

dividends, stock distributions, and stock splits consistent with the adjustment rules for stock options with respect to stock dividends, stock distributions, and stock splits and thus should protect investors and the public interest.

#### IV. Conclusion

On the basis of the foregoing, the Commission finds that the proposed rule change is consistent with the requirements of the Act and in particular Section 17A of the Act and the rules and regulations thereunder. In approving the proposed rule change, the Commission considered the proposal's impact on efficiency, competition and capital formation.

*It is therefore ordered*, pursuant to section 19(b)(2) of the Act, that the proposed rule change (File No. SR-OCC-2006-08) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>6</sup>

**Florence E. Harmon,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-55362; File No. SR-OCC-2007-01]

### Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing of Proposed Rule Change Relating to Credit Default Options

February 27, 2007.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> notice is hereby given that on February 13, 2007, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change described in Items I, II, and III below, which items have been prepared primarily by OCC. The Commission is publishing this notice to solicit comments on the proposed rule change from interested parties.

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

The proposed rule change would permit OCC to clear and settle credit default options ("CDOs"), which are options related to the creditworthiness of an issuer or guarantor of one or more specified debt securities. Credit default

options are proposed to be traded by the Chicago Board Options Exchange ("CBOE").<sup>2</sup>

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

In its filing with the Commission, OCC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. OCC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of these statements.<sup>3</sup>

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

The purpose of this rule change is to permit OCC to clear and settle CDOs, which are options related to the creditworthiness of an issuer or guarantor ("reference entity") of one or more specified debt securities ("reference obligation(s)"). CDOs are binary options that pay a fixed amount to the holder of the option upon the occurrence of a "credit event" affecting the reference obligations.<sup>4</sup> Characteristics of CDOs are described below, followed by an explanation of the specific rule changes being proposed to clear them.

##### Description of Credit Default Options

CDOs are structured as binary options that are automatically exercised and the exercise settlement amount payable if a "credit event" occurs at any time prior to the last day of trading. A "credit event" is generally defined as any failure to pay on any of the reference obligations or any other occurrence that would constitute an "event of default" or "restructuring" under the terms of any of the reference obligations and that the listing exchange has determined would be a credit event for purposes of the CDO. Under CBOE's current proposal, the payout or "settlement amount" for a single exercised option would be \$100,000.

OCC does not currently clear any binary options although OCC has filed

a rule change<sup>5</sup> seeking to clear binary options on securities and securities indexes that have been proposed for trading by CBOE and the American Stock Exchange ("Amex").<sup>6</sup> The binary options rule filings of OCC, Amex, and CBOE are still pending approval by the Commission, and OCC expects to amend its binary options rule filing in the near future in order to conform it to the changes made in this filing and to make any additional changes necessary to accommodate the Amex and CBOE products. Under the binary options rule filings, binary options are proposed to be traded on the price of single securities or on the price of indexes of securities where the option is exercised if the closing value of the underlying interest meets the specified criterion for automatic exercise, which could be defined as "at or above" a certain value, "below" a certain value, or in other ways. In other words, the underlying interest is a continuous measure that could have a wide range of positive values. CDOs, on the other hand, are options for which the payout is determined by the occurrence or non-occurrence of a discrete credit event affecting underlying securities. The rules proposed in the current rule filing for CDOs are intended to be sufficiently generic to be the basis for clearing CDOs as well as other binary options although certain provisions specific to other binary options proposals will be filed separately.

##### By-Law and Rule Amendments Applicable to CDOs

In order to accommodate trading in CDOs and to provide a framework of rules that can accommodate other binary option products as well, OCC proposes to add a new By-Law Article and a new Chapter to its Rules to incorporate several new defined terms and procedures for clearing and settling binary options generally and CDOs specifically.

##### 1. Terminology—Article I, Section 1 and Article XIV, Section 1 of the By-Laws

"Binary Option" is defined in Article XIV, Section 1 of the By-Laws, and that definition is cross-referenced in Article I of the By-Laws. The definition of "expiration time" in Article I is modified to be a default provision, permitting the expiration time to be defined differently for different classes of options. The definition of "option contract" in Article I of the By-Laws is amended to include a binary option and

<sup>5</sup> File No. SR-OCC-2004-21.

<sup>6</sup> File Nos. SR-Amex-2004-27 and SR-CBOE-2006-105.

<sup>2</sup> File No. SR-CBOE-2006-84, Securities Exchange Act Release No. 55251 (February 7, 2007), 72 FR 7091 (February 14, 2007) (notice of filing of proposed rule change).

<sup>3</sup> The Commission has modified the text of the summaries prepared by OCC.

