than 100% of the sum of each Basket Component's cash settlement amount sum as defined in Rule 29.1 in the case of Multiple Payout Credit Default Basket Options or 100% of the Basket Component cash settlement amount as defined in Rule 29.1 that is the highest in the case of Single Payout Credit Default Basket Options, and that the bank will promptly pay the member organization the cash settlement amount in the event of a Credit Event as defined in Rule 29.1. In addition, in accordance with Rule 12.3(a)(3), an escrow agreement must be issued in a form acceptable to the Exchange. In this regard, the Exchange notes that it has traditionally recognized as acceptable the escrow agreement forms of the OCC and the New York Stock Exchange.

The Exchange notes that, in accordance with Rule 12.10, *Margin Required is Minimum*, the Exchange would also have the ability to determine at any time to impose higher margin requirements than those described above in respect of any Credit Default Basket Option position(s) when it deems such higher margin requirements appropriate.

In setting the proposed margin requirements, particularly those with respect to qualified customers, and the proposed position limit and reporting requirements described above, the

Exchange has been cognizant of the sophistication and capitalization of the particular market participants and their need for substantial options transaction capacity to hedge their substantial investment portfolios, on the one hand, and the potential for untoward effects on the market and on firms that might be attributable to excessive Credit Default Basket Option positions, on the other. The Exchange has also been cognizant of the existence of the competitive OTC market, in which similar restrictions do not apply. For these reasons, the Exchange believes that the requirements set forth in the proposed rules strike a necessary and appropriate balance and adequately address concerns that a member or its customer may try to maintain an inordinately large unhedged position in Credit Default Basket Options.

As part of its regulatory oversight of member organizations, the Exchange, in its capacity as a Designated Examining Authority ("DEA"), generally reviews member organizations' compliance with margin requirements applicable to customer accounts. In the future, the Exchange will include Credit Default Basket Option margin requirements as part of this review. Additionally, the Exchange, as a DEA, will review applicable member organizations' internal procedures for managing credit risk associated with extending margin to customers trading Credit Default Basket Options. The Exchange also notes that, pursuant to Rule 12.10, the Exchange may at any time impose higher margin requirements when it deems such higher margin requirements advisable.

#### f. Trading Mechanics for Credit Default Basket Options and Credit Options Generally Where Applicable (Amendments to Rules 29.11–29.15 and 29.17–29.19)

The Exchange proposes to trade all Credit Options, including Credit Default Basket Options, similar to the manner in which it trades equity options on its Hybrid Trading System ("Hybrid"). This is the same manner in which the Exchange proposed to trade Credit Default Options. As a result, the Exchange is proposing to globally amend the rules governing the trading mechanics for Credit Default Options to apply to Credit Options in general. Where applicable, the Exchange notes proposed amendments that are specific to Credit Default Basket Options.

- *Days and Hours of Business (Amendment to Rules 29.11 and Rule 6.1):* The Exchange proposes amending Rule 29.11 so that it would apply to all Credit Options. Rule 29.11 provides that, except under unusual conditions

as may be determined by the Exchange, the hours during which Credit Options transactions may be made on the Exchange would be from 8:30 a.m. to 3:00 p.m. (CT). The Exchange notes that there is a cross-reference to Rule 29.11 in existing Rule 6.1, *Days and Hours of Business*. This reflects that Rule 29.11 supplements existing Rule 6.1. The Exchange similarly proposes to amend Rule 6.1 so that it would apply to all Credit Options.

- *Trading Rotations (Amendment to Rule 29.12):* The Exchange proposes amending Rule 29.12 so that it would apply to all Credit Options. Trading rotations would generally be conducted through use of the Hybrid Opening System ("HOSS"), which is described in existing Rule 6.2B. Normally, equity options open at a randomly selected time following the opening of the underlying security. Because Credit Options would not have a traditional underlying security, the opening rotation process would begin at a randomly selected time within a number of seconds after 8:30 a.m. (CT), unless unusual circumstances exist.

