

OMB APPROVAL

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
Form 19b-4

File No. SR - 2007 - 26

Amendment No.

Proposed Rule Change by Chicago Board Options Exchange
Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial ☒ Amendment ☐ Withdrawal ☐

Section 19(b)(2) ☒Section 19(b)(3)(A) ☐Section 19(b)(3)(B) ☐

Pilot ☐ Extension of Time Period
for Commission Action ☐ Date Expires

Rule

☐ 19b-4(f)(1) ☐ 19b-4(f)(4)
☐ 19b-4(f)(2) ☐ 19b-4(f)(5)
☐ 19b-4(f)(3) ☐ 19b-4(f)(6)

Exhibit 2 Sent As Paper Document ☐Exhibit 3 Sent As Paper Document ☐**Description**

Provide a brief description of the proposed rule change (limit 250 characters).

Proposal to list and trade Credit Default Basket Options.

Contact Information

Provide the name, telephone number and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the proposed rule change.

First Name Jennifer Last Name Klebes
Title Senior Attorney
E-mail klebes@cboe.com
Telephone (312) 786-7466 Fax (312) 786-7919

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934,

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized officer.

Date 04/05/2007

By Jennifer L. Klebes

(Name)

Senior Attorney/Assistant Secretary

(Title)

NOTE: Clicking the button at right will digitally sign and lock
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signature, and once signed, this form cannot be changed.



SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EFFT website.

Form 19b-4 Information

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The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.

Exhibit 1 - Notice of Proposed Rule Change

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The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3).

Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications

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Exhibit Sent As Paper Document

☐

Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.

Exhibit 3 - Form, Report, or Questionnaire

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Exhibit Sent As Paper Document

☐

Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.

Exhibit 4 - Marked Copies

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The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.

Exhibit 5 - Proposed Rule Text

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The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.

Partial Amendment

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If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

Item 1. Text of Proposed Rule Change

The Chicago Board Options Exchange, Incorporated (“CBOE” or “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. The text of the proposed rule change is provided below (additions are underlined; deletions are [bracketed]).¹

Chicago Board Options Exchange, Incorporated

Rules

* * * * *

Rule 6.1 – Days and Hours of Business

RULE 6.1. No change

. . . Interpretations and Policies:

.01 No change.

.02 The hours of trading for certain securities are set forth in the Rules listed below:

Corporate Debt Security Options – Rule 28.9.

Credit [Default] Options – Rule 29.11.

Government Securities Options – Rule 21.10, Interpretation and Policy .01.

Index Options – Rule 24.6

Stocks, Warrants and Other Securities – Rule 30.4

* * * * *

Rule 12.3 – Margin Requirements

RULE 12.3. (a) – (k) No change.

(l) Credit [Default] Options.

(1) Margin Account - Credit Default Options.

¹ This rule filing assumes that the proposed Chapter XXIX and proposed amendments contained in a separate rule filing are effective. See Securities Exchange Act Release No. 55251 (February 7, 2007), 72 FR 7091 (February 14, 2007) (noticing SR-CBOE-2006-84, proposal to list and trade Credit Default Options).

(i) The initial and maintenance margin required on any Credit Default Option carried long in a customer's account is 100% of the current market value; provided, however, for the account of a qualified customer, the margin is 20% of the current market value. For purposes of this Rule 12.3(l), the term "qualified customer" shall be a person or entity that owns and invests on a discretionary basis no less than \$5,000,000 in investments.

(ii) The initial and maintenance margin required on any Credit Default Option carried short in a customer's account is the cash settlement amount as defined in Rule 29.1; provided, however, for the account of a qualified customer, the margin is the lesser of the current market value plus 20% of the cash settlement amount defined in Rule 29.1 or the cash settlement amount.

(iii) Credit Default Option margin requirements may be satisfied by a deposit of cash or marginable securities.

(2) Margin Account - Credit Default Basket Options.

(i) The initial and maintenance margin required on any Credit Default Basket Option carried long in a customer's account is 100% of the current market value; provided, however, for the account of a qualified customer (as defined above), the margin is 15% of the current market value.

(ii) The initial and maintenance margin required on any Credit Default Basket Option carried short in a customer's account is as follows:

(A) 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 above), the margin is 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

(B) for Single Payout Credit Default Options, the Basket Component cash settlement amount as defined in Rule 29.1 that is the highest; provided, however, for the account of a qualified customer (as defined above), the margin is the lesser of the current value plus 15% of the Basket Component cash settlement amount defined in Rule 29.1 that is the highest or the Basket Component cash settlement amount that is the highest.

(iii) Credit Default Basket Option margin requirements may be satisfied by a deposit of cash or marginable securities.

(3) [(2)] Cash Account - Credit Default Options. A Credit Default Option carried short in a customer's account is 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) cash or cash equivalents equal to 100% of the cash settlement amount as defined in Rule 29.1; or

(ii) 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.

(4) Cash Account - Credit Default Basket Options. A Credit Default Basket Option carried short in a customer's account is 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.

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 amount as defined in Rule 29.1 in the case of Multiple Payout Credit Default Basket Option or 100% of the Basket Component cash settlement amount as defined in Rule 29.1 that is the highest in the case of a Single Payout Credit Default Basket Option 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.

...Interpretations and Policies:

.01 – .19 No change.

* * * * *

Rule 12.5 – Determination of Value for Margin Purposes

RULE 12.5. Positions in active securities, except security futures contracts, dealt in on a recognized exchange (including option contracts) shall, for margin purposes, be valued at current market value prices; provided that only the following may be deemed to have market value for the purposes of Rule 12.3(c): (a) whether or not dealt in on an exchange, those options contracts on a stock or stock index, or a stock index warrant, having an expiration that exceeds 9 months and which are listed or guaranteed by the carrying broker-dealer, or (b) a Credit [Default] Option as defined in Rule 29.1 that is carried for the account of a qualified customer. Security futures contracts shall have no value for margin purposes. Positions in other securities shall be valued conservatively in the light of current market prices and the amount of anticipated realization upon a liquidation of the entire position. Substantial additional margin must be required in all cases where the securities carried are subject to unusually rapid or violent changes in value, or where the amount carried is such that they cannot be liquidated promptly.

* * * * *

Chapter XXIX – Credit [Default] Option Contracts

Introduction

The rules in this Chapter are applicable only to Credit [Default] Options. In addition, the rules in Chapters I through XIX, XXIVA and XXIVB are also applicable to the options provided for in this Chapter, in some cases supplemented by rules in this Chapter, except for rules that have been replaced in respect of Credit [Default] Options in this Chapter and except where the context otherwise requires. Whenever a rule in this Chapter supplements or, for purposes of this Chapter, replaces rules in Chapter I through XIX, XXIVA and XXIVB, that fact is indicated following the rule in this Chapter.

Rule 29.1 Definitions

RULE 29.1. The following terms as used in this Chapter, shall unless the context otherwise indicates, have the meanings herein specified.

Cash Settlement Amount

(a) The term “cash settlement amount” means the amount of cash that a holder will receive upon exercise of the contract.

(i) For Credit Default Options, [T]he cash settlement amount [for a Credit Default Option] is generally \$100,000 per contract (equal to an exercise settlement value of \$100 multiplied by a contract multiplier of 1,000) upon automatic exercise if the Exchange confirms a Credit Event in accordance with Rule 29.9. If a Credit Event is not confirmed, the cash settlement value will be \$0. If applicable, the cash settlement amount will be adjusted in accordance with Rule 29.4.

