

THE OPTIONS CLEARING CORPORATION

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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 06-76,
Proposing to Trade Credit Event Contracts

Dear Ms. Donovan:

The Options Clearing Corporation ("OCC") is submitting this letter in response to the request for comments issued by the Commodity Futures Trading Commission (the "Commission") relating to the filing by the Chicago Mercantile Exchange ("CME") on October 17, 2006, as amended by a filing dated October 24, 2006, for approval under Commission Rule 40.3 of a new contract designated by CME as "CME Credit Event Futures" (the "CME Product"). The Commission has requested that comments be submitted by November 3, 2006.

OCC is a securities clearing agency registered as such under Section 17A of the Securities Exchange Act of 1934 as well as a derivatives clearing organization registered under Section 5b of the Commodity Exchange Act (the "CEA"). As such, OCC has the ability to clear securities options subject to the jurisdiction of the Securities and Exchange Commission (the "SEC") and commodity futures and commodity options subject to the Commission's exclusive jurisdiction under the CEA, as well as security futures.

The Chicago Board Options Exchange ("CBOE") is a participant exchange of OCC, and OCC acts as the clearing agency for options traded on CBOE. OCC is familiar with the content of a comment letter that has been or will be submitted by CBOE with respect to the CME Product. OCC concurs in CBOE's conclusion that the CME Product should be regarded as a securities option subject to the jurisdiction of the SEC rather than as a commodity futures contract. The creditworthiness of an issuer of securities is intimately related to the value of the issuer's securities and to its debt securities in particular. An option on the issuer's

creditworthiness is, in that essential economic sense, an option based on the value of the issuer's securities.

Quite apart from its analysis of the underlying interest, however, OCC finds particularly disturbing the CME's characterization of the CME Product as a futures contract and, at least implicitly, not an option. For all the reasons set forth in the CBOE letter, we believe that the CME Product is an option. "Digital" or "binary" contracts that obligate the seller of the contract to pay the purchaser of the contract a fixed amount upon the occurrence of an event or outcome (e.g., when a securities index reaches or exceeds a specified level) have long been recognized by the markets, by commentators and by the Commission itself as options.¹ It is obvious from the terms of the CME Product, as CBOE's letter so clearly articulates, that the CME Product is an option for which the purchaser pays a premium and has no further exposure to loss. The seller earns the premium and hopes that the option will expire unexercised—*i.e.*, that the contingency requiring a payout will not occur. The fact that the payout is fixed and exercise is automatic upon the occurrence of the event are typical terms of a digital or binary option. Aside from the mere characterization of the option as a futures contract and the premium as a margin payment, the only feature of the CME Product that would distinguish it from the typical paradigm of a digital option is that the premium is paid over time and the buyer posts margin to collateralize its obligation to pay the premium. But it has long been recognized that it is possible to apply "futures style margining" to an option contract. The fact that the buyer of an option finances the premium rather than paying it in full at the outset does not somehow transform the contract from an option to a futures contract. Indeed, under existing margin rules of the securities exchanges, securities customers are permitted to purchase long-term options, including stock and index options, "on margin."² The option obviously remains an option even when it is purchased through an extension of credit to the buyer.

Whatever other action the Commission takes with respect to the CME Product, OCC strongly urges the Commission to make clear that, as a legal matter and for purposes of the CEA specifically, the CME Product is an option contract. As the Commission is well aware, the boundary between its own jurisdiction and that of the SEC can often turn on whether a contract is or is not an option. To permit this legal result to be determined by a market's mere characterization of the product or by the financing of a premium payment would, we believe, be an impermissible interpretation of the CEA and would exceed the Commission's statutory authority. We believe that a court would find such an interpretation to be inconsistent with applicable legal precedent and the Commission's own prior interpretations of the CEA as cited in the CBOE letter. The inventiveness of today's markets create sufficient opportunities for genuine ambiguity as to the proper jurisdictional characterization of a product. We urge the

¹ In addition to the authorities cited in CBOE's comment letter, we also note that in 2004 Michael Gorham, who was at that time Director of the Commission's Division of Market Oversight, published an article expressing the view that event contracts, such as a contract that would pay a specified sum if and only if a particular candidate won the Democratic nomination, is an option. Futures Industry Magazine, January/February 2004, <http://www.futuresindustry.org/fimagazi-1929.asp?a=893&iss=140>.

² See, e.g., CBOE Rule 12.3(c)(4)(B).

Commission not to muddy the waters unnecessarily by calling into question the settled designation of binary or digital contracts such as the CME Product as options.

OCC appreciates the opportunity to make its view known to the Commission. Please do not hesitate to contact the undersigned if you wish to discuss any aspect of this matter with us.

Sincerely,

William H. Navin /mp

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