- *Trading Halts and Suspension of Trading (Amendment to Rule 29.13):* The Exchange proposes amending Rule 29.13 so that it would apply to all Credit Options. The trading halt procedures contained in existing Rules 6.3 and 6.3B that are applicable to equity options would also be applicable to Credit Options. In addition, Rule 29.13 would provide that another factor that may be considered by Floor Officials in connection with the institution of trading halts under existing Rule 6.3 in Credit Options is that current quotations for the Relevant Obligations or other securities of the Reference Entity are unavailable or have become unreliable.

- *Premium Bids and Offers & Minimum Increments, Priority, and Allocation (Amendment to Rule 29.14):* The Exchange proposes amending Rule 29.14 so that it would apply to Credit Default Basket Options and, where applicable, generally to all Credit Options. Bids and offers for Credit Default Basket Options would be expressed in terms of dollars per the contract multiplier unit (e.g., a bid of "7" would represent a bid of \$7,000 for a Credit Option with a specified contract multiplier of 1,000). In addition, the minimum price variation ("MPV") for bids and offers on both simple and complex orders for Credit Default Basket Options would be \$0.05. All bids or offers made for Credit Option contracts shall be deemed to be for one contract unless a specific number of option contracts is expressed in the bid or offer. A bid or offer for more than one



option contract shall be deemed to be for the amount thereof or a smaller number of option contracts. The rules of priority and order allocation procedures set forth in Rule 6.45A, *Priority and Allocation of Equity Option Trades on the CBOE Hybrid System*, shall apply to Credit Options.

- *Nullification and Adjustment of Credit Default Option Transactions (Amendment to Rule 29.15)*: The provisions in existing Rule 6.25, which pertain to the nullification and adjustment of equity option transactions, would be generally applicable to Credit Options. The Exchange proposes amending Rule 29.15 so that it would apply to all Credit Options. Rule 29.15 provides that for Credit Options, there would be two categories of obvious errors. The first type of error pertains to an obvious pricing error, which occurs when the execution price of an electronic transaction is below or above the theoretical price range (*i.e.*, \$0–\$100) for the series by an amount equal to at least 5% per contract. Trading Officials would adjust such transactions to a price within 5% of the theoretical price range (*i.e.*, to—\$5 or \$105), unless both parties agree to a nullification. The second type of error pertains to electronic or open outcry transactions arising out of a verifiable disruption or malfunction in the use or operation of any Exchange automated quotation, dissemination, execution, or communication system. Trading Officials would nullify such transactions, unless both parties agree to an adjustment. All other provisions of existing Rule 6.25 related to procedures for review, and obvious error panel and appeals committee reviews, would apply unchanged.

- *Market-Maker Appointments & Obligations (Amendment to Rule 29.17)*: The Exchange proposes amending Rule 29.17 so that it would apply to all Credit Options. Rule 29.17 provides that the Market-Maker appointment process for Credit Option classes shall be the same as the appointments for other options, as set out in existing Rules 8.3, *Appointment of Market-Makers*; 8.4, *Remote Market-Makers*; 8.15A, *Lead Market-Makers in Hybrid Classes*; and 8.95, *Allocation of Securities and Location of Trading Crowds and DPMs*. This rule would further provide that an appointed Market-Maker may, but would not be obligated to, enter a response to a request for quotes in an appointed Credit Option class and need not provide continuous quotes or quote a minimum bid-offer spread. When quoting, the Market-Maker's minimum value size would be at least one

contract. With respect to an appointed DPM or LMM, as applicable, there would be additional obligations to enter opening quotes in accordance with existing Rule 6.2B, *Hybrid Opening System ("HOSS")*, in 100% of the series in the appointed class and to enter a quote in response to any open outcry request for quotes on any appointed Credit Option class. The Exchange also could establish permissible price differences for one or more series of classes of Credit Options as warranted by market conditions. These quoting mechanics would be similar to the mechanics that exist today for trading Flexible Exchange Options ("FLEX Options") on the Exchange.