<sup>4</sup> "Binary" options (also sometimes referred to as "digital" options) are "all-or-nothing" options that pay a fixed amount if automatically exercised and otherwise pay nothing.

<sup>6</sup> 17 CFR 200.30-3(a)(12).

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

to provide a more generic definition of “cash-settled option.”

“Adjustment event” is defined in Article XIV by reference to the rules of the listing exchange. Similarly, “credit event” is defined by reference to exchange rules. The terms “credit event confirmation” and “credit event confirmation deadline” are used, respectively, to refer to the notice that must be provided by the listing exchange or other reporting authority to OCC that a credit event has occurred (and that a CDO will therefore automatically be exercised) and to the deadline for receipt of such notice if it is to be treated as having been received on the business day on which it is submitted. Credit event confirmations received after the deadline on the expiration date but before the expiration time will be given effect but may result in delayed exercise settlement.

The definition of “exercise price” in Article I is replaced with respect to CDOs with a revised definition in Article XIV, Section 1 which recognizes that binary options will be settled by a fixed cash payment. The “exercise price” of a binary option is not, as defined in Article I, an amount that is paid in exchange for an underlying interest and is not used to determine the exercise settlement amount as in the case of other cash-settled options. In the case of a binary option other than a CDO, the exercise price is simply a defined value or range of values for the underlying interest. If the underlying interest falls within the defined range at expiration of the option, the option will be automatically exercised. Otherwise, it will expire unexercised. A CDO is said to have no exercise price.

OCC is also redefining the term “exercise settlement amount” in Article XIV for purposes of binary options. The exercise settlement amount of a binary option is the amount specified by the exchange on which the option is traded that will be paid in settlement of an automatically exercised option. CBOE has specified the exercise settlement amount for a single CDO as \$100,000. OCC’s proposed definition would permit an exchange to specify a different exercise settlement amount. The exercise settlement amount will be determined by the exchange at the time of listing when the exchange fixes the other variable terms for the options of a particular class or series.

OCC is replacing the definitions of “variable terms,” “premium,” and “multiplier” in Article I with revised definitions in Article XIV, Section 1 that are applicable to binary options generally. The term “class” is also redefined in Article XIV, Section 1. This

new definition of “class” does not apply to binary options other than CDOs and will need to be supplemented for other binary options. To be within the same class, CDOs must have the same reporting authority, which OCC anticipates will ordinarily be the listing exchange. This is necessary because of the degree of discretion that the reporting authority will have in determining whether a credit event has occurred.

CDOs will be a subcategory of binary options where exercise is triggered by a discrete event such as a “credit event” affecting the “reference obligations” issued by a “reference entity,” which terms are defined to have the meanings given to them in the rules of the listing exchange. The term “underlying interest” is defined in the case of CDOs to be the reference obligation(s) with respect to which the credit event will or will not occur. In the case of other binary options, “underlying interest” is defined as the underlying security, index, or measure whose underlying interest value is compared to the option’s exercise price to determine whether the option will be automatically exercised. “Underlying interest value” is defined to mean the value or level of the underlying interest used to determine whether a binary option will be automatically exercised. The term “underlying interest value” is not applicable to CDOs.

#### 2. Terms of Cleared Contracts—Article VI, Section 10(e)

A new paragraph (e) is added to Article VI, Section 10 so that an exchange is required to designate the exercise settlement amount, expiration date, and exercise price for a series of binary options at the time the series is opened for trading. Section 10(e) also reminds the reader that binary options are subject to adjustment under Article XIV.

#### 3. Rights and Obligations—Article XIV, Section 2

Article XIV, Section 2 defines the general rights and obligations of holders and writers of binary options. As noted above, the holder of a binary option that is automatically exercised has the right to receive the fixed exercise settlement amount from OCC, and the assigned writer has the obligation to pay that amount to OCC.

#### 4. Adjustments of Credit Default Options—Article XIV, Section 3; Determination of Occurrence of Credit Event—Article XIV, Section 4

Article XIV, Section 3 provides for adjustment of CDOs in accordance with

the rules of the listing exchange. CBOE’s proposed rules provide for adjustment of CDOs in the case of certain corporate events affecting the reference obligations, and OCC proposes simply to defer to those rules and to the determinations of CBOE pursuant to those rules. Accordingly, OCC will have no responsibility for adjustment determinations with respect to CDOs. Adjustment rules for other binary options will be supplied as necessary for other products.

Similarly, Section 4 provides that the listing exchange for a class of CDOs will have responsibility for determining the occurrence of a credit event that will result in automatic exercise of the options of that class. The listing exchange has the obligation to provide a credit event confirmation to OCC in order to trigger the automatic exercise.

