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November 3, 2006

Ms. Eileen Donovan
Acting Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: Chicago Mercantile Exchange Submission Under Rule 40.3, Regarding a Proposal to List Credit Event Futures

Dear Ms. Donovan:

This letter is submitted on behalf of Chicago Board Options Exchange, Incorporated ("CBOE") in response to the request for comments issued by the Commodity Futures Trading Commission (the "Commission") regarding the voluntary submission by the Chicago Mercantile Exchange ("CME") on October 17, 2006, as amended by a filing dated October 24, 2006, pursuant to Commission Rule 40.3, for review and approval by the Commission of a new credit default option product designated as "CME Credit Event Futures" (the "CME Product"). The documents filed by the CME ("CME Proposal") were published on the Commission's website on October 18, 2006 and October 26, 2006, together with a request by the Commission that comments be submitted by November 3, 2006.

CBOE is registered as a national securities exchange, regulated by the Securities and Exchange Commission ("SEC"). Founded in 1973, CBOE is the largest options marketplace in the U.S. and the creator of listed options. Currently CBOE trades options on more than 1,766 individual equities, 56 broad- and sector- based indexes, 61 exchange-traded funds, and 4 interest rate products.

As set forth more fully below, CBOE's principal concern is that the approval of the CME Proposal by the Commission will exceed the Commission's statutory authority and will result in the CME listing and offering a security without being registered as a national securities exchange under the Securities Exchange Act of 1934 ("Exchange Act"). In particular, based on the description of the CME Product provided in the CME Proposal, we believe it is clear that the CME Product is excluded from the Commodity Exchange Act ("CEA") and the Commission's jurisdiction. Section 2(a)(1)(C)(i) of the CEA states that

> This Act shall not apply to and the Commission shall have no jurisdiction to designate a board of trade as a contract market for any transaction whereby any party to such transaction acquires any put, call, or other option on one or more securities (as defined in section 2(1) of the Securities Act of 1933 or section 3(a)(10) of the Securities Exchange Act of 1934 on the date of enactment of the Futures Trading Act of 1982), including any group or index of such securities, or any interest therein or based on the value thereof.

For the reasons set forth below, we believe it is clear that the CME Product is an option, and not a futures contract as the CME contends. Moreover, because the CME Product requires payments to be made based on one or more securities of the Reference Entity, and is not otherwise excluded from the securities laws as a "swap agreement," it is itself a separate security that can only be offered on a national securities exchange or in the over-the-counter market, subject to the securities laws. The CME Product, in our view, cannot be traded on a designated contract market such as the CME.

1. The CME Product is an Option and not a Futures Contract

The starting point for the analysis of a product under Section 2(a)(1)(C) of the CEA is whether the derivative instrument is an option or a futures contract. The CEA does not define the term "option." Therefore, in order to determine whether a derivative is an option, the Commission and the courts have examined market practices, traditional contract law, and the economic nature of the product. *See*, CFTC v. Precious Metals Associates, 620 F.2d 900, 907-908 (1st Cir. 1980); CFTC v. Goldex International Ltd., [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) 20,839 at 23,441 (N.D. Ill. 1979) at 23,441. In addition, the Commission and the courts have carefully examined, among other factors, "the economic reality of the transaction, not its name" to determine whether an instrument is an option. *See*, CFTC v. Precious Metals Associates, 620 F. 2d 908. *See also*, CFTC v. Morgan, Harris & Scott, Ltd., 484 F. Supp. 669, 675 (S.D.N.Y. 1979).[1] Merely characterizing a product as a futures contract or other type of derivative is not determinative if in fact the product exhibits the legal and economic characteristics of an option.

Although designated as a futures contract the CME Product is clearly an option and is therefore presumptively covered by Section 2(a)(1)(C), subject to a determination of the nature of the underlyer. The fact that the CME has applied the label "futures contract" to the CME Product is not dispositive and is, in fact, irrelevant. Under the "economic reality" standard, the character of a derivative must be determined on the basis of its terms and structure, not its label.