- *Exchange Authority (Existing Rule 29.18)*: Existing rule 29.18 provides that, for purposes of options that are subject to Chapter XXIX, references in the Exchange Rules to the appropriate committee shall be read to be to the Exchange.<sup>16</sup> Under this rule, the Exchange may determine to assign these authorities with respect to options that are subject to Chapter XXIX, including Credit Default Basket Options, to committees and/or Exchange staff. Under this rule, the Exchange has the flexibility to delegate the authorities under the rules with respect to options that are subject to Chapter XXIX, including Credit Default Basket Options, to an appropriate committee or appropriate Exchange staff and does not have to make a rule change merely, for instance, to accommodate the reassignment of any such authority.

- *FLEX Trading Rules (Amendment to Rule 29.19)*: In addition to Hybrid, the Exchange is proposing that all Credit Options also would be eligible for trading as FLEX Options. For purposes of existing Chapter XXIVA and proposed Chapter XXIVB, which chapters contain the Exchange's rules pertaining to FLEX Options, references to the term "FLEX Equity Options" would include a Credit Option and references to the "underlying security" or "underlying equity security" in respect of a Credit Default Option would mean the Reference Obligation as defined in proposed Rule 29.1. For purposes of existing Rule 24A.4 and Rule 24B.4, FLEX Equity Options that are Credit Options would be cash-settled and may have maximum terms equal in length to those provided for under Rules 29.2 and 29.2A, and the

<sup>16</sup> For example, references to determinations regarding the applicable opening parameter settings established by the "appropriate Procedure Committee" in Exchange Rule 6.2B, *Hybrid Opening System ("HOSS")*, are read to be by the "Exchange."

exercise by exception provisions of OCC Rule 805 would not apply.

These trading mechanics are designed to create a modified trading environment that takes into account the relatively small number of transactions that are likely to occur in this sophisticated, large-size market, while at the same time providing the Credit Default Basket Options market with the price improvement and transparency benefits of competitive Exchange floor bidding, as compared to the OTC market. The Exchange believes that the resulting market environment would be fair, efficient, and creditworthy and, as such, would prove to be particularly suitable to the large sophisticated trades and investors that now resort to the OTC market to affect these types of options transactions.

#### g. Options Disclosure Document

To accommodate the listing and trading of Credit Default Basket Options, it is expected that the OCC would amend its by-laws and rules to reflect the different structure of Credit Default Basket Options.<sup>17</sup> In addition, the Exchange states that the OCC has sought to revise the Options Disclosure Document ("ODD") to incorporate Credit Default Basket Options.<sup>18</sup>

#### h. Systems Capacity

CBOE represents that it believes the Exchange and the Options Price Reporting Authority have the necessary systems capacity to handle the additional traffic associated with the listing and trading of Credit Default Basket Options as proposed herein.

#### i. Applicability of Rule 9b–1 under the Act

The Exchange asks the Commission to clarify that Credit Default Basket Options are standardized options under Rule 9b–1 Under the Act.<sup>19</sup> Subsection (a)(4) of Rule 9b–1<sup>20</sup> defines "standardized options" as "options 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."

<sup>17</sup> See SR–OCC–2007–06 (proposal by OCC to amend and supplement its by-laws and rules to clear and settle "credit default basket options" proposed to be listed CBOE).

<sup>18</sup> See Securities Exchange Act Release No. 55921 (June 18, 2007) (SR–ODD–2007–03) (approving accelerated delivery of supplement to the ODD reflecting certain changes to disclosure regarding credit default options).

<sup>19</sup> 17 CFR 240.9b–1.

<sup>20</sup> 17 CFR 240.9b–1(a)(4).