(ii) For Credit Default Basket Options, the cash settlement amount paid for a Basket Component that has a confirmed Credit Event is equal to the Notional Face Value of the Basket Component multiplied by one minus the Basket Component recovery rate specified by the Exchange at listing. 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 will be \$6,000 ($\$10,000 * (1 - 0.40)$). For a holder of a long Single Payout Credit Default Basket Option, the cash settlement amount, based on this equation, is paid a single time when the first Credit Event is confirmed during the life of the option. If no Credit Event is confirmed in any Basket Component in either type of Credit Default Basket Options, the cash settlement value will be \$0.

Credit Default Option

(b) The term “Credit Default Option” means a binary call that settles in cash based on the confirmation of a Credit Event in a Reference Entity.

Credit Event

(c) A “Credit Event” occurs 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 obligation(s), (the set of these obligations and the Reference Obligation are referred to as the “Relevant Obligations”). The term “Failure-to-Pay Default” will be specified by the Exchange in accordance with Rule 29.2 or Rule 29.2A and will be defined in accordance with the terms of the Relevant Obligation(s); and/or

(ii) has any other Event of Default on the Relevant Obligation(s). Each such

“Event(s) of Default” will be specified by the Exchange in accordance with Rule 29.2 or 29.2A and, if so specified, will be defined in accordance with the terms of the Relevant Obligation(s); and/or

(iii) has 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 29.2 or Rule 29.2A and, if so specified, will be defined in accordance with the terms of the Relevant Obligation(s).

Expiration Date

(d) (i) For Credit Default Options, t[T]he “expiration date” shall be the 4th business day after the 3rd Friday of the expiration month (or, if that day is not a business day, the 4th 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 [the 3rd Friday of the expiration month], or a Redemption Event, as provided for in Rule 29.4, has been confirmed prior to that day, the expiration date will be accelerated to the 2nd business day immediately following the confirmation date.

(ii) For Credit Default Basket Options, the “expiration date” shall be the 4th business day after the 3rd Friday of the expiration month (or, if that day is not a business day, the 4th 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 (A) every Basket Component for a Multiple Payout Credit Default Basket Option; or (B) 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 will be accelerated to the 2nd business day immediately following the last confirmation date.

Last Trading Day

(e) (i) For Credit Default Options, t[T]he “last trading day” shall be the 3rd Friday of the expiration month (or, if that day is not a business day, the preceding business day); provided, however, if a Credit Event has been confirmed is confirmed by the Exchange to members and the Clearing Corporation prior to that day, or a or a Redemption Event, as provided for in Rule 29.4, has been confirmed prior to that day, the series will cease trading at the time of the confirmation of the Credit Event and the last trading day will [would] be accelerated to the confirmation date.

(ii) For Credit Default Basket Options, the “last trading day” shall be the 3rd 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 Clearing Corporation prior to that day in (A) every Basket Component for a Multiple Payout Credit Default Basket Option; or (B) 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 will cease trading at the time of the confirmation and the last trading day will be changed to the confirmation date.

Reference Entity

(f) The term “Reference Entity” means the issuer or guarantor of the Reference Obligation that underlies [underlying] a Credit Default Option or the issuer of guarantor of one of the Reference Obligations that underlies a Credit Default Basket Option.

Credit Option

(g) The term “Credit Option” means an option that is subject to the Rules in this Chapter.

Credit Default Basket Option

(h) The term “Credit Default Basket Option” means a call option based on a basket comprised of at least two Reference Entities (“Basket Component(s)”), which settles in cash in one of the following manners:

(i) Multiple Payout Credit Default Basket Options 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 will only be paid once in connection with a particular Basket Component that has a confirmed Credit Event, after which time that Basket Component will be removed from the Credit Default Basket. If a Credit Event is confirmed in every Basket Component prior to expiration, the option will cease to trade.

(ii) Single Payout Credit Default Basket Options are 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 expires worthless.

Notional Face Value of Basket

(i) The term “Notional Face Value of Basket” is the total face value for the Credit Default Basket as specified by the Exchange at listing.

Notional Face Value of Basket Component

(j) The term “Notional Face Value of Basket Component” is the weight of the Basket Component multiplied by the Notional Face Value of Basket as specified by the Exchange at listing.

* * * * *

Rule 29.2A – Designation and Terms of Credit Default Basket Option Contracts

RULE 29.2A. (a) The Exchange may from time to time approve for listing and trading on the Exchange Credit Default Basket Options. Each Credit Default Basket Option class is designated by reference to:

- (1) the Notional Face Value of Basket (e.g., \$100,000),
- (2) the Basket Components,
- (3) the weight of each Basket Component, which represents the fraction of the Notional Face Value of the Basket allocated to each Basket Component,
- (4) the recovery rate of each Basket Component,
- (5) the specified debt security that defines the Reference Obligation of each Basket Component (e.g., Corporation XYZ 8.375% July 2033 bond), and
- (6) the applicable Credit Event(s). The applicable Credit Event(s) will include a Failure-to-Pay Default and may include any other Event(s) of Default or Restructuring, if any, that is specified by the Exchange.

(b) After a particular Credit Default Basket Option class has been approved for listing and trading on the Exchange, the Exchange from time to time may 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 may be purchased or sold on the Exchange. Prior to the opening of trading in a particular Credit Default Basket Options series

in a given class, the Exchange will fix the expiration month and year.

(1) Credit Default Basket Option series will generally expire up to 123 months from the time they are listed, may expire in the months of March, June, September and December.

(2) The Exchange usually will 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 may 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 will not affect any other series of options of the same class previously opened.

Rule 29.2A replaces, for purposes of Chapter XXIX, Rules 5.1, 5.3, 5.5 and 5.8.

* * * * *

Rule 29.4 - Adjustments

RULE 29.4. (a) Credit Default Option contracts are subject to adjustment in accordance with the following:

(1) Adjustment for Succession: Each Credit Default Option will be replaced by one or more Credit Default Options derived from Successor Reference Entities that have succeeded the original Reference Entity as a result of a Succession Event based on the applicable share of each Successor Reference Entity.

(i) A "Successor Reference Entity" and a "Succession Event" will be defined in accordance with the terms of the Relevant Obligation(s).

(ii) In respect of each successor Credit Default Option, the cash settlement amount and contract multiplier will be adjusted based on the applicable share of each Successor Reference Entity. All other terms and conditions of each successor Credit Default Option will be the same as the original Credit Default 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.

(2) Adjustment for Redemption: Once the Exchange has confirmed a Redemption Event, the Credit Default Option contract will cease trading on the confirmation date. If no Credit Event has been confirmed to have occurred prior to the effective date of the Redemption, the contract payout will be \$0. If a Credit Event has been confirmed to have occurred prior to the effective date of the Redemption, the cash settlement amount shall be as provided in Rule 29.1(a). The Credit Event confirmation period will begin when the Credit Default Option contract is listed and will extend to 3:00 p.m. (CT) on the 4th Exchange business day after the effective date of the Redemption.

(i) A "Redemption Event" will be defined in accordance with the terms of the Relevant Obligation(s) and will include the redemption of the Reference Obligation and of all other Relevant Obligations.

