



## Regulatory Circular RG07-82

To: Members and Member Organizations  
From: Division of Member and Regulatory Services  
Date: July 27, 2007  
Subject: Margin and Net Capital Requirements  
for Basket Credit Event Binary Options  
Exchange  
Contact: James Adams, (312) 786-7718

### KEY POINTS

- On July 31, 2007, the Chicago Board Options Exchange (“CBOE”) plans to list and begin trading Basket Credit Event Binary Options (“Basket CEBOs”), pending receipt of regulatory approval.<sup>1</sup>
- Only a Qualified Customer<sup>2</sup> may purchase Basket CEBOs on margin (15%). Only a Qualified Customer may write a Basket CEBO on margin (see below for requirement).
- Risk-based haircut treatment is not available for Basket CEBOs. A position or strategy-based requirement applies.

### DISCUSSION

Basket CEBOs are Credit Event binary call options that have several Reference Entity components and are specified as either multiple payout or single payout.

Upon the confirmation of a Credit Event in any of the Reference Entities composing a **multiple** payout Basket CEBO, a predetermined settlement value is paid to the option holder. The Reference Entity experiencing the Credit Event is removed and the option continues to exist until its expiration, with additional Credit Events and payouts possible. A multiple payout Basket CEBO pays \$0 if there is no Credit Event in any Reference Entity prior to the last trading day.

Upon the confirmation of a Credit Event in any one of the Reference Entities composing a **single** payout Basket CEBO, a predetermined settlement value is paid to the option

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<sup>1</sup> Initially, only multiple payout Basket CEBOs will be listed.

<sup>2</sup> 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.

holder and the option ceases to exist. A single payout Basket CEBO pays \$0 if there is no Credit Event prior to the last trading day.

There are no exercise prices associated with Basket CEBOs. Payout is automatic if a Credit Event is declared.

The Reference Entities for a Basket CEBO can be issuers with securities listed on a U.S. national market. A Reference Entity is said to have a "Credit Event" if any of the following events occur between the listing date and the last trading day:

(1) A Failure-to-Pay Default on the Reference Obligation (e.g., Company ABC 8.5% July 2013 bond) or on any other debt security obligations other than non-recourse indebtedness 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 specified by the Exchange in accordance with Rule 29.2A and will be defined in 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 in accordance with Rule 29.2A and, if so specified, will be 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 in accordance with Rule 29.2A 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 accordance with the terms of the Relevant Obligation(s).

For each Basket CEBO class, the Exchange will specify the:

- (a) Notional Face Value of each Basket (e.g., \$100,000),
- (b) Basket Components (Reference Entities),
- (c) weight of each Basket Component, which represents the fraction of the Notional Face Value of the basket allocated to each Basket Component,
- (d) recovery rate of each Basket Component,
- (e) specific debt security that defines the Reference Obligation of each Basket Component, and
- (f) applicable Credit Events.

More detailed information about Basket CEBOs can found on the CBOE's website at [www.cboe.com/micro/credit/introduction.aspx](http://www.cboe.com/micro/credit/introduction.aspx).

## MARGIN

Margin requirements for Basket CEBOs are set-forth in CBOE Rule 12.3(l).<sup>3</sup>

### Initial and Maintenance Margin

Purchases of Basket CEBOs must be paid for in full. Writers of multiple payout Basket CEBOs must deposit / maintain 100% of the sum of each basket component's cash settlement value. Writers of single payout Basket CEBOs must deposit / maintain 100% of the cash settlement value that is the highest. Basket CEBOs have no value for margin equity purposes, except in the case of a Qualified Customer (see below).

### Initial and Maintenance Margin – Qualified Customer<sup>4</sup> - **Multiple Payout**

Purchases – 15% of the purchase amount\*

Sales (short) – the lesser of:

- option proceeds\* plus 15% of the sum of each basket component's cash settlement value, or
- the sum of each basket component's cash settlement value

### Initial and Maintenance Margin – Qualified Customer - **Single Payout**

Purchases – 15% of the purchase amount\*

Sales (short) – the lesser of:

- option proceeds\* plus 15% of the cash settlement value that is the highest, or
- the cash settlement value that is the highest

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. Basket CEBOs 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.

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<sup>3</sup> Basket CEBOs are not eligible for a Portfolio Margin Account.

<sup>4</sup> 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.

