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## A New Breed of Securities: Credit Default Options Proposed by CBOE

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### Overview

On February 7, 2007, the Chicago Board Options Exchange, Incorporated (CBOE), filed a proposal to amend its rules to permit the listing and trading of Credit Default Options (CDOs).[i] The CDOs will be modeled after credit default swaps and structured as binary call options that settle in cash based on confirmation of one or more specified adverse credit developments (such as payment default) involving a Reference Entity. A "binary call option" is an option contract that will pay the contract holder a fixed amount upon exercise, and the "Reference Entity" would be the issuer or guarantor of the debt security underlying the CDO (referred to as the Reference Obligation). To the extent possible, the CBOE intends to have the CDOs recognized and treated as existing standardized options.

The CBOE submitted its filing with the Securities and Exchange Commission (SEC or Commission) shortly after the Chicago Mercantile Exchange (CME) received approval from the Commodities Futures Trading Commission (CFTC) to move forward with its own plans to offer the first exchange-traded credit derivative contracts modeled after credit default swaps.[ii] The CFTC approved the new products, despite protests from the CBOE that the CME's new futures contracts are characterized more properly as options and therefore should be reviewed and regulated by the SEC instead of the CFTC.[iii]

This alert describes some of the benefits of trading CDOs on the CBOE (as cited by the CBOE) and highlights the key terms and provisions of these instruments under the CBOE's rule proposals. Comments are due by March 7, 2007.

### Benefits of Trading the CBOE's CDOs

According to the CBOE, CDOs will be useful to those with substantial investments in debt securities, including both institutional investors (such as credit market participants and fixed income traders) and individual investors. In particular, these instruments will provide market participants with additional hedging and risk-shifting vehicles, and enable them to supplement income by writing CDO calls. In its Notice, the CBOE cited the following additional benefits:

- Given the binary nature of the product, the purchaser and the writer of the options would know the expected return at the time the contract is entered.
- Since the payment is fixed, the risk (return) to the writer (purchaser) would be limited.
- By trading CDOs in the CBOE's centralized, open-outcry auction market (with designated members having market-making responsibilities), investors would be better able to initiate and close out positions efficiently and at the best available prices.
- Unlike the existing over-the-counter (OTC) market, CBOE's market would provide transparency as the result of the real-time dissemination of best bids and offers and reports of completed CDO transactions.
- The role of the Options Clearing Corporation (OCC) as issuer and guarantor of CDOs would eliminate concern over contra-party creditworthiness and assure performance upon automatic exercise of CDOs.
- Subjecting CDOs to CBOE's rules, regulations and oversight would provide enhanced investor protection and market surveillance.

### **Key Provisions and Terms of CDOs**

As stated above, the CBOE intends to have CDOs recognized and treated as existing standardized options. To that end, standardized systems for listing, trading, transmitting, clearing and settling options (including systems used by OCC) would be used in connection with CDOs. Additional details regarding some of the key provisions and terms of CDOs are described below.

**Designation of CDOs.** After a particular CDO class has been approved for listing and trading, the CBOE would periodically open for trading a series of options on that class.<sup>[iv]</sup> Only CDO contracts approved by the CBOE and currently open for trading on the CBOE would be eligible to be purchased or written on the exchange. Prior to the opening of trading in a particular CDO series in a given class, the CBOE would fix the expiration month and year.

**Determination of Credit Events.** Generally, a Credit Event would occur when the Reference Entity has:

- a Failure-to-Pay Default on 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");<sup>[v]</sup>
- any other Event of Default on the Relevant Obligation(s);<sup>[vi]</sup> and/or
- a change in the terms of the Relevant Obligation(s) (a Restructuring).<sup>[vii]</sup>

The CBOE would confirm a Credit Event 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. Every determination of a Credit Event would be within the CBOE's sole discretion, and would be conclusive and binding on all holders as well as sellers of the CDO, and not subject to review by market participants.

**Automatic Exercise and Settlement.** If the CBOE confirms a Credit Event, the CDO class would be subject to an automatic exercise and the holders of long options positions would receive a fixed

cash settlement payment equal to \$100,000 per contract. Otherwise, if there were no Credit Event confirmed prior to the expiration date, the cash settlement amount would be \$0. Under proposed Rule 29.9, the Credit Event confirmation period would begin when the CDO contract is listed and would extend to 3:00 p.m. (CT) on the expiration date. Once a Credit Event is confirmed, the CBOE would also provide the OCC with notice of the Credit Event and the applicable cash settlement value, similar to the notification procedures currently in place for existing index products trading on the CBOE. The settlement rights and obligations of holders and sellers of CDOs dealt on the CBOE will be set forth in the OCC By-Laws and Rules.