(ii) If the Reference Obligation is redeemed but other Relevant Obligation(s) remain, a new Reference Obligation will be specified from among the remaining Relevant Obligation(s).

(b) Credit Default Basket Option contracts are subject to adjustment in accordance with the

following:

(1) Adjustment for Succession: Once the Exchange has confirmed a Succession Event in a Basket Component, that component may be replaced by one or more Basket Components ("Successor Basket Components") consisting of the Successor Reference Entity(ies).

(i) A "Successor Reference Entity" and a "Succession Event" will be defined in accordance with the terms of the Relevant Obligations of the Basket Component that is subject to adjustment for succession.

(ii) In the event of an adjustment for succession, the Exchange will specify the Reference Obligation, recovery rate and the basket weight of each Successor Basket Component. The newly specified weight(s) will equal the weight of the predecessor Basket Component replaced by the Successor Basket Component(s).

(iii) In respect of each Credit Default Basket Option contract that was subject to adjustment for succession, all other terms and conditions of each Credit Default Basket Option containing a Successor Basket Component will 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.

(2) Adjustment for Redemption: 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 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 will begin when the Credit Default Basket Option contract is listed and will extend to 3:00 p.m. (CT) on the 4th Exchange business day after the effective date of the Redemption Event.

(i) A "Redemption Event" will be defined in accordance with the terms of the Relevant Obligations and will include the redemption of the Reference Obligation and of all other Relevant Obligations.

(ii) If the Reference Obligation is redeemed or matures but other Relevant Obligations remain, a new Reference Obligation will be specified from among the remaining Relevant Obligation(s) and the substitution will not be deemed a Redemption Event.

(c) [(b)] The Exchange will confirm adjustment events based on at least two sources, which may include announcements published via newswire services or information services companies, the names of which will be announced to the membership via Regulatory Circular, and/or information submitted to or filed with the courts, the SEC, an exchange or association, the Clearing Corporation, or another regulatory agency or similar authority.

(d) [(c)] When adjustments have been made, announcement of that fact will be made by the Exchange, and the adjusted unit of trading and the adjusted exercise price will be posted at the post at which the series is traded and will be effective at the time specified in the announcement for all subsequent transactions in that series.

(e) [(d)] Every determination of the Exchange pursuant to this Rule 29.4 will be within its sole discretion and shall be conclusive and binding on all holders and sellers and not subject to review.

Rule 29.4 replaces, for purposes of [this] Chapter XXIX, Rule 5.7.

Rule 29.5 – Position Limits

RULE 29.5. (a) In determining compliance with Rule 4.11, cash-settled Credit Default Option contracts shall have a position limit equal to 5,000 contracts on the same side of the market and cash-settled Credit Default Basket Options shall have a position limit equal to 50,000 contracts on the same side of the market.

(b) In determining compliance with the position limits set forth in paragraph (a), Credit [Default] Options shall not be aggregated with option contracts on the same or similar underlying security.

(c) Credit [Default] Options shall not be subject to the hedge exemption to the standard position limits found in Rule 4.11.04. The following qualified hedge exemption strategies and positions shall be exempt from the established position limits as prescribed in the Rule above:

(1) A Credit [Default] 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 Option with an exercise settlement value of \$100 and a contract multiplier of 1,000 or \$100,000 for a Credit Default Basket Option with a Notional Face Value of Basket of \$100,000.)

(2) A Credit Default Option position “hedged” or “covered” by a sufficient amount of the underlying Relevant Obligation(s) and/or other securities, instruments or interests related to the Reference Entity to meet the cash settlement amount obligation (e.g., a long Credit Default Option position could be offset by a long position in a debt security of the Reference Entity that is worth \$100,000 per contract (or the applicable adjusted amount) and short Credit Default Option position could be offset by a short position in a debt security of the Reference Entity that is worth \$100,000 per contract (or the applicable adjusted amount)).

(3) 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.

(d) Credit [Default] Options shall be subject to the Market-Maker hedge and firm facilitation exemptions to the standard position limits found in Rule 4.11.05 and .06, respectively. With respect to the Market-Maker hedge exemption, the positions must generally be within 20% of the applicable limits of the Credit [Default] Option before an exemption will be granted as described in Rule 4.11.05(a)(2). With respect to the firm facilitation exemption, the aggregate exemption position may not exceed 3 x the standard limits [of 5,000] set forth in paragraph (a) and be consistent with the procedures described in Rule 4.11.06.

Rule 29.6 – Reports Related to Position Limits and Liquidation of Positions

RULE 29.6. For purposes of Rules 4.13 and 4.14, references to Rule 4.11 in connection with position limits shall be deemed, in the case of Credit [Default] Options, to be to Rule 29.5. In computing reportable Credit [Default] Options under Rule 4.13, Credit [Default] Options shall not be aggregated with non-Credit [Default] Option contracts. In addition, Credit [Default] Options of a given class shall not be aggregated with any other class of Credit

[Default] Options. The applicable hedge reporting requirement described in Rule 4.13(b) shall apply to a position in excess of 1,000 Credit [Default] Option contracts on the same side of the market.

Rule 29.6 supplements Rules 4.13 and 4.14.

Rule 29.7 – Exercise Limits

RULE 29.7. There shall be no exercise limits for Credit [Default] Options.

Rule 29.7 replaces, for purposes of Chapter XXIX, Rule 4.12

Rule 29.8 – Other Restrictions on Credit [Default] Option Transactions

RULE 29.8. Rule 4.16 shall be applicable to Credit [Default] Options.

Rule 29.9 – Determination of Credit Event, Automatic Exercise and Settlement

RULE 29.9. (a) Credit Default Options will be subject to automatic exercise upon the Exchange confirming that a Credit Event has occurred in a Reference Entity between the listing date and the last trading day.

(b) Credit Default Basket Options will 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:

(1) Multiple Payout Credit Default Basket Options will be subject to automatic payouts each time a Credit Event is confirmed in a Basket Component.

(2) Single Payout Credit Default Basket Options will be subject to automatic exercise as soon as a Credit Event is confirmed in any one of the Basket Components.

(c) [(b)] The Credit Event confirmation period will begin when the Credit [Default] Option contract is listed and will extend to 3:00 p.m. (CT) on the expiration date.

(d) [(c)] The Exchange will confirm Credit Events based on at least two sources, which may include announcements published via newswire services or information services companies, the names of which will be announced to the membership via Regulatory Circular, and/or information submitted to or filed with the courts, the SEC, an exchange or association, the Clearing Corporation, or another regulatory agency or similar authority.

(e) [(d)] For Credit Default Options, i[f] the Exchange determines that a Credit Event in the underlying Reference Entity has occurred prior to 10:59 p.m. (CT) on the last trading day, the cash settlement amount will be \$100,000 per contract (or the applicable adjusted amount). Otherwise the cash settlement amount will be \$0. If a Credit Event has been confirmed by the Exchange prior to the last trading day, the Credit Default Option will cease trading upon confirmation of the Credit Event.

