



Regulatory Circular RG07-67

To: Members and Member Organizations
From: Division of Member and Regulatory Services
Date: June 15, 2007
Subject: Margin and Net Capital Requirements
for CBOE Credit Default Options
Exchange
Contact: James Adams, (312) 786-7718

KEY POINTS

- On June 19, 2007, Chicago Board Options Exchange ("CBOE") plans to list and begin trading CBOE Credit Default Options ("CDOs").
- Only a Qualified Customer¹ may purchase CDOs on margin (20%). Only a Qualified Customer may write a CDO on margin (see below for requirement).
- Risk-based haircut treatment is not available for CDOs at this time. A position or strategy-based requirement applies.

DISCUSSION

CDOs are binary call options that pay \$100,000 upon the confirmation of a Credit Event in a Reference Entity and \$0 if there is no Credit Event prior to the last trading day.

There are no exercise prices associated with CDOs. They are automatically exercised if a Credit Event is confirmed. If no Credit Event is confirmed, they will contain trading until the last trading day.

The Reference Entity for a CDO can be an issuer or guarantor with securities listed on a U.S. national market. A Reference Entity is said to have a "Credit Event" if any one of the following occurs between the listing date and the last trading day:

(1) A Failure-to-Pay Default on its Reference Obligation (e.g., Company ABC 8.5% July 2013 bond) or on any other debt security obligations of the Reference Entity (the set of these obligations and the Reference Obligation are referred as the "Relevant Obligations"). A "Failure-to-Pay Default" will be defined in

¹ A "Qualified Customer" is defined as a person or entity that owns and invests on a discretionary basis no less than \$5,000,000 in investments.

accordance with the terms of the Relevant Obligation(s), 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

(2) The occurrence of any other Event of Default on the Relevant Obligation(s), with each such "Event of Default" being specified by the Exchange and, if so specified, defined in accordance with the terms of the Relevant Obligation(s); provided that the default 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

(3) A change in the terms of the Relevant Obligation(s) (a "Restructuring"). The terms of such a Restructuring will be specified by the Exchange and, if so specified, will be defined in accordance with the terms of the Relevant Obligation(s); 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).

Each CDO class shall specify (a) the Reference Entity, (b) the specific debt security that serves as the Reference Obligation and (c) the applicable Credit Events.

More detailed information about CDOs can found on the CBOE's website at www.cboe.com/micro/credit/introduction.aspx.

MARGIN

Margin requirements for CDOs are set-forth in CBOE Rule 12.3(l).²

Initial and Maintenance Margin

Purchases of CDOs must be paid for in full. Writers of CDOs must deposit / maintain 100% of the cash settlement amount. CDOs have no value for margin equity purposes, except in the case of a Qualified Customer (see below).

Initial and Maintenance Margin – Qualified Customer³

Purchases – 20% of the purchase amount*

Sales (short) – the lesser of:

- option proceeds* plus 20% of the cash settlement value, or
- the cash settlement value

² CBOE Credit Default Options are not eligible for a Portfolio Margin Account.

³ See supra note 1.

Member organizations must be able to demonstrate that a person or entity is a Qualified Customer. Member organizations are expected to learn essential facts relating to a person or entity on an on-going basis through normal contact with the person or person(s) acting on behalf of a Qualified Customer account, and through updates of customer information on file, as required by other rules, in order to determine whether the person or entity remains eligible for Qualified Customer status.

*For calculating maintenance margin, use option current market value instead of purchase amount / option proceeds. CDOs in the margin account of a Qualified Customer may be valued at current market value for margin equity purposes. Additional margin may be required pursuant to Exchange Rule 12.10.

Spreads

No margin is required other than payment of the net debit in full in the case of a long CDO held with a Short CDO having the same underlying Reference Obligation, provided the long option does not expire before the short option, CBOE Rule 12.3 (c)(5)(C)(4).

Cash Account

The sale (short) of a CDO is deemed a covered position, and eligible for the cash account, provided any of the following is either held in the account at the time the option is written or is received into the account promptly thereafter:

- cash or cash equivalents equal to 100% of the cash settlement amount, or
- an escrow agreement.

The escrow agreement must certify that the bank holds for the account of the customer as security for the agreement (A) cash, (B) cash equivalents, (C) one or more qualified equity securities, or (D) a combination thereof having an aggregate market value of not less than 100% of the cash settlement amount as defined in Rule 29.1 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. (Note: The Options Clearing Corporation is not currently accepting escrow agreements for CDOs.)

OPTION MARKET-MAKER MARGIN REQUIREMENTS

Pursuant to CBOE Rule 12.3(f), member organizations may margin the CDO transactions of a CDO market-maker on a good faith basis.

NET CAPITAL

Risk-based haircut treatment is not available for CDOs at this time. The requirements given below are the result of consultation with staff of the Securities and Exchange Commission (the "Commission") as to how to apply the Commission's Net Capital Rule (Rule 15c3-1) to CDOs. Discussions with Commission staff continue and modifications or alternative treatments may follow. The current haircut requirements are as follows:

Long positions are subject to a deduction of 15% of the cash settlement amount of the CDO less any amount by which the current market value of the option is below 15% of the cash settlement amount.

Short positions are subject to a deduction of 15% of the cash settlement amount of the CDO less any amount by which the current market value of the option exceeds 85% of the cash settlement amount.

Where a broker-dealer is short a CDO and is also long a CDO having the same underlying Reference Obligation (debt security / securities), a \$1,000 deduction is required.

Where a broker-dealer has a short position in a CDO and also has an offsetting long position in put options overlying equity securities of the issuer or guarantor whose debt security is the Reference Obligation, and the aggregate exercise price amount of the puts rounded to the nearest contract equals \$100,000, the combined deduction on the CDO and puts is 15% of the cash settlement amount, less any amount by which the current market value of the CDO exceeds 85% of the cash settlement amount.

Where a broker-dealer has a long position in a CDO and also has an offsetting long position in \$150,000 principal value of the debt security that is the underlying Reference Obligation, the deduction on the CDO and debt security combined is the greater of 15% of the current market value of the debt security or 7.5% of the principal amount of the debt security.

Where a broker-dealer has a short position in a CDO and also has an offsetting short position in \$150,000 principal value of the debt security that is the underlying Reference Obligation, the deduction on the CDO and debt security combined is the greater of 15% of the current market value of the debt security or 7.5% of the principal amount of the debt security.

Undue Concentration. In the two largest classes of CDOs carried by a broker-dealer, as measured in net long or short current market value, a broker-dealer shall deduct 100% of the current market value of any net long position, and deduct 100% of the cash settlement amount of any net short position. For purposes of this Undue Concentration calculation, the term “class” means all CDOs having a Reference Obligation tied to a single issuer or guarantor.

Questions regarding the margin and capital treatment of CDOs should be directed to James Adams at (312) 786-7718.