**Adjustments.** Proposed Rule 29.4 would contain information about adjustments due to succession or redemption events in the Reference Entity. The CBOE would confirm adjustment events based on at least two sources, which could include announcements published via newswire services or information services companies, the names of which would be announced to the membership via Regulatory Circular. Every such determination made pursuant to the proposed rule would be within the CBOE's sole discretion and be conclusive and binding on all holders as well as sellers, and not subject to review by market participants.

**Position Limits.** The CBOE has proposed that position limits for CDO contracts be equal to 5,000 contracts on the same side of the market.<sup>[viii]</sup> In determining compliance with position limit requirements, proposed Rule 29.5 would provide that CDOs should not be aggregated with option contracts on the same or similar underlying security. CBOE believes that the "all-or-none" nature of CDOs, 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, CDOs would not be subject to the hedge exemption to the standard position limits found in existing CBOE rules.<sup>[ix]</sup> Instead, the following qualified hedge exemption strategies and positions would be exempt from the established position limits: (i) a CDO position "hedged" or "covered" by an appropriate amount of cash to meet the cash settlement amount obligation (e.g., \$100,000 for a CDO with an exercise settlement value of \$100 multiplied by a contract multiplier of 1,000); and (ii) a CDO position "hedged" or "covered" by an amount of an underlying debt security (or securities) that serves as a Relevant Obligation(s) and/or other securities, instruments or interests related to the Reference Entity that are sufficient to meet the cash-settlement amount obligation. Also, the existing market maker and firm facilitation exemptions to position limits currently available to members would apply to CDOs.<sup>[x]</sup>

**Position Reporting Requirements.** Under proposed Rule 29.6, the standard equity reporting requirements described in existing CBOE rules would be applicable to CDOs.<sup>[xi]</sup> As such, positions in CDOs would be reported to the CBOE via the Large Option Positions Report when an account establishes an aggregate same-side-of-the-market position of 200 or more CDOs. In computing reportable CDOs under existing CBOE rules, CDOs could not be aggregated with non-Credit Default contracts.<sup>[xii]</sup> In addition, CDOs on a given class may not be aggregated with any other class of CDOs. Unlike existing CBOE reporting requirements, however, a reporting obligation would be triggered for a CDO 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 usual 10,000-contract trigger amount.

**Exercise Limits.** Upon determination of a Credit Event, the CDO class would cease trading and all outstanding CDO contracts would be subject to automatic exercise. As a result and given the fixed payout nature of these options, there would be no exercise limits for CDOs.<sup>[xiii]</sup>

**Margin Requirements.** The CBOE has proposed to supplement its existing margin requirement rules to include requirements applicable to the initial and maintenance margin required on any CDOs carried in a customer's account. The initial and maintenance margin required on any CDO carried long in a customer's account would be 100% of the current market value of the CDO. For qualified customers, however, the margin would be 20% of the current market value of the CDO. The CBOE is also proposing to amend its margin rules to provide that CDOs carried for the account of a qualified investor that are listed or guaranteed by the carrying broker-dealer may be deemed to have additional market value. For purposes of these proposed provisions, the term "qualified customer" would be defined as a person or entity that owns and invests on a discretionary basis no less than \$5,000,000 in investments.<sup>[xiv]</sup>

**Options Disclosure Document.** To accommodate the listing and trading of CDOs, it is expected that the OCC would amend its By-Laws and Rules to reflect the different structure of CDOs. It is also likely that OCC would seek a revision to incorporate CDO's into the Options Disclosure Document.

**Applicability of Rule 9b-1 under the Act.** The CBOE also asked the Commission to confirm that CDOs are standardized options under the SEC's Options Disclosure Document requirements (Rule 9b-1 under the Securities Exchange Act of 1934). Rule 9b-1 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 SEC may, by order, designate." According to the CBOE, CDOs are similar to existing standardized options trading on CBOE in every respect except for the exercise price. To that end, CDOs (i) trade on a national securities exchange; (ii) have a specific expiration date; (iii) have fixed terms; (iv) have a specific exercise style; and (v) would be issued and cleared by the OCC. Moreover, as pointed out by the CBOE, a party entering into a CDO would know exactly the terms under which it would be automatically exercised and the option's cash settlement value, which would be an exercise settlement value of \$100 multiplied by the contract multiplier of 1,000.