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[1] *See*, Characteristics Distinguishing Cash and Forward Contracts and "Trade Options," 50 Fed. Reg. 39656 (Sept. 20, 1985).

The Commission itself, as well as the courts, has characterized an option as a derivative that requires the purchaser to pay a premium and exposes the purchaser to limited risk. Specifically, because the option buyer pays a premium for the option, representing only a portion of its value, and has no legal obligation with respect to any further performance, the option buyer simply forfeits the premium but cannot be exposed to additional downside risk:

> In particular, an option is a limited risk instrument. That is, the option purchaser is not liable for payment resulting from any adverse price movement of the commodity underlying the option. Rather, the option purchaser [will benefit from a favorable price move and] will not be liable for any other losses beyond the premium or other payment that the purchaser pays for the option.

Characteristics Distinguishing Cash and Forward Contracts and "Trade Options," 50 Fed. Reg. 39656 (Sept. 20, 1985). *See also*, CFTC v. U.S. Metals Depository Co., 468 F. Supp. 1149, 1154 (S.D.N.Y. 1979); United States v. Bein, 728 F. 2d 107 (2d Cir. 1984).

Thus, an option is a contract in which only the seller is obligated to perform at exercise or expiration. As a result, the option purchaser has a limited risk from adverse price movements. This non-linear, asymmetric character distinguishes an option from a forward or futures contract in which both parties must routinely perform and face the full risk of loss from adverse price changes. Id.

The Commission and its staff have, in the past, found that other types of derivative instruments that exhibited characteristics of an option, including the fact that the exposure of one of the parties of such transaction to loss is limited to the premium paid by such party, should be treated as options, rather than as futures contracts. *See, e.g.*, Commission Interpretative Letter No. 94-32 (Off-Exchange Task Force, February 4, 1994) (concluding that a derivative based on securities, "while possessing attributes of futures contracts," should be characterized as options that are outside the Commission's jurisdiction based on their "predominantly option-like attributes . . . because they reflect a return based on one-way indexing as opposed to two-way indexing").

Like other types of options, the CME Product will be purchased for a non-refundable premium. Although the premium payment obligation is styled as a "margin" payment and is spread out over a period of time, it is clear that one party -- the buyer of the protection under the CME Product -- will have risk exposure that is limited to the amounts paid as premium. The buyer will also have no payment obligations at expiration other than unpaid predetermined premium, which is also characteristic of an option. Under the CME Product, the seller of the protection will be the only party bearing the credit risk, being obligated to make a payment only if a credit event occurs with respect to a third party ("Reference Entity"). The CME Product therefore exhibits the non-linear asymmetric payout that is characteristic of an option. As described under the CME Proposal, a credit event for the purposes of the CME Product would include, among others, the failure by the Reference Entity to pay on certain identified debt securities or some form of restructuring of the Reference Entity's securities.

Indeed, the Commission has previously recognized as options products with similar characteristics and "binary" payout features. *See*, Designation Memorandum, dated February 10, 2004, regarding Application of HedgeStreet, Inc. ("HedgeStreet") for Designation as a Contract Market. In that instance, the Commission's staff, in recommending approval of the HedgeStreet application, noted that HedgeStreet proposed "to list for trading European-style binary options, rather than the more conventional futures or options contracts listed on existing exchanges." These options, like the CME Product, provided for payment of a fixed amount premium by the purchaser and for payment of a fixed amount by the seller if certain "events" occurred. In recommending approval of the application, the staff noted that "[t]he Commission has approved option contracts that have some features similar to the types of contracts that HedgeStreet intends to list."[2]

The CME Product will similarly be offered as a binary option with a final cash settlement that is binary in character: the final settlement amount will be established at zero in the absence of any credit event and there will be a fixed amount payout upon the occurrence of a credit event. Therefore, although the CME appears to propose that its new product will be marketed as a futures contract (i.e. subject to daily margining requirements), this does not change the characterization of the CME Product as an option.