(f) For Credit Default Basket Options, 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:

(1) a Multiple Payout Credit Default Basket Option will automatically pay the cash settlement amount (i.e., Notional Face Value of the Basket Component multiplied by one minus the Basket Component recovery rate specified by the Exchange at listing), 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 will cease trading upon confirmation of the last Credit Event; and

(2) a Single Payout Credit Default Basket Option will automatically exercise and pay

the cash settlement amount (i.e., Notional Face Value of the Basket Component multiplied by one minus the Basket Component recovery rate specified by the Exchange at listing), 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 will cease trading upon confirmation of the Credit Event.

(g) [(e)] Every determination of the Exchange pursuant to this Rule 29.9 will be within its sole discretion and shall be conclusive and binding on all holders and sellers and not subject to review.

Rule 29.9 replaces, for purposes of Chapter XXIX, Rule 11.1.

Rule 29.10 – Rights and Obligations of Holders and Sellers

RULE 29.10. (a) Subject to the provisions of Rules 4.14, 4.16 and 11.3, the rights and obligations of holders and sellers of Credit [Default] Options dealt in on the Exchange shall be set forth in the By-Laws and Rules of the Clearing Corporation. Rules 11.1 and 11.2 shall not be applicable to Credit [Default] Options.

(b) The Exchange shall have no liability for damages, claims, losses or expenses caused by any errors, omissions or delays in confirming or disseminating notice of any Credit Event resulting from a negligent act or omission by the Exchange or any act, condition or cause beyond the reasonable control of the Exchange, including, but not limited to, an act of God; fire; flood; extraordinary weather conditions; war; insurrection; riot; strike; accident; action of government; communications or power failure; equipment or software malfunction; any error, omission or delay in the reports of transactions in one or more underlying securities.

Rule 29.11 – Days and Hours of Business

RULE 29.11. The Exchange has resolved that except under unusual conditions as may be determined by the Exchange, the hours during which Credit [Default] Options transactions may be made on the Exchange shall be from 8:30 a.m. to 3:00 p.m. (CT).

Rule 29.11 supplements Interpretation and Policy .02 to Rule 6.1.

Rule 29.12 – Trading Rotations

RULE 29.12. Rules 6.2 and 6.2B shall be applicable to Credit [Default] Options. In accordance with Rule 6.2B, at a randomly selected time within a number of seconds after 8:30 a.m. (CT), unless unusual circumstances exist, the System will initiate the opening procedure and send a Rotation Notice.

Rule 29.13 – Trading Halts and Suspension of Trading

RULE 29.13. Rule 6.3 and 6.3B shall be applicable to Credit [Default] Options. Another factor that may be considered by Floor Officials in connection with the institution of trading halts (Rule 6.3) in Credit [Default] Options is that current quotations for Reference Obligation or other securities of the Reference Entity are unavailable or have become unreliable.

Rule 29.14 – Premium Bids and Offers; Minimum Increments; Priority and Allocation

RULE 29.14. (a) Bids and offers shall be expressed in terms of dollars per the contract multiplier unit (e.g., a bid of “7” shall represent a bid of \$7,000 for a Credit [Default] Option

with a specified contract multiplier of 1,000).

(b) The minimum price variation (“MPV”) for bids and offers on both simple and complex orders for Credit Default Options and Credit Default Basket Options shall be \$0.05 [(\$50 per contract)].

(c) All bids or offers made for Credit [Default] 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.

(d) The rules of priority and order allocation procedures set forth in Rule 6.45A shall apply to Credit [Default] Options.

Rule 29.14 supplements Rules 6.41, 6.42, 6.44 and 6.45A.

Rule 29.15 – Nullification and Adjustment of Credit [Default] Option Transactions

RULE 29.15. (a) Except as provided below, Rule 6.25 shall govern the nullification and adjustment of transactions involving Credit [Default] Options.

(b) Paragraph (a) of Rule 6.25 has no applicability to Credit [Default] Option transactions. For purposes of paragraph (a) of Rule 6.25, a member or person associated with a member may have a trade nullified or adjusted if, in addition to the procedural requirements of paragraph (b) of Rule 6.25, one of the following conditions is satisfied:

(1) Obvious Price Error: An obvious pricing error 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. Such transactions will be adjusted by Trading Officials to a price within 5% of the theoretical price range (i.e., to -\$5 or \$105), unless both parties agree to a nullification.

(2) Verifiable Disruptions or Malfunctions of Exchange Systems. 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 will be nullified by Trading Officials, unless both parties agree to an adjustment.

* * * * *

Rule 29.17 – Market-Maker Appointments & Obligations

RULE 29.17. (a) Market-Makers shall be appointed to Credit [Default] Option classes in accordance with the requirements of Rules 8.3, 8.4, 8.15A and 8.95, as applicable.

(b) A Credit [Default] Option-appointed Market-Maker may, but shall not be obligated to enter a response to a request for quotes on a Credit [Default] Option class in which he is appointed. However, the Order Book Official or two Trading Officials may call upon Credit [Default] Option-appointed Market-Makers to provide quotes in their appointed classes. In addition, a Credit [Default] Option-appointed Market-Maker need not provide continuous quotes or quote a minimum bid-offer spread, but when quoting the Market-Maker’s minimum value size shall be at least 1 contract.

(c) In addition to the requirements of paragraph (b), a DPM or LMM, as applicable, appointed to a Credit [Default] Option class shall enter opening quotes in accordance with Rule 6.2B in 100% of the series of the class and shall be obligated to enter a quote in response to any open outcry request for quotes on any Credit [Default] Option class in which

it is appointed.

. . . Interpretations and Policies:

.01 The Exchange may establish permissible price differences for one or more series or classes of Credit [Default] Options as warranted by market conditions.

Rule 29.17 supplements the rules in Chapter VIII.

* * * * *

Rule 29.19 – FLEX Trading

RULE 29.19. Credit [Default] Options shall be eligible for trading as Flexible Exchange Options. For purposes of Chapters XXIVA and XXIVB, references to the term “FLEX Equity Options” shall include a Credit [Default] Option and references to the “underlying security” or “underlying equity security” in respect of a Credit [Default] Option shall mean the Reference Obligation as defined in Rule 29.1. For purposes of Rules 24A.4 and 24B.4, the FLEX Equity Option shall be cash-settled, and may have maximum terms equal in length to those provided for under Rules 29.2 and 29.2A, and the exercise by exception provisions of the Clearing Corporation Rule 805 shall not apply.

* * * * *

Item 2. Procedures of the Self-Regulatory Organization

(a) The CBOE's Office of the Chairman pursuant to delegated authority approved the proposed rule change on March 5, 2007. No further action is required.

(b) Please refer questions and comments on the proposed rule change to Joanne Moffic-Silver, General Counsel, CBOE, 400 South LaSalle, Chicago, IL 60605, (312) 786-7462 or Jennifer Klebes, (312) 786-7466.

Item 3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

The Exchange recently proposed for listing and trading, 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).² 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 a type of Credit Option that would enable investors to trade cash-settled call options that are 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

² See supra note 1, at 3.

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, in which the option 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 only be paid 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 Events 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, in which the 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 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 the Notional Face Value of the Basket Component multiplied by one minus the Basket Component recovery rate as specified by the Exchange at listing. The Notional Face Value of the Basket Component would represent the weight that a particular Basket Component would be given relative to the Credit Default Basket in which it is included. And 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. As an 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 \$6,000 ($\$10,000 * (1 - 0.40)$).

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 only be paid 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 (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; 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; 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.