## **Conclusion**

Ultimately, it is unclear whether the CBOE's CDOs will become important hedging vehicles for market participants, given the availability of similar products in the OTC markets (including credit default swaps, which may be structured to avoid characterization as securities and, therefore, the applicability of the federal securities laws and self-regulatory organization rules). <sup>[xv]</sup> The CBOE appears to be sensitive to such issues regarding competitiveness; in its Notice, it stated that, in setting the proposed margin, position limit and reporting requirements, it was cognizant of the existence of the competitive OTC market, in which similar restrictions do not apply. In the CBOE's view, however, the proposed rules strike a necessary and appropriate balance of encouraging the use of CDOs while at the same time addressing concerns that market participants may try to

maintain inordinately large unhedged positions in CDOs.

It also remains to be seen what effect the availability of the CDOs will have on issuers and, in particular, whether these new hedging vehicles will provide enhanced liquidity for issuers' debt securities, thereby facilitating capital raising efforts.

For more information on this or other securities matters, please contact the authors listed above.

[i] Notice of Filing of a Proposed Rule Change and Amendment Nos. 1, 2, 3, and 4 thereto to List and Trade Credit Default Options, Securities Exchange Act Release No. 55,251 (Feb. 7, 2007), 72 Fed. Reg. 7,091 (Feb. 14, 2007) ("Notice"), available at <http://www.sec.gov/rules/sro/cboe/2007/34-55251.pdf>. The CBOE initially filed a proposal with the Securities and Exchange Commission to list and trade CDOs on October 26, 2006. On December 21, 2006, CBOE filed Amendment No. 1 to the proposed rule change; on January 16, 2007, CBOE filed Amendment No. 2; and on February 2, 2007, CBOE filed Amendment No. 3.

[ii] A copy of the CME's submission, as amended, is available at <http://www.cftc.gov/files/submissions/filings/CmeCreditEventSupplement1-16-07a.pdf>.

[iii] In December 2006, the CBOE wrote to the CFTC, arguing that the CME's credit event futures contract should not be characterized as a futures contract, but rather as options based on one or more securities.

[iv] Proposed CBOE Rule 29.2 sets forth the designation criteria and requirements.

[v] A Failure-to-Pay Default would be defined in accordance with the terms of the Relevant Obligation. Generally, a failure to pay would occur when a Reference Entity fails to make payments in accordance with the terms of the applicable Reference Obligations (and after the expiration of any applicable grace period).

[vi] Any applicable Event of Default would be specified by the CBOE at the time the option class is initially listed in accordance with the procedures of proposed Rule 29.2 and, for each such Event of Default specified, would be defined in accordance with the terms of the Relevant Obligation.

[vii] The terms of such a Restructuring would be specified by the CBOE in accordance with proposed Rule 29.2 and, if so specified, would be defined in accordance with the terms of the Relevant Obligation.

[viii] The CBOE, however, anticipates these limits would be increased over time and based on its experience in trading CDOs.

[ix] See CBOE Rule 4.11.04.

[x] See CBOE Rules 4.11.05 and 4.11.06, respectively. With respect to the market-maker hedge exemption, the CBOE is proposing that the positions must generally be within 20% of the applicable limits of the Credit Default Option before an exemption would be granted. With respect to the firm facilitation exemption, the CBOE is proposing that the aggregate exemption position could not exceed three times the standard limit of \$5,000 and be applied consistent with the procedures

described in existing Rule 4.11.06.

[xi] See CBOE Rule 4.13.

[xii] See *id.*

[xiii] See proposed CBOE Rule 29.7.

[xiv] The definition of "qualified purchaser" in Section 2(a)(51)(A) of the Investment Company Act of 1940, as amended, includes (1) any natural person who owns not less than \$5,000,000 in investments, and (2) any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than \$25,000,000 in investments.

[xv] Security-based swaps, however, are still subject to the fraud, manipulation and insider trading prohibitions of the federal securities laws.

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