2. The CME Product is a Security

As noted, Section 2(a)(1)(C)(i) of the CEA excludes from the Commission's jurisdiction any option "on one or more securities . . .," as defined under the Securities Act of 1933 ("Securities Act") and the Exchange Act, "including any group or index of such securities, or any interest therein or based on the value thereof." Because the CME Product is clearly an option, the second level of inquiry in determining its status under the CEA is an analysis of the underlying instrument or asset. The CME Product is based on a security "or any interest therein or based on the value thereof" and is therefore encompassed within Section 2(a)(1)(C)(i).

A. Cash Settled Options on Securities

First, although the CME Product does not provide for the delivery of an underlying security, it is clear that Section 2(a)(1)(C)(i) covers cash settled options based on the price or value, or other features, of a specified security. *See* Caiola v. Citibank, N.A., 295 F.3d 312 (2d Cir. 2002). In Caiola, the Second Circuit held that cash-settled options based on the prices of securities are options "on" such securities and are therefore within the definition of a security. The Court in that instance stated that the phrase "based on the value thereof" in the

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[2] For example, the Commission approved the Chicago Board of Trade to list the PCS Catastrophe Single-Event Insurance contracts, which are binary options with a fixed payout of $10,000 (*see* the Memorandum dated December 8, 1997 to the Commission from the Division of Economic Analysis). Id.

definition of a security applies to any option, and not only an option on a group or index of securities:

> Procter & Gamble [a prior District Court decision] concluded that a critical feature of an option was the right to take possession of the security because the parenthetical "based on the value thereof" in section 3(a)(10) applied only to the immediately preceding phrase, "group or index of securities" and not to "any security." We believe this conclusion is incorrect, and we decline to follow its lead. We hold that the parenthetical applies to "any security." The text of the statute itself includes cash-settled options by defining "option" to include an option on a "group or index of securities." This provision is sufficiently clear that a resort to legislative history is not necessary . . ."

295 F.3d 312, 396. Therefore, a cash-settled option based on the price or value of an individual security is unquestionably a separate security.

B. The CME Product Is Based on a Security

Second, the CME Product is based on a security and must therefore be considered a separate security. The CME Product is either based directly on one or more securities of the Reference Entity or on a swap that is not excluded from the definition of a security under the securities laws and is therefore a security. In this regard, the CME Product is distinct from credit default swaps traded in the over-the-counter market, which are excluded from the definition of a "security" under the Commodity Futures Modernization Act of 2000 (the "CFMA"). However, the exclusion for credit default swaps is only applicable to swaps that satisfy certain specified criteria, including the requirement that they be individually negotiated and entered into solely between "eligible contract participants."[3] The CME Product obviously does not meet these criteria and does not qualify as a swap agreement that would be excluded from the definition of a security under the securities laws. Moreover, the instrument or interest underlying the CME Product cannot qualify as a swap agreement for the same reasons, and the CME Product cannot be characterized as an option on a swap that is excluded from the securities laws. Therefore, the CME Product can only be characterized as an option that is based either directly on a security, or on a swap that is a security because it does not qualify for exclusion from the securities laws under the CFMA.

We note initially that the SEC has determined that a cash-settled option based on a variety of other features of a specified security -- and not simply one based on the price or value of the security alone -- is within the statutory definition of a security under the language quoted above. *See e.g.*, In the Matter of Gary S. Missner, Securities Exchange Act Release No.

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[3] However, a credit default swap is nevertheless a "security-based swap" under the CFMA, and is subject to certain provisions of the securities laws, including the antifraud provisions.

37,301, June 11, 1996 (finding that a cash-settled put on the spread between the price and yield of two Treasury securities was a separate security). On this basis, options on the yields of specified securities have long been considered securities. The yield to maturity of a fixed income security is the promised annual rate of return if the security is held to maturity and its coupons are reinvested. Equivalently, the price of a fixed income security is the sum of the promised coupons and principal discounted at a rate equal to the yield-to-maturity. The price and yield-to-maturity are two equivalent quotation methods by which the cash market represents the value of fixed-income securities. The yield-to-maturity is calculated from the price and the price is calculated from the yield-to-maturity. For this reason, options on the yields of specified securities have traded as securities and have been listed on national securities exchanges for many years. *See* Securities Exchange Act Release No. 26938 (June 22, 1989). In approving yield options for trading on national securities exchanges, the SEC concluded that they are securities and that "these interest rate measure instruments fall within the [Exchange] Act's definition of security because they are an option on a security or a 'group or index of securities (including any interest therein or based on the value thereof)." Id. On this basis, CBOE in particular has listed options based on the yield-to-maturity of on-the-run Treasury securities – the five-year Treasury Note, the ten-year Treasury Note and the thirty-year Treasury Bond. In addition, the CBOE has made the necessary filings with the SEC to list price-based options on corporate debt securities, and may in the future file to list yield-based options on corporate debt securities.

