

COMMODITY FUTURES TRADING COMMISSION**Order Exempting the Trading and Clearing of Certain Credit Default Products Pursuant to the Exemptive Authority in §4(c) of the Commodity Exchange Act (“CEA”)**

Agency: Commodity Futures Trading Commission.

Action: Final order.

SUMMARY: On May 14, 2007, the Commodity Futures Trading Commission (“CFTC” or the “Commission”) published for public comment in the Federal Register¹ a proposal to exempt from the CEA² the trading and clearing of certain products called credit default options (“CDOs”) and credit default basket options (“CDBOs”) that are proposed to be traded on the Chicago Board Options Exchange (“CBOE”), a national securities exchange registered under Section 6 of the Securities Exchange Act of 1934 (“1934 Act”),³ and cleared through the Options Clearing Corporation (“OCC”), a registered securities clearing agency registered under Section 17A of the 1934 Act,⁴ and Derivatives Clearing Organization registered under Section 5b of the CEA⁵. The proposed order was preceded by a request from OCC to approve rules that would permit it to clear these CDOs and CDBOs in its capacity as a registered securities clearing agency. OCC’s request presented novel and complex issues of jurisdiction and the Commission determined that an order exempting the trading and clearing of such instruments from pertinent requirements of the CEA may be appropriate. The Commission has reviewed the comments made in response to its proposal and the entire record in this matter and has determined to issue an order exempting the trading and clearing of these contracts from the CEA.

¹ 72 FR 27091 (May 14, 2007).

² 7 U.S.C. §§ 1 *et seq.*

³ 15 U.S.C. § 78f.

⁴ 15 U.S.C. § 78q-1.

⁵ 7 U.S.C. § 7a-1.

Authority for this exemption is found in Section 4(c) of the CEA.⁶

EFFECTIVE DATE: June 5, 2007

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SUPPLEMENTARY INFORMATION:

I. Introduction

The OCC is both a Derivatives Clearing Organization (“DCO”) registered pursuant to Section 5b of the CEA,⁷ and a securities clearing agency registered pursuant to Section 17A of the 1934 Act.⁸ The CBOE is a national securities exchange registered as such under Section 6 of the 1934 Act.⁹

CBOE has filed with the Securities and Exchange Commission (“SEC”) proposed rule changes to provide for the listing and trading on CBOE of cash-settled products characterized by CBOE as options based on credit events in one or more debt securities of specified “Reference Entities.”¹⁰ These products are referred to as Credit Default Options (“CDOs”), and would pay the holder a specified amount upon the occurrence, as determined by CBOE, of a “Credit Event,” defined to mean an “Event of Default” on any debt security issued or guaranteed by a specified “Reference Entity.”

⁶ 7 U.S.C. § 6(c).

⁷ 7 U.S.C. § 7a-1.

⁸ 15 U.S.C. § 78q-l.

⁹ 15 U.S.C. § 78f.

¹⁰ See Release No. 34-55251, 72 FR 7091 (Feb. 14, 2007).

CBOE has also filed with the SEC proposed rule changes to provide for the listing and trading on CBOE of products called Credit Default Basket Options (“CDBOs”).¹¹ These are similar in concept to CDOs, except that a CDBO covers more than one Reference Entity. For each individual Reference Entity, a notional value (a fraction of the aggregate Notional Face Value of the basket) and a recovery rate is specified. CDBOs may be of the multiple-payout variety, or of the single-payout variety, where a payout occurs only the first time a Credit Event is confirmed with respect to a Reference Entity prior to expiration.

OCC has filed with the CFTC, pursuant to Section 5c(c) of the CEA and Commission Regulations 39.4(a) and 40.5 thereunder,¹² requests for approval of rules and rule amendments that would enable OCC to clear and settle these CDOs and CDBOs in its capacity as a registered securities clearing agency (and not in its capacity as a DCO).¹³ Section 5c(c)(3) provides that the CFTC must approve any such rules and rule amendments submitted for approval unless it finds that the rules or rule amendments would violate the CEA.

The request for approval concerning the CDO product was filed effective March 8, 2007. On April 23, 2007, the review period was extended pursuant to Regulation 40.5(c) until June 6, 2007, on the ground that the CDOs “raise novel or complex issues, including the nature of the contract, that require additional time for review.” The request for approval concerning the CDBO product was filed effective April 23, 2007.

II. Section 4(c) of the Commodity Exchange Act

¹¹ See [SR-CBOE-2007-026](#)

¹² 7 U.S.C. §7a-2(c), 17 C.F.R. §§39.4(a), 40.5.