New Article XIV, Section 5 provides, in essence, that the underlying interest value of a series of binary options other than CDOs will be determined by the exchange or exchanges on which such series is traded. OCC reserves the right to override that determination in certain circumstances. If a series of binary options is traded on more than one exchange, OCC may use the underlying interest value received from the exchange deemed by OCC to be the principal exchange, or OCC may employ a procedure to derive a single value based on some or all of the values received.

#### 5. Exercise and Settlement—Chapter XV of the Rules and Rule 801

Binary options would not be subject to the exercise-by-exception procedures applicable to most other options under OCC’s Rules but would instead be automatically exercised at expiration if the specified criterion for exercise is met. The procedures for the automatic exercise of binary options, as well as their assignment and settlement (including during periods when a clearing member is suspended), are set forth in Rules 1501 through 1505 of new Chapter XV and in revised Rule 801(b).

#### 6. Special Margin Requirements—Rule 601; Deposits in Lieu of Margin—Rule 1506

OCC will not initially margin CDOs through its usual “STANS” system. Because of CDOs’ fixed payout feature, further systems development is needed to accommodate these options in STANS. Until such development is completed, OCC has initially determined to require that writers of such options post margin in a fixed amount that will be set at 100% of the fixed exercise settlement amount

applicable to each series of CDOs. OCC would have discretion to reduce the requirement to something less than 100% if research, analysis, and experience suggest that a lower percentage is sufficient. Initially, long positions in CDOs will be valued at zero and will provide no offset against margin requirements on the shorts. Again, based on research, analysis, and experience, OCC may determine to give some value to the longs. Ultimately, CDOs will be incorporated into the STANS system and valued and will be margined on a risk basis.

OCC does not propose to accept escrow deposits in lieu of clearing margin for binary options. Therefore, Rule 1506 states that Rule 610, which otherwise would permit such deposits, does not apply to binary options.

#### 7. Acceleration of Expiration Date—Rule 1507

This provision permits OCC to accelerate the expiration date of a binary option when the value of the underlying interest has become fixed (e.g., where a stock underlying a binary option has been converted by a merger into the right to receive a fixed amount of cash). If the value of the underlying interest does not meet the specified criterion for automatic exercise, it will expire unexercised. Otherwise, it will be automatically exercised.

The proposed changes to OCC's By-Laws and Rules are consistent with the purposes and requirements of Section 17A of the Act, as amended, because they are designed to promote the prompt and accurate clearance and settlement of transactions in, including exercises of, credit default options and other binary options, and to foster cooperation and coordination with persons engaged in the clearance and settlement of such transactions, to remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of such transactions, and, in general, to protect investors and the public interest. They accomplish these purposes by applying substantially the same rules and procedures to binary options and specifically CDOs as OCC applies to similar transactions in other cash-settled options. Other than as described in this Item II, the proposed rule change is not inconsistent with the existing rules of OCC, including rules proposed to be amended.

#### (B) Self-Regulatory Organization's Statement on Burden on Competition

OCC does not believe that the proposed rule change would impose any burden on competition.

#### (C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

Written comments were not and are not intended to be solicited with respect to the proposed rule change, and none have been received.

#### III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within thirty-five 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 ninety days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) By order approve such proposed rule change or

(B) Institute proceedings to determine whether the proposed rule change should be disapproved.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

##### Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>) or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-OCC-2007-01 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-OCC-2007-01. 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. The text of the proposed rule change is available at OCC, the Commission's Public Reference Room, and [http://www.theocc.com/publications/rules/proposed\\_changes/sr\\_occ\\_07\\_01.pdf](http://www.theocc.com/publications/rules/proposed_changes/sr_occ_07_01.pdf). 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-OCC-2007-01 and should be submitted on or before March 26, 2007.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>7</sup>

**Florence E. Harmon,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-55358; File No. SR-Phlx-2007-14]

### Self-Regulatory Organizations; Philadelphia Stock Exchange, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Extending the Dividend, Merger, and Short Stock Interest Strategies Fee Cap Program

February 27, 2007.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on February 21, 2007, the Philadelphia Stock Exchange, Inc. ("Phlx" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been substantially prepared by the Exchange. Phlx has designated this proposal as one establishing or changing a due, fee, or other charge imposed by a self-regulatory organization pursuant to Section 19(b)(3)(A)(ii) of the Act<sup>3</sup> and Rule 19b-4(f)(2) thereunder,<sup>4</sup> which

<sup>7</sup> 17 CFR 200.30-3(a)(12).

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

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

<sup>3</sup> 15 U.S.C. 78s(b)(3)(A)(ii).

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