Similar to Credit Default Options, the particular Credit Events applicable to Credit Default Basket Options 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 Credit Events for Credit Default Basket Options 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 U.S. Securities and Exchange Commission (“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 shall 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 payout (for Multiple Payout Credit Default Basket Options) or would 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 3rd 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 4th business day after the 3rd 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 only be paid 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 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 \$0.00.

Description of Rules Proposed

The proposed new rules and amendments for the listing and trading of Credit Default Basket Options are premised on the assumption that proposed Chapter XXIX is effective.³ The proposed new rules and amendments for Credit Default Basket Options are layered into Chapter XXIX. 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 limited to, new definitions, new margin requirements and new settlement procedures. The Exchange will also note 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).⁴

(1) Definitions (Amendment 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.”

³ See *supra* note 1, at 3.

⁴ The Exchange is proposing changing all references to “Credit Default Options” in the

The term “Credit Option” would be defined as an option that would be 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. Multiple Payout Credit Default Basket Options 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 only be paid 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. Single Payout Credit Default Basket Options 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 Events were confirmed in any Basket Components 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. As for Credit Default Basket Options, the term “Cash Settlement Amount” would be defined as the amount paid for a Basket Component that has a confirmed Credit Event is being equal to the Notional Face Value of the Basket Component multiplied by one minus the Basket Component recovery rate specified by the Exchange at listing.

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 ($\$10,000 * (1 - 0.40)$). 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. If no Credit Event is confirmed in any Basket Component in either type of Credit Default Basket Options, 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.⁵ As for Credit Default Basket Options, the term “Expiration Date” would be defined as the 4th business day after the 3rd Friday of the expiration month (or, if that day is not a business day, the 4th 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 (A) every Basket Component for a Multiple Payout Credit

⁵ The Exchange also proposes to make a conforming amendment to the definition of “Expiration Date” for Credit Default Options by replacing the phrase “the 3rd Friday

Default Basket Option; or (B) 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 2nd 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.⁶ As for Credit Default Basket Options, the term “Last Trading Date” would be defined as the 3rd 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 Clearing Corporation prior to that day in (A) every Basket Component for a Multiple Payout Credit Default Basket Option; or (B) 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 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 proposed amendment would include reference to Rules 29.2, Designation of Credit Default Option Contracts, and 29.2A,

of the expiration month” with the phrase “that day.”

⁶ 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.”

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.”

(2) Designation and Terms of Credit Default Basket Options and Adjustments

(Proposed Rule 29.2A and Amendment to Rule 29.4)

Proposed Rule 29.2A would be added to provide the terms by which that the Exchange would designate for each Credit Default Basket Option class.⁷ Under the proposed rule, the Exchange would each designate each Credit Default Basket Option class by reference to: (1) the Notional Face Value of Basket (e.g., \$100,000), (2) the Basket Components, (3) the weight of each Basket Component, which would represent the fraction of the Notional Face Value of the Basket allocated to each Basket Component, (4) the recovery rate of each Basket Component, (5) the specified debt security that defines the Reference Obligation of each Basket Component (e.g., Corporation XYZ 8.375% July 2033 bond), and (6) 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, if any that is specified by the Exchange.⁸

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

⁷ 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.

⁸ The Exchange would specify the applicable Credit Event(s) in accordance with

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.

Credit Default Basket Option series would generally be listed up to 123 months ahead of their expiration date and may 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 may 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 an 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, 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 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 will extend to 3:00 p.m. (CT) on the 4th 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 effecting 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.

As to Credit Default Basket Options, 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.

(3) 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: (1) Multiple Payout Credit Default Basket Options would be subject to automatic payouts each time a Credit Event is confirmed in an Basket Component;⁹ and (2) 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 will extend to 3:00 p.m. (CT) on the expiration date.

The Exchange would confirm Credit Events 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, 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 the proposed Rule 29.9 would be within the Exchange's sole discretion and

⁹ As provided for in proposed Rule 29.1(h)(i), a cash settlement amount would only be paid 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.

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: (1) a Multiple Payout Credit Default Basket Option would automatically pay the cash settlement amount (i.e., Notional Face Value of the Basket Component multiplied by one minus the Basket Component recovery rate specified by the Exchange at listing), 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 (2) a Single Payout Credit Default Basket Option would automatically exercise and pay the cash settlement amount (i.e., Notional Face Value of the Basket Component multiplied by one minus the Basket Component recovery rate specified by the Exchange at listing), 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 currently 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 Exchange shall have no liability for damages, claims, losses or expenses caused by any errors, omissions or delays in confirming or disseminating

notice of any Credit Event resulting from an negligent act or omission by the Exchange or any act, condition or cause beyond the reasonable control of the Exchange, including, but not limited to, an act of God; fire; flood; extraordinary weather conditions; war; insurrection; riot; strike; accident; action of government; communications or power failure; equipment or software malfunction; any error, omission or delay in the reports of transactions in one or more underlying securities.

(4) 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.¹⁰

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 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 shall 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 shall 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 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. With respect to the Market-Maker hedge exemption, the positions must generally be within 20% of the applicable limits of the Credit Option before an exemption will be granted. With respect to the firm facilitation exemption, the aggregate exemption position may not exceed three times the standard limit of 50,000 (for Credit Default Basket Options) 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

¹⁰ 15 U.S.C. 78s(b).

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 shall 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. The applicable position reporting requirements described in existing Rule 4.13(b) would also apply, 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 is not 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.

(5) Margin Requirements (Amendment to Rules 12.3 and 12.5)

The Exchange is proposing to amend Rule 12.3(l), Margin Requirements, so that it would apply to all Credit Options. Rule 12.3(l) would also be amended to include subparagraphs 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(l), 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: (A) 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(l)(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 (B) 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(l)(1)(i)), the margin would be the lesser of the current value plus 15% 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 for Credit Options carried for the account of a qualified investor that are listed or guaranteed by the carrying broker-dealer 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 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.

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.

(6) Trading Mechanics for Credit Default Basket Options and Credit Options
Generally Where Applicable (Amendments to Rules 29.11 – 29.15, 29.17 and
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 shall also be applicable to Credit Options. In addition, Rule 29.13 provides 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 shall be expressed in terms of dollars per the contract multiplier unit (e.g., a bid of “7” shall 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 shall 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 further provides that an appointed Market-Maker may, but are not 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. However, when quoting, the Market-Maker's minimum value size shall be at least 1 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 may also establish permissible price differences for one or more series of classes of Credit Options as warranted by market conditions. These quoting mechanics are similar to the mechanics that exist today for trading Flexible Exchange Options ("FLEX Options") on the Exchange.

- FLEX Trading Rules (Amendment to Rule 29.19): In addition to Hybrid, the Exchange is proposing that all Credit Options shall also be eligible for trading as FLEX Options. For proposes 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” shall include a Credit Option and references to the “underlying security” or “underlying equity security” in respect of a Credit Default Option shall 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 shall be cash-settled and may have maximum terms equal in length to those provided for under Rules 29.2 and 29.2A, and the exercise by exception provisions of OCC Rule 805 shall 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 effect these types of options transactions.

(7) Options Disclosure Document

In order to accommodate the listing and trading of Credit Default Basket Options, it is expected that the OCC would amend their By-Laws and Rules to reflect the different structure of Credit Default Basket Options. In addition, it is expected that OCC would seek a revision to the Options Disclosure Document (“ODD”) to incorporate Credit Default Basket Options.