¹³ See [SR-OCC-2007-01 A-1](#); [SR-OCC-2007-06](#). OCC has filed identical proposed rule changes with the SEC.

Section 4(c)(1) of the CEA empowers the CFTC to “promote responsible economic or financial innovation and fair competition” by exempting any transaction or class of transactions from any of the provisions of the CEA (subject to exceptions not relevant here) where the Commission determines that the exemption would be consistent with the public interest. The Commission may grant such an exemption by rule, regulation or order, after notice and opportunity for hearing, and may do so on application of any person or on its own initiative. In enacting Section 4(c), Congress noted that the goal of the provision “is to give the Commission a means of providing certainty and stability to existing and emerging markets so that financial innovation and market development can proceed in an effective and competitive manner.”¹⁴ As noted in the proposing release,¹⁵ in granting an exemption, the CFTC need not find that the CDOs and CDBOs are (or are not) subject to the CEA.

Section 4(c)(2) provides that the Commission may grant exemptions only when it determines that the requirements for which an exemption is being provided should not be applied to the agreements, contracts or transactions at issue, and the exemption is consistent with the public interest and the purposes of the CEA; that the agreements, contracts or transactions will be entered into solely between appropriate persons; and that the exemption will not have a material adverse effect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory responsibilities under the CEA.

In the May 14, 2007 Federal Register release, the Commission requested public comment on the matters discussed above and all issues raised by its proposed exemptive order.

III. Comment Letters

¹⁴ HOUSE CONF. REPORT NO. 102-978, 1992 U.S.C.C.A.N. 3179, 3213 (“4(c) Conf. Report”).

¹⁵ 72 FR 27091 (May 14, 2007).

The Commission received four comment letters. The Chicago Mercantile Exchange (“CME”) stated that it “applauds” the Commission’s proposal to promote innovation but that it believed some issues should be addressed before a final order is issued. CME argued that: (1) it would be unfair for OCC and CBOE to receive exemptive relief yet continue to oppose CME’s efforts to list competitive products; (2) the Commission should not accept OCC’s and CBOE’s characterization of the products as options; (3) there are strong arguments that the products are based on commodities, not securities; and (4) it is not proper to define “appropriate persons” in terms of the status of the person’s intermediary.

OCC focused on the “appropriate persons” issue. OCC argued that in light of the customer suitability rules and the overall federal securities regulatory framework, the products would be limited to “appropriate persons.”

The CBOE stated that, although it believes CDOs and CDBOs to be securities subject to the securities laws, it has no objection to the Commission issuing a Section 4(c) exemptive order without reaching the issue of whether CDOs and CDBOs are (or are not) subject to the CEA.

The Chicago Board of Trade (“CBOT”) suggested that characterizing the CDOs and CDBOs as “novel instruments” should be repudiated or clarified because it could have implications under the patent laws.

IV. Findings and Conclusions

After considering the complete record in this matter, including the comments received, the Commission has determined that the requirements of Section 4(c) have been met.¹⁶ First, the exemption is consistent with the public interest and with the purposes of the CEA. The purposes of the CEA include “promot[ing] responsible innovation and fair competition among boards of

¹⁶ In this regard, consistent with the legislative history to Section 4(c) of the CEA, the Commission is not making a finding that CDOs and CDBOs are (or are not) subject to the CEA.

trade, other markets and market participants.”¹⁷ With respect to the competitive issue raised by CME in its comment letter, the Commission believes that an exemptive order in response to OCC’s request for rule approval is the best way to promote responsible innovation and fair competition among futures markets and securities markets. In cases such as this one where innovative products come close to the jurisdictional line between commodities and securities, rather than attempting to draw that line with precision with regard to the CBOE products and thereby potentially imposing litigation costs on both the private sector and the public sector, it may be more efficient and is a proper use of Section 4(c) exemptive authority to permit, without compromising the public interest, the products to trade on both sides of the line and let competitive forces determine which venue is successful.

Second, the CDOs and CDBOs would be entered into solely between appropriate persons. This issue was discussed by both CME and OCC in their respective comment letters. Section 4(c)(3) includes within the term “appropriate persons” a number of specified categories of persons, but also in subparagraph (K), “such other persons that the Commission determines to be appropriate in light of ... *the applicability of appropriate regulatory protections.*” (Emphasis added.) These products will be traded on a regulated exchange. CBOE, OCC, and their members who will intermediate these transactions, are subject to extensive and detailed oversight by the SEC and, in the case of the intermediaries, the securities self-regulatory organizations. It should be noted that CME has listed or will list comparable products and has not limited access to its markets to specified categories of persons. In light of where the products will be traded, the regulatory protections available under the securities laws, and the goal of promoting fair competition, these products will be traded by appropriate persons.