## Spreads

No margin is required other than payment of the net debit in full in the case of a long Basket CEBO held with a Short Basket CEBO having the same underlying Reference Obligations, 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 Basket CEBO 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:

### Multiple Payout Basket CEBOs

- cash or cash equivalents equal to 100% of the sum of each basket component's cash settlement value, or
- an escrow agreement

### Single Payout Basket CEBOs

- cash or cash equivalents equal to 100% of the cash settlement value that is the highest, 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 sum of each basket component's cash settlement value in the case of a multiple payout Basket CEBO, or 100% of the cash settlement value that is the highest in the case of a single payout Basket CEBO, and that the bank will promptly pay the member organization the cash settlement value in the event of a Credit Event. (Note, the Options Clearing Corp. is not currently accepting escrow agreements for Basket CEBOs)

## OPTION MARKET-MAKER MARGIN REQUIREMENTS

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

## NET CAPITAL

Risk-based haircut treatment is not available for Basket CEBOs. 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 Basket CEBOs. Discussions with Commission staff continue and modifications or alternative treatments may follow. The current haircut requirements are as follows:

### Multiple Payout Basket CEBOs

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

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

Where a broker-dealer is short a Basket CEBO and is also long a Basket CEBO having the same components, and provided corresponding components have equal cash settlement amounts, a \$1,000 deduction is required.

Where a broker-dealer is long(short) a Credit Default Option and is also short(long) multiple contracts of Basket CEBOs with a component that has the same Reference Obligation as the Credit Default Option and the number of Basket CEBO contracts is such that, for the subject component, the aggregate cash settlement amount is as close as possible, using the optimum ratio of whole contracts, to the cash settlement value of the Credit Default Option, the deduction for the Credit Default Option is the amount, if any, of the difference in aggregate cash settlement amounts plus \$2,500.

Where a broker-dealer has a short position in a Basket CEBO and, for one or more components, also has an offsetting long position in put options overlying equity securities of the issuer whose debt security is the Reference Obligation, and, for each component, the aggregate exercise price amount of the puts rounded to the nearest contract equals the cash settlement amount, the combined deduction on the Basket CEBO and puts is 15% of the two highest cash settlement amounts, less any amount by which the current market value of the Basket CEBO exceeds 85% of those combined cash settlement amounts.

Where a broker-dealer has a long position in a Basket CEBO and, for each component, also has an offsetting long position in the debt security that is the underlying Reference Obligation with a face value equal to the notional face value of the component, the deduction on the Basket CEBO and debt security combined is the greater of 15% of the current market value or 7.5% of the principal amount of each debt security.

Where a broker-dealer has a short position in a Basket CEBO and, for each component, also has an offsetting short position in the debt security that is the underlying Reference Obligation with a face value equal to the notional face value of the component, the deduction on the Basket CEBO and debt security combined is the greater of 15% of the current market value or 7.5% of the principal amount of each debt security.

### Single Payout Basket CEBOs

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

Short positions are subject to a deduction of 15% of the highest cash settlement amount of the Basket CEBO 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 Basket CEBO and is also long a Basket CEBO having the same components, and provided corresponding components have equal cash settlement amounts, a \$1,000 deduction is required.

Where a broker-dealer is long(short) a Credit Default Option and is also short(long) multiple contracts of Basket CEBOs with a component that has the same Reference Obligation as the Credit Default Option and the number of Basket CEBO contracts is such that, for the subject component, the aggregate cash settlement amount is as close as possible, using the optimum ratio of whole contracts, to the cash settlement value of the Credit Default Option, the deduction for the Credit Default Option is the amount, if any, of the difference in aggregate cash settlement amounts, plus \$2,500.

Where a broker-dealer has a short position in a Basket CEBO and, for one or more components, also has an offsetting long position in put options overlying equity securities of the issuer whose debt security is the Reference Obligation, and, for each component, the aggregate exercise price amount of the puts rounded to the nearest contract equals the cash settlement amount, the combined deduction on the Basket CEBO and puts is 15% of the highest cash settlement amount, less any amount by which the current market value of the Basket CEBO exceeds 85% of that cash settlement amount.

Where a broker-dealer has a long position in a Basket CEBO and, for each component, also has an offsetting long position in the debt security that is the underlying Reference Obligation with a face value equal to the notional face value of the component, the deduction on the Basket CEBO and debt security combined is the greater of 15% of the current market value or 7.5% of the principal amount of each debt security.

Where a broker-dealer has a short position in a Basket CEBO and, for each component, also has an offsetting short position in the debt security that is the underlying Reference Obligation with a face value equal to the notional face value of the component, the deduction on the Basket CEBO and debt security combined is the greater of 15% of the current market value or 7.5% of the principal amount of each debt security.

### *Undue Concentration*

Across all Basket CEBOs, deduct 100% of the aggregate cash settlement values for the two components with the highest aggregate net long or net short exposure in terms of cash settlement value. Where positions in Credit Default Options are also carried, include them in the forgoing computation, except that, in the case of a net long exposure that includes Credit Default Options, deduct 100% of the aggregate current

market value relating to the Credit Default Options represented in the exposure, instead of deducting 100% of the aggregate cash settlement amount relating to those Credit Default Options.

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