(8) 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.

(9) Applicability of Rule 9b-1 of the Act

The Exchange asks the Commission to clarify that Credit Default Basket Options are standardized options under Rule 9b-1 under the Act.¹¹ Subsection (a)(4) of Rule 9b-1¹² 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.” Credit Default Basket Options are like existing standardized options trading on CBOE in every respect except for the exercise price. Credit Default Basket Options (1) trade on a national securities exchange, (2) have a specific expiration date, (3) have fixed terms, (4) have a specific exercise style, and (5) 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),

¹¹ 17 CFR 240.9b-1.

¹² 17 CFR 240.9b-1(a)(4).

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.¹³ 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”).¹⁴ 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 the Notional Face Value of the Basket Component multiplied by one minus the Basket Recovery Rate specified by the Exchange at listing.

The cash settlement amount would be automatically paid each time a Credit Event is confirmed for a Basket Component for Multiple Payout Credit Default Basket Options (this amount would only be paid once in connection with a particular Basket Component, after which time that Basket Component would be removed from the Credit Default Basket) or the

¹³ See ODD at 6-7.

cash settlement amount would be paid a single time when the first Credit Event is confirmed for Single Payout Credit Basket Options. 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 will 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, are 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, then 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 in 1993 to designate "FLEX Options" as standardized options.¹⁵ In making this designation, the Commission found that, "[a]part from the flexibility with respect to strike prices, settlement, expiration dates, and exercise style, all of the other terms of [FLEX] Options are standardized." The Commission observed that standardized terms include matters such as "exercise procedures, contract adjustments, time of issuance, effect of closing transactions, restrictions on exercise under OCC rules [and] margin requirements...." Credit Default

¹⁴ Id.

¹⁵ See Securities Exchange Act Release No. 31910 (February 23, 1993), 58 FR 12056 (March 2, 1993).

Basket Options share all of these characteristics and, in fact, are more standardized than FLEX Options in that the exercise settlement calculation, settlement, expiration dates, and exercise style of a given class may not vary.

(10) 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.

(b) Statutory Basis

The Exchange believes the proposed rule change is consistent with the Act¹⁶ and the rules and regulations under the Act applicable to national securities exchanges and, in particular, the requirements of Section 6(b) of the Act.¹⁷ Specifically, the Exchange believes the proposed rule change is consistent with the Section 6(b)(5)¹⁸ 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.

Item 4. Self-Regulatory Organization's Statement on Burden on Competition

This proposed rule change does not impose any burden on competition that is not

¹⁶ 15 U.S.C. 78s(b)(1).

¹⁷ 15 U.S.C. 78f(b).

¹⁸ 15 U.S.C. 78f(b)(5).

necessary or appropriate in furtherance of the purposes of the Act.

Item 5. 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.

Item 6. Extension of Time Period for Commission Action

The Exchange does not consent to an extension of the time period specified in Section 19(b)(2) of the Act¹⁹ for Commission consideration of the proposed rule change.

Item 7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

Item 8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or the Commission

This proposed rule change is not based on the rules of another self-regulatory organization or of the Commission.

Item 9. Exhibits

Exhibit 1. Form of Notice of Proposed Rule Change for Publication in the Federal Register.

Exhibit 3. Product Description.

¹⁹ 15 U.S.C. 78s(b)(2).

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-CBOE-2007-26)

Dated: _____

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of a Proposed Rule Change to List and Trade Credit Default Index Options

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”),¹ and Rule 19b-4 thereunder,² notice is hereby given that on _____, 2007, the Chicago Board Options Exchange, Incorporated (the “Exchange” or “CBOE”) filed with the Securities and Exchange Commission (the “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. 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 Chicago Board Options Exchange, Incorporated (“CBOE” or “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. The text of the proposed rule change is available on the Exchange’s website (<http://www.cboe.org/legal>), at the Office of the Secretary, CBOE and at the Commission.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

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 self-regulatory organization 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 parts 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 Exchange recently proposed for listing and trading, 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).³ 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 a type of Credit Option that would enable investors to trade cash-settled call options that are 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.,

³ See supra note 1, at 3.

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, in which the option 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 only be paid 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 Events 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, in which the 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 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 the Notional Face Value of the Basket Component multiplied by one minus the Basket Component recovery rate as specified by the Exchange at listing. The Notional Face Value of the Basket Component would represent the weight that a particular Basket Component would be given relative to the Credit Default Basket in which it is included. And 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. As an 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 \$6,000 ($\$10,000 * (1 - 0.40)$).

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 only be paid 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 (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; 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; 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.

Similar to Credit Default Options, the particular Credit Events applicable to Credit Default Basket Options 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 Credit Events for Credit Default Basket Options 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 U.S. Securities and Exchange Commission (“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 shall 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 payout (for Multiple Payout Credit Default Basket Options) or would 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 3rd 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 4th business day after the 3rd 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 only be paid 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 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 \$0.00.

Description of Rules Proposed

The proposed new rules and amendments for the listing and trading of Credit Default Basket Options are premised on the assumption that proposed Chapter XXIX is effective.⁴ The proposed new rules and amendments for Credit Default Basket Options are layered into

⁴ See supra note 1, at 3.

Chapter XXIX. 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 limited to, new definitions, new margin requirements and new settlement procedures. The Exchange will also note 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).⁵

(a) Definitions (Amendment 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 would be 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. Multiple Payout Credit Default Basket Options 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 only be paid 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

⁵ The Exchange is proposing changing all references to “Credit Default Options” in the Title and Introduction to Chapter XXIX to “Credit Options.”

expiration, the option would cease to trade. Single Payout Credit Default Basket Options 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 Events were confirmed in any Basket Components 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. As for Credit Default Basket Options, the term “Cash Settlement Amount” would be defined as the amount paid for a Basket Component that has a confirmed Credit Event is being equal to the Notional Face Value of the Basket Component multiplied by one minus the Basket Component recovery rate specified by the Exchange at listing.

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 ($\$10,000 * (1 - 0.40)$). 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. If no Credit Event is confirmed in any Basket Component in either type of Credit Default Basket Options, 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.⁶ As for Credit Default Basket Options, the term “Expiration Date” would be defined as the 4th business day after the 3rd Friday of the expiration month (or, if that day is not a business day, the 4th 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 (A) every Basket Component for a Multiple Payout Credit Default Basket Option; or (B) 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 2nd 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.⁷ As for Credit Default Basket Options, the term “Last Trading Date” would be defined as the 3rd Friday of the contract month (or if that day is not a business day, the

⁶ The Exchange also proposes to make a conforming amendment to the definition of “Expiration Date” for Credit Default Options by replacing the phrase “the 3rd Friday of the expiration month” with the phrase “that day.”

