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January 26, 2007

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 by 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 filings dated October 24, 2006, January 12, 2007 and January 16, 2007, 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"). This letter supplements the comment letters submitted by CBOE on this matter, dated November 3, 2006, December 5, 2006 and December 19, 2006 (the "Prior CBOE Letters").

As set forth more fully in the Prior CBOE Letters, the CME Product (even as modified) is an option, not a futures contract, and is based on one or more securities. As a result, the CME Product is a security within the meaning of the Securities Act of 1933 and the Securities Exchange Act of 1934 ("SEA"). Accordingly, the CME Product is excluded from the Commodity Exchange Act ("CEA") and the Commission's jurisdiction pursuant to Section 2(a)(1)(C)(i) of the CEA. In this regard, CBOE has filed with the Securities and Exchange Commission ("SEC") proposed rules to permit CBOE to list credit default options, because this product is a security and can only trade on a national securities exchange.

In its most recent filing with the Commission, the CME has revised the proposed terms of the CME Product by limiting the definition of a "Credit Event" to a bankruptcy of the Reference Entity. In so doing, the CME has eliminated a number of Credit Events that

previously formed part of the definition and that expressly related to the Reference Entity's outstanding securities, such as "Failure to Pay."<sup>1</sup>

As set forth in the Prior CBOE Letter dated December 19, 2006, even if payment under the CME Product is triggered only by the occurrence of a "bankruptcy event," without an explicit reference to any securities, the CME Product still constitutes a security, given the fact that a "bankruptcy event" is merely a proxy for an express reference to the valuation of such securities and, moreover, necessarily results in defaults on debt securities. Indeed, because it is a certainty that a bankruptcy event constitutes an event of default under a Reference Entity's outstanding debt securities, and because the CME proposed product can compensate owners of debt securities for their losses following an event of default, a bankruptcy event is inextricably linked to debt securities. A bankruptcy event also reflects the diminution in or elimination of the value of a Reference Entity's securities caused by the fact that the Reference Entity can no longer service its debt. Indeed, Nobel laureate Robert C. Merton, in his seminal work on valuation of options, characterized the value of a corporate debt as riskless debt and a short credit put position struck at the face value of that debt. Bankruptcy based on this firm structural approach would be expected if the entity can no longer service its debt, so it is in no sense independent of the entity's debt. As a result, while the CME's revised proposal reflects a creative attempt to obfuscate the link between the CME Product and a Reference Entity's securities, this link remains clearly established and the CME Product is irrefutably based on one or more securities.

Evidence of this link is also found elsewhere in the CME's proposed rules. For example, in Section III of CME's proposed Interpretations and Policies to Chapter 455, CME has proposed that the identification of a successor to a Reference Entity be made based on a determination of whether a successor(s) succeeds to a specified percentage of the Relevant Obligations of the Reference Entity, with such "Relevant Obligations" being defined as "Obligations constituting Bonds and Loans of the Reference Entity." Because the identity of a successor and relative percentage of bonds and loans to which it is succeeding will affect the value of the CME Product and the determination of a Credit Event, these features of the CME Product will still be based on securities of the Reference Entity. Thus, CME has in several

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<sup>1</sup> CME has also eliminated various provisions of the proposed rule text that are no longer applicable in light of the proposed limitation of "Credit Events" to include only a bankruptcy of the Reference Entity. We note, however, that there appear to be at least two remaining obsolete references that should be removed or, at a minimum, clarified as to their meaning. In particular, with respect to Rule 45504, entitled "Adjustments to CME Credit Event Futures," the reference to "events affecting Reference Entities and their Successors," appears to be a carryover from a prior version of the filing wherein CME referenced various Credit Events. See page 17 of the latest amendment filed on January 16, 2007. It should be made clear that the "events" referred to in this provision relate only to bankruptcies and, as applicable, successions. In addition, with respect to Section II of the Interpretations to Chapter 455, entitled "Reference Entity," the reference to "or entities" appears to be a carryover from a prior version of the filing wherein CME referenced baskets. See page 19 of the latest amendment filed on January 16, 2007. This reference should be removed or, if still applicable, further explained.

respects acknowledged that material issues related to the CME Product, and consequently its value, will remain linked to the Reference Entity's securities. The bankruptcy event itself (a bankruptcy statutorily entails the liquidation or reorganization of the entity's debts, including bonds and loans) and the options contract on that event (which compensates for a diminution in value of the underlying securities) are necessarily about the ultimate valuation of the entity's securities.

In addition, the Commission should make it clear that the CME Product should be properly identified as an option, and not as a futures contract as the CME has asserted. As we have previously noted, there is no question that the CME Product is an option, and not a futures contract, because it exhibits the characteristics of options identified by the Commission and the Courts, such as a non-refundable premium and limited one-way risk exposure for the holder.<sup>2</sup> The fact that the CME spreads the premium out over a period of time, and refers to it as margin, does not affect the fact that the CME Product as an option. Indeed, on the one hand, while the CME refers to this amount as "margin," it clearly is not consistent with a good faith performance bond, which is characteristic of futures-style margin. On the other hand, it has long been recognized that it is possible to apply futures-style margining to an options contract. Because, as noted in the Prior CBOE Letters and the OCC's letter, the scope of the Commission's jurisdiction can often turn on this issue, the CME should not be permitted to characterize the CME Product as a futures contract merely by labeling it as such and treating the premium as margin. The consequence of mischaracterizing the CME Product would have numerous negative implications, but the most significant are the regulatory inconsistencies and uncertainty with respect to any subsequent product proposals.

Because the CME Product is an option based on one or more securities, it constitutes a security and is therefore outside the Commission's jurisdiction. The CME's proposed limitation on the definition of a "Credit Event" to include only bankruptcy does not negate this basic statutory, and economic, reality. A so-called "futures contract" based on an issuer's bankruptcy is nothing more than a traditional security put option contract dressed up in futures vernacular.

Moreover, limiting the CME Product to bankruptcies does not address the concern we have raised that, if the CME Product is considered a futures contract and not a security, a Reference Entity's insiders and tippees could trade the CME Product without being subject to the legal prohibitions against insider trading imposed under the securities laws. Absent the safeguards that exist with respect to transactions in securities under the federal securities laws, including SEA Section 10b-5, use of inside knowledge about a company's financial condition or impending bankruptcy in trading the CME Product (which would clearly be subject to insider trading restrictions if the product were deemed a security) would not be subject to any criminal or civil sanction under the securities laws. In particular, such activity would not violate any provision of the CEA and would not otherwise be subject to Commission sanction. This result

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<sup>2</sup> This point was also made by the Options Clearing Corporation ("OCC") in its comment letter with respect to the CME Product, dated November 3, 2006.

is clearly contrary to the purpose of the insider trading provisions of the securities laws. As such, it is important to the principles of market fairness, integrity and public policy that the SEC regulate products such as that being proposed by CME, that are options based on securities.

Finally, we note that CME has indicated that the most recent amendments were submitted without any prejudice to its position that its original filing with the CFTC is in accordance with the CEA, and the proposed contract does not constitute a security or security future contract. For the foregoing reasons, we disagree with CME's position with respect to its original and amended filings and the characterization of the CME Product. Furthermore, any subsequent submissions by CME respecting credit-related products should be filed for Commission approval and subject to public comment.

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

Sincerely,

A handwritten signature in black ink that reads "Joanne Moffic Silver". The signature is written in a cursive, flowing style.

Joanne Moffic-Silver