¹⁷ CEA §3(b), 7 U.S.C. §5(b)(emphasis added). *See also* CEA §4(c)(1), 7 U.S.C. §6(c)(1) (purpose of exemptions is “to promote responsible economic or financial innovation and fair competition.”)

Third, the exemption would not have a material adverse effect on the ability of the Commission or any designated contract market to carry out their regulatory responsibilities under the CEA. There is no reason to believe that granting an exemption here would interfere with the Commission's or a designated contract market's ability to oversee the trading of similar products on a designated contract market or otherwise to carry out their duties. None of the comment letters received addressed this issue.¹⁸

Therefore, upon due consideration, pursuant to its authority under Section 4(c) of the CEA, the Commission hereby issues this Order and exempts the trading and clearing of CDOs and CDBOs to be listed and traded on CBOE and cleared through OCC as a securities clearing agency from the CEA. This Order is contingent upon the approval by the SEC, pursuant to Section 19(b) of the 1934 Act, of CBOE and OCC rules to permit the listing and trading of CDOs and CDBOs on CBOE. This Order is subject to termination or revision, on a prospective basis, if the Commission determines upon further information that this exemption is not consistent with the public interest. If the Commission believes such exemption becomes detrimental to the public interest, the Commission may revoke this Order on its own motion.

V. Related Matters

A. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 ("PRA")¹⁹ imposes certain requirements on federal agencies (including the Commission) in connection with their conducting or sponsoring any collection of information as defined by the PRA. The exemptive order would not require a

¹⁸ Under Section 4(c) of the CEA, the Commission need not resolve whether, as CME argues in its comment letter, these products are based on commodities and not securities, or, as CBOE argues in its comment letter, these products are securities subject to the securities laws. Nor need the Commission determine, as CME urges, whether the products are properly characterized as options. Finally, the Commission notes that its references to the novelty of the issues raised by these products refer to issues under the CEA and were not intended to be applicable in any matter relating to patent or intellectual property law.

¹⁹ 44 U.S.C. § 3507(d).

new collection of information from any entities that would be subject to the order.

B. Cost-Benefit Analysis

Section 15(a) of the CEA, as amended by Section 119 of the Commodity Futures Modernization Act of 2000 (“CFMA”),²⁰ requires the Commission to consider the costs and benefits of its action before issuing an order under the CEA. By its terms, Section 15(a) as amended does not require the Commission to quantify the costs and benefits of an order or to determine whether the benefits of the order outweigh its costs. Rather, Section 15(a) simply requires the Commission to “consider the costs and benefits” of its action.

Section 15(a) of the CEA further specifies that costs and benefits shall be evaluated in light of five broad areas of market and public concern: protection of market participants and the public; efficiency, competitiveness, and financial integrity of futures markets; price discovery; sound risk management practices; and other public interest considerations. Accordingly, the Commission could in its discretion give greater weight to any one of the five enumerated areas and could in its discretion determine that, notwithstanding its costs, a particular order was necessary or appropriate to protect the public interest or to effectuate any of the provisions or to accomplish any of the purposes of the CEA.

The exemptive order issued today is expected to facilitate market competition. The Commission has considered the costs and benefits of the order in light of the specific provisions of Section 15(a) of the CEA, as follows:

1. Protection of market participants and the public. Protections for market participants and the public exist in that CBOE, OCC and their members who will intermediate CDOs and CDBOs are subject to extensive oversight by the SEC and, in the case of intermediaries, securities self-regulatory organizations.

²⁰ 7 U.S.C. § 19(a).

2. Efficiency, competition, and financial integrity. The exemptive order may enhance market efficiency and competition since it could encourage potential trading of CDOs and CDBOs on markets other than designated contract markets. Financial integrity will not be impaired since the CDOs and CDBOs will be cleared by OCC, a DCO and SEC-registered clearing agency, and intermediated by SEC-registered broker-dealers.

3. Price discovery. Price discovery may be enhanced through market competition.

4. Sound risk management practices. OCC has described appropriate risk-management practices that it will follow in connection with the clearing of CDOs and CDBOs.

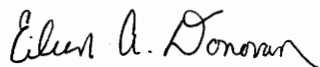
5. Other public interest considerations. The exemptive order may encourage development of credit derivative products through market competition without unnecessary regulatory burden.

The Commission requested comment on its application of these factors in the proposing release. No comments were received.

After considering these factors, the Commission has determined to issue this Order.

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Issued in Washington, DC, on June 5, 2007 by the Commission.



Eileen A. Donovan

Acting Secretary of the Commission