⁷ 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.”

preceding business day); provided, however, if a Credit Event has been confirmed by the Exchange to members and the Clearing Corporation prior to that day in (A) every Basket Component for a Multiple Payout Credit Default Basket Option; or (B) 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 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 proposed amendment 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) Designation and Terms of Credit Default Basket Options and Adjustments
(Proposed Rule 29.2A and Amendment to Rule 29.4)

Proposed Rule 29.2A would be added to provide the terms by which that the Exchange would designate for each Credit Default Basket Option class.⁸ Under the proposed rule, the Exchange would each designate each Credit Default Basket Option class by reference to: (1) the Notional Face Value of Basket (e.g., \$100,000), (2) the Basket Components, (3) the weight of each Basket Component, which would represent the fraction

⁸ 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.

of the Notional Face Value of the Basket allocated to each Basket Component, (4) the recovery rate of each Basket Component, (5) the specified debt security that defines the Reference Obligation of each Basket Component (e.g., Corporation XYZ 8.375% July 2033 bond), and (6) 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, if any that is specified by the Exchange.⁹

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.

Credit Default Basket Option series would generally be listed up to 123 months ahead of their expiration date and may 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 may be opened for trading on the Exchange when the Exchange deems it

⁹ 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.

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 an 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, 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 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 will extend to 3:00 p.m. (CT) on the 4th 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 effecting 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.

As to Credit Default Basket Options, 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: (1) Multiple Payout Credit Default Basket Options would be subject to automatic payouts each time a Credit Event is confirmed in an Basket Component;¹⁰ and (2) 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

¹⁰ As provided for in proposed Rule 29.1(h)(i), a cash settlement amount would only be paid 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.

begin when the Credit Default Basket Option is listed and will extend to 3:00 p.m. (CT) on the expiration date.

The Exchange would confirm Credit Events 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, 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 the 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: (1) a Multiple Payout Credit Default Basket Option would automatically pay the cash settlement amount (i.e., Notional Face Value of the Basket Component multiplied by one minus the Basket Component recovery rate specified by the Exchange at listing), 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 (2) a Single Payout Credit Default Basket Option would automatically exercise and pay the cash settlement amount (i.e., Notional Face Value of the Basket Component multiplied by one minus the Basket Component recovery rate specified by the Exchange at listing), 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 currently 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 Exchange shall have no liability for damages, claims, losses or expenses caused by any errors, omissions or delays in confirming or disseminating notice of any Credit Event resulting from a negligent act or omission by the Exchange or any act, condition or cause beyond the reasonable control of the Exchange, including, but not limited to, an act of God; fire; flood; extraordinary weather conditions; war; insurrection; riot; strike; accident; action of government; communications or power failure; equipment or software malfunction; any error, omission or delay in the reports of transactions in one or more underlying securities.

(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.¹¹

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 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 shall 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 shall 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 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,

¹¹ 15 U.S.C. 78s(b).

would also apply. With respect to the Market-Maker hedge exemption, the positions must generally be within 20% of the applicable limits of the Credit Option before an exemption will be granted. With respect to the firm facilitation exemption, the aggregate exemption position may not exceed three times the standard limit of 50,000 (for Credit Default Basket Options) 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 shall 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. The applicable position reporting requirements described in existing Rule 4.13(b) would also apply, 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 is not 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(l), Margin Requirements, so that it would apply to all Credit Options. Rule 12.3(l) would also be amended to include subparagraphs 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(l), 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: (A) 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(l)(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 (B) 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(l)(1)(i)), the margin would be the lesser of the current value plus 15% 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 for Credit Options carried for the account of a qualified investor that are listed or guaranteed by the carrying broker-dealer 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 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.

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.

(f) Trading Mechanics for Credit Default Basket Options and Credit Options Generally Where Applicable (Amendments to Rules 29.11 – 29.15, 29.17 and 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 shall also be applicable to Credit Options. In addition, Rule 29.13 provides 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 shall be expressed in terms of dollars per the contract multiplier unit (e.g., a bid of “7” shall 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 shall 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 further provides that an appointed Market-Maker may, but are not 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.

However, when quoting, the Market-Maker's minimum value size shall be at least 1 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 may also establish permissible price differences for one or more series of classes of Credit Options as warranted by market conditions. These quoting mechanics are similar to the mechanics that exist today for trading Flexible Exchange Options ("FLEX Options") on the Exchange.

- FLEX Trading Rules (Amendment to Rule 29.19): In addition to Hybrid, the Exchange is proposing that all Credit Options shall also 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" shall include a Credit Option and references to the "underlying security" or "underlying equity security" in respect of a Credit Default Option shall 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 shall be cash-settled and may have maximum terms equal in length to those provided for under Rules 29.2 and 29.2A, and the exercise by exception provisions of OCC Rule 805 shall 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 effect these types of options transactions.

g. Options Disclosure Document

In order to accommodate the listing and trading of Credit Default Basket Options, it is expected that the OCC would amend their By-Laws and Rules to reflect the different structure of Credit Default Basket Options. In addition, it is expected that OCC would seek a revision to the Options Disclosure Document (“ODD”) to incorporate Credit Default Basket Options.

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 of the Act

The Exchange asks the Commission to clarify that Credit Default Basket Options are standardized options under Rule 9b-1 under the Act.¹² Subsection (a)(4) of Rule 9b-1¹³

¹² 17 CFR 240.9b-1.

¹³ 17 CFR 240.9b-1(a)(4).

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.” Credit Default Basket Options are like existing standardized options trading on CBOE in every respect except for the exercise price. Credit Default Basket Options (1) trade on a national securities exchange, (2) have a specific expiration date, (3) have fixed terms, (4) have a specific exercise style, and (5) 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.¹⁴ 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

¹⁴ See ODD at 6-7.

amount”).¹⁵ 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 the Notional Face Value of the Basket Component multiplied by one minus the Basket Recovery Rate specified by the Exchange at listing.

The cash settlement amount would be automatically paid each time a Credit Event is confirmed for a Basket Component for Multiple Payout Credit Default Basket Options (this amount would only be paid once in connection with a particular Basket Component, after which time that Basket Component would be removed from the Credit Default Basket) or the cash settlement amount would be paid a single time when the first Credit Event is confirmed for Single Payout Credit Basket Options. 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 will be automatically paid and/or automatically exercised and the option’s cash settlement amount. In this regard,

¹⁵ Id.

the Exchange believes that Credit Default Basket Options, by their proposed terms, are 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, then 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 in 1993 to designate “FLEX Options” as standardized options.¹⁶ In making this designation, the Commission found that, “[a]part from the flexibility with respect to strike prices, settlement, expiration dates, and exercise style, all of the other terms of [FLEX] Options are standardized.” The Commission observed that standardized terms include matters such as “exercise procedures, contract adjustments, time of issuance, effect of closing transactions, restrictions on exercise under OCC rules [and] margin requirements....” Credit Default Basket Options share all of these characteristics and, in fact, are more standardized than FLEX Options in that the exercise settlement calculation, settlement, expiration dates, and exercise style of a given class may not vary.

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.

¹⁶ See Securities Exchange Act Release No. 31910 (February 23, 1993), 58 FR 12056 (March 2, 1993).

(2) Statutory Basis

The Exchange believes the proposed rule change is consistent with the Act¹⁷ and the rules and regulations under the Act applicable to national securities exchanges and, in particular, the requirements of Section 6(b) of the Act.¹⁸ Specifically, the Exchange believes the proposed rule change is consistent with the Section 6(b)(5)¹⁹ 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

This proposed rule change does not 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

¹⁷ 15 U.S.C. 78s(b)(1).

¹⁸ 15 U.S.C. 78f(b).

¹⁹ 15 U.S.C. 78f(b)(5).