Credit Default Basket Options are like existing standardized options trading on CBOE in every respect except for the exercise price. Credit Default Basket Options (i) Trade on a national securities exchange, (ii) have a specific expiration date, (iii) have fixed terms, (iv) have a specific exercise style, and (v) would be issued and cleared by the OCC. All of these are attributes of "standardized options" as defined in Rule 9b-1. The one respect with which Credit Default Basket Options differ from existing standardized options is in the exercise price.

- "Exercise price" is not a defined term in Rule 9b-1. However, the significance of having a specific exercise price term in a standardized option is that traditionally it, in conjunction with the specific exercise style (e.g., American-, European-, or capped-style), symbolizes the formula for calculating the exercise settlement of the option that is publicly known and announced, objectively determined, and unalterable. For example, in the case of a physical delivery option, the exercise price (which is sometimes called the "strike price") is the price at which the option holder has the right either to purchase (in the case of a call) or to sell (in the case of a put) the underlying interest upon exercise.<sup>21</sup> In the case of a cash-settled option, the exercise price is the base used for determining the amount of cash, if any, that the option holder is entitled to receive upon exercise (referred to as the "cash settlement amount").<sup>22</sup> Traditionally, the cash settlement amount is the amount by which the exercise settlement value of the underlying interest of a cash-settled call exceeds the exercise price, or the amount by which the exercise price of a cash-settled put exceeds the exercise settlement value of the underlying interest, multiplied by the multiplier for the option.

Whereas for traditional cash-settled options the cash settlement amount is determined by reference to the particular price of the underlying interest, the cash settlement amount for a Credit Default Basket Option would be an amount established by a fixed equation at the listing of the option. The equation would establish the cash settlement amount of a Credit Default Basket Option as one minus the Basket Recovery Rate specified by the Exchange at listing multiplied by the Notional Face Value of the Basket Component.

The cash settlement amount would be automatically paid each time a Credit

Event is confirmed for a Basket Component for a Multiple Payout Credit Default Basket Options. This amount would be paid only once in connection with a particular Basket Component, after which time that Basket Component would be removed from the Credit Default Basket. For Single Payout Credit Basket Options, the cash settlement amount would be paid a single time when the first Credit Event is confirmed. As with traditional cash-settled options, the calculation of the cash settlement amount of a Credit Default Basket Option would be established prior to the commencement of trading according to this formula, which would be publicly known and announced, objectively determined, and unalterable. Thus, as with a traditional cash-settled option, a party entering into a Credit Default Basket Option would know exactly the terms under which a Credit Default Basket Option would be automatically paid and/or automatically exercised and the option's cash settlement amount. In this regard, the Exchange believes that Credit Default Basket Options, by their proposed terms, would be standardized options within the meaning of Rule 9b-1.

If the Commission cannot determine that Credit Default Basket Options are, by their proposed terms, standardized options, the Exchange requests that the Commission use its authority under Rule 9b-1(a)(4) to otherwise designate options, such as Credit Default Basket Options, as standardized options. The Commission used this authority very recently in 2007 to designate "Credit Default Options" as standardized options.<sup>23</sup> In making this designation the Commission found that Credit Default Options "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 obligation 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." Credit Default Basket Options are a grouping or collection of Credit Default Options. Therefore, the Exchange believes that Credit Default Basket Options share all of the same characteristics recently highlighted by the Commission warranting their

designation as standardized for purposes of Rule 9b-1.

#### j. Surveillance Program

The Exchange represents that it 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 Basket Options.

#### 2. Statutory Basis

The Exchange believes the proposed rule change is consistent with the Act and the rules and regulations under the Act applicable to national securities exchanges. Specifically, the Exchange believes the proposed rule change is consistent with the Section 6(b)(5)<sup>24</sup> requirements that the rules of an exchange be designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts, to remove impediments to and to perfect the mechanism for 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

CBOE does not believe that the proposed rule change would impose 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

No written comments were solicited or received with respect to the proposed rule change.