In the same way, credit default options, such as the CME Product, are based on the price or value of corporate debt securities, and/or interests therein, including the yield of specified debt securities. The yield-to-maturity of a corporate debt security is the sum of two components. The first is the yield-to-maturity of a Treasury security of comparable maturity and the second is the credit spread. The credit spread is the additional yield required by investors to compensate them for the expected loss if the issuer of a corporate debt security defaults on its payment obligations. The credit spread therefore increases with the probability of default. Since a corporate debt security is discounted at a higher yield-to-maturity that incorporates the probability of default, its price is lower than the price of a Treasury security and decreases as the probability of default increases.

The CME Product is an option that results in a payment by the seller if a "Credit Event" occurs with respect to a security issued by a Reference Entity, among other things. A "Credit Event" is defined as a default by the Reference Entity on its outstanding obligations, including corporate debt securities issued by such Reference Entity (each a "Reference Security"), or the bankruptcy of the Reference Entity. The CME Product, by referencing defaults on securities of the Reference Entity, is unquestionably based "on" a security or an "interest therein" or "the value thereof," within the meaning of Section 2(a)(1)(C)(i). If the Reference Entity defaults on the Reference Security, either as a result of non-payment on such Reference Security or on another Reference Security, or as a result of a bankruptcy, the value of such Reference Security will be directly and materially affected. Moreover, because of the connection between the price and credit spread of a particular debt security, the Credit Event (or the market's assessment of the likelihood of a Credit Event) will similarly have a material adverse effect on the price of the Reference Security.

Further, the settlement value of a credit default option - and of the CME Product - is a function of the cash flows of the payment obligations to investors under the Reference Security. Specifically, the settlement value of a credit default option compensates investors in the Reference Security for the promised interest and principal payments which they lose because of a Credit Event.

The CME Product must therefore be characterized as an option "on" a security or an option based on the "value" of a security. Indeed, the market's view of the likelihood of a Credit Event with respect to the Reference Entity which, as noted, will be reflected in the price of and credit spread on that security, will determine the price at which the CME Product will trade. Moreover, there will be a direct and substantial correlation between the occurrence of a Credit Event and the price and value of the underlying security. For this reason, models that price credit infer the probability of default from corporate debt security prices.

As noted, if the CME Product qualified as a "swap agreement" under the CFMA, it would be excluded from the definition of a security under the securities laws. Similarly, if it were based on a swap that qualified for this exclusion, it would be an option on a non-security that would not itself be a security. However, because neither the CME Product nor its underlyer can meet the criteria specified in the CFMA, the CME Product cannot be characterized as an option on a non-security and must therefore be treated as a security.

3. Conclusion

On the basis of the foregoing, as the CME Product is clearly an option "on a security", or on an "interest therein or based on the value thereof," and is therefore excluded from the CEA, and the jurisdiction of the Commission, under Section 2(a)(1)(C)(i) of the CEA. Accordingly, the Commission has no authority to approve the CME Proposal and the CME has no authority to list and trade the CME Product. CBOE therefore urges the Commission to deny approval of the CME Proposal in order to clarify the scope of the Commission's and the CME's jurisdiction, provide legal certainty to the marketplace and avoid the potential for disruptive legal ambiguities and disputes.

CBOE appreciates the opportunity to provide these comments. Should you require any further information, please do not hesitate to contact the undersigned.

Sincerely,

Joanne Moffic-Silver