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.

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. 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 Section, 100 F Street, NE, Washington, DC 20549-1090. Copies of such filing also will be available for inspection and copying at the principal office of the CBOE. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-CBOE-2007-26 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²⁰

Dated: _____

Nancy M. Morris
Secretary

²⁰ 17 CFR 200.30-3(a)(12).

EXHIBIT 3

CBOE Credit Default Basket Options
Product Description

Description of Basket Underlying Contract Credit Default Basket Options are cash-settled call options based on a Basket of Reference Entities (“Basket Components”). The options automatically pay out a cash settlement amount upon the confirmation of a Credit Event in one, some or all of the Basket Components, as specified by the Exchange at listing. The cash settlement amount could be different for different Basket Components. The Credit Default Basket can be reconstituted periodically and new option series based on the reconstituted Credit Default Basket can be listed as new option classes. Existing options based on the original Credit Default Basket will continue to trade until expiration.

The following will be specified at the time a Credit Default Basket Option contract is listed:

- (a) the Notional Face Value of Basket(e.g., \$100,000),
- (b) the Basket Components,
- (c) the weight of each Basket Component, which represents the fraction of the Notional Face Value of the Basket allocated to each Basket Component. (For example, if the Notional Face Value of Basket is \$100,000, and there are 10 equally weighted Basket Components, each Basket Component has a Notional Face Value of \$10,000).
- (d) the recovery rate of each Basket Component,
- (e) the specified debt security that defines the Reference Obligation of each Basket Component (e.g., Corporation XYZ 8.375% July 2033 bond), and
- (f) the applicable Credit Event(s).

Basket Components will 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.

Definition of Default “Credit Event”

For each Basket Component, a “Credit Event” will include the occurrence of one or more of the following events 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 Basket Component. A “Failure-to-Pay Default” will be defined 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); 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).

Relevant Securities	The specified debt security that defines the Reference Obligation of each Basket Component and all its other debt security obligations.
Strike Price	Not applicable.
Cash Settlement Types	<p>Credit Default Basket Options settle in two manners:</p> <ul style="list-style-type: none"> • <u>Multiple Payout Credit Default Basket Options.</u> This type of Credit Default Basket Option automatically pays a cash settlement amount upon the confirmation of each Credit Event until the scheduled last day of trading. A cash settlement amount would only be paid once per Credit Event confirmed in a Basket Component, after which time it would be removed from the Credit Default Index. If a Credit Event is confirmed in every Basket Component prior to expiration, the option will cease to trade, or if no Credit Event is confirmed in any Basket Component prior to expiration, the option will expire worthless. • <u>Single Payout Credit Default Basket Options.</u> This type of Credit Default Basket Option is automatically exercised upon the confirmation of the first Credit Event in a Basket component, at which time the option will cease to trade. If no Credit Event is confirmed in any Basket Component prior to expiration, the option will expire worthless.
Cash Settlement	If the Exchange confirms a Credit Event in an Basket

Amount	<p>Component prior to 10:59 p.m. (CT) on the last trading day, the cash settlement amount will be equal to the Notional Face Value of the Basket Component times one minus its Recovery Rate. 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 is $\\$6,000 = \\$10,000 * (1 - 0.40)$.</p> <p>Multiple Payout Credit Default Basket Options automatically pay holders a cash settlement amount for each Basket Component that has a confirmed Credit Event.</p> <p>Single Payout Credit Default Basket Options pay holders a cash settlement amount a single time when the first Credit Event is confirmed during the life of the option.</p>
Unit/Multiplier	The Basket Notional Face Value is divided by 100. For example if the Basket Notional Face Value is \$100,000, the multiplier is 1,000.
Exercise Settlement Value	The automatic payout (for a Multiple Payout Credit Default Basket Option) or exercise settlement value (for Single Credit Default Basket Option) will be equal to the cash settlement amount divided by the contract multiplier specified by the Exchange.
Minimum Price Increment	\$0.05 per unit
Contract Months	The Exchange usually will list one to four series for each year up to 10.25 years from the current expiration cycle. Unless a Credit Event has been confirmed, the last trading day in the series will be the 3rd Friday of the expiration month in the March, June, September or December expiration month (however, if that day is not a business day, the last trading day in the series will be on the preceding business day).
Special Contingencies	<p>Special procedures will apply if one or more of the following events occur on or before the last trading day:</p> <p>(1) A Succession Event, which will be defined in accordance with the terms of the Relevant Obligation(s).</p> <p><u>Adjustment for Succession:</u> Once the Exchange has confirmed a Succession Event in an Basket Component, that component may be replaced by one or more Basket Components ("Successor Basket Components") consisting of</p>

the Successor Reference Entity(ies), as determined in accordance with Rule 29.4

For each Successor Basket Component, the Exchange will specify the Reference Obligation (e.g., XYW 8.375% December 2033 bond), recovery rate and the Basket weight of each Successor Basket Component. The sum of the weights of the Successor Basket Components will equal the weight of the Basket Component replaced by the Successor Basket Components.

- (2) A Redemption Event, which will be defined in accordance with the terms of the Relevant Obligation(s) and will include the redemption of the Reference Obligation and of all other Relevant Obligations. If the Reference Obligation is redeemed or matures but other Relevant Obligation(s) remain, a new Reference Obligation will be specified from among the remaining Relevant Obligation(s) and the substitution will not be deemed a Redemption Event.

Adjustment for Redemption: Once the Exchange has confirmed a Redemption Event in a Basket Component, that Basket Component will be removed from the Credit Default Index.

Confirmation of Credit
Event and Special
Contingencies

The Exchange will confirm Credit Events and Special Contingencies based on at least two of the following sources of publicly available information: (1) announcements published by newswire services or information services companies, the names of which will be announced to the membership via Regulatory Circular; and/or (2) information submitted to or filed with the courts, the SEC, an exchange or association, the OCC, or another regulatory agency or similar authority.

Every determination made by the Exchange shall be within its sole discretion and shall be conclusive and binding on all investors and not subject to review.

The confirmation period will begin when the Credit Default Basket Option contract is listed and will extend to 3:00 p.m. (CT) on the expiration date.

Last Trading Day

The 3rd Friday of the expiration month (or, if that day is not a business day, the preceding business day); however, if a Credit Event has been confirmed prior to that date in every Basket Component for a Multiple Payout Credit Default Basket Option or the first Credit Event in any one of the Basket Components for a Single Payout Credit Default Option, or if a Redemption

Event has been confirmed in the last Basket Component prior to that day, the series will cease trading at the time of the confirmation and the last trading will be changed to the confirmation date.

Expiration Date	The 3rd Friday after the Last Trading Day (or, if that day is not a business day, the 4th business day after the preceding business day); however, if a Credit Event has been confirmed before that day in every Basket Component for a Multiple Payout Credit Default Basket Option or the first Credit Event in any one of the Basket Components for a Single Payout Credit Default Option, or if a Redemption Event has been confirmed in the last Basket Component prior to that day, the expiration date will be accelerated to the 2nd business date immediately following the last confirmation date.
Final Settlement Date	The date following the expiration date.
Trading Hours	8:30 a.m. – 3:00 p.m. (CT)
Trading Platform	CBOE <i>direct</i>
Position Limit	50,000 contracts
Margin	As described in Rule 12.3(l).