#### 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 self-regulatory organization 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.

The Commission has determined that a 15-day comment period is appropriate in this case.

<sup>21</sup> See ODD at 6-7.

<sup>22</sup> See *id.*

<sup>23</sup> See *supra* note 4.

<sup>24</sup> 15 U.S.C. 78f(b)(5).

#### 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-CBOE-2007-26 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-2007-26. 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 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-2007-26 and should be submitted on or before July 13, 2007.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>25</sup>

**Florence E. Harmon,**

*Deputy Secretary.*

[FR Doc. E7-12485 Filed 6-27-07; 8:45 am]

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#### SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-55940; File No. SR-DTC-2007-04]

#### **Self-Regulatory Organizations; The Depository Trust Company; Notice of Filing of a Proposed Rule Change Relating to a Policy Statement on the Eligibility of Foreign Securities**

June 21, 2007.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> notice is hereby given that on April 19, 2007, The Depository Trust Company ("DTC") 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 DTC. 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 add a new Policy Statement on the Eligibility of Foreign Securities to DTC's rules.<sup>2</sup>

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

In its filing with the Commission, DTC 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. DTC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of such statements.<sup>3</sup>

<sup>25</sup> 17 CFR 200.30-3(a)(12).

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

<sup>2</sup> A Policy Statement is used by DTC to clarify and consolidate the Rules of DTC with respect to the subject of the Policy Statement. A Policy Statement is a part of the Rules of DTC. As such, pursuant to Rule 2 Section 1 of the DTC Rules and the Participants Agreement that participants enter into with DTC, a Policy Statement is binding on DTC participants.

<sup>3</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 Policy Statement is to set forth in a single place in an accessible manner the criteria and procedures for making the securities of foreign issuers ("Foreign Securities") eligible for deposit and book-entry transfer through the facilities of DTC in accordance with the Securities Act of 1933 ("Securities Act")<sup>4</sup> and the rules and regulations of the Commission thereunder. For purposes of the Policy Statement, (1) the term "security" has the meaning provided in Section 2(a)(1) of the Securities Act,<sup>5</sup> (2) the term "foreign issuer" has the meaning provided in Rule 405 of the Commission under the Securities Act (and includes both a "foreign government" and a "foreign private issuer" as defined in Rule 405)<sup>6</sup> and (3) capitalized terms that are used but not otherwise defined in the Policy Statement have the meanings given to such terms in the Rules of DTC.

The Policy Statement covers both Foreign Securities deposited with DTC at the time that such Foreign Securities are first distributed (referred to as "new issues" in the DTC system) and Foreign Securities deposited with DTC subsequent to the time that such Foreign Securities are first distributed (referred to as "older issues" in the DTC system). The criteria and procedures for making new issues of Foreign Securities eligible for deposit and book-entry transfer through the facilities of DTC have previously been codified by DTC. The criteria and procedures for making older issues of Foreign Securities eligible for deposit and book-entry transfer through the facilities of DTC have not previously been codified by DTC. Accordingly, what would be new in the Policy Statement are the criteria and procedures for making older issues of unregistered Foreign Securities DTC-eligible.<sup>7</sup> These are generally securities that may be freely traded outside the U.S. over the counter or on foreign exchanges or traded in the U.S. over the counter market subject to the resale restrictions of the Securities Act.

The proposed rule change, as it relates to older issues of unregistered Foreign

<sup>4</sup> 15 U.S.C. 77 *et seq.*

<sup>5</sup> 15 U.S.C. 77b(a)(1).

<sup>6</sup> 17 CFR 230.405. The term foreign issuer means any issuer which is a foreign government, a national of any foreign country or a corporation or other organization incorporated or organized under the laws of any foreign country.

<sup>7</sup> Registered securities, whether new issues or older issues, whether foreign or domestic, can always be made DTC-eligible.