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## CME Credit Index Event Contract

Introduced in the mid 1990s, credit derivatives are the fastest growing segment of the over-the-counter (OTC) derivatives market with an outstanding notional value of ~ \$26 trillion. Credit indexes, marketed under brand names CDX or iTraxx represent the fastest growing segment of this market. These products are not "indexes" in the traditional sense ... rather, they are derivatives tied to a bundle of corporate credits.

**CME Credit Index Event Contracts** – Are based upon an index of North American (NA) High-Volatility (HV) Reference Entities designated the CME North American High-Volatility Index Series 1.

CME Credit Index Event Contracts settle on the Final Settlement Date at a Final Settlement Value (FSV) =  $NV \times [\sum E_i \times W_i \times F_i]$  where NV=contract Notional Value;  $E_i=1$  if credit event occurs for index constituent  $i$  or  $E_i=0$  in absence of credit event;  $W_i$ =Weight of constituent  $i$ ;  $F_i$ =Final Settlement Rate for constituent  $i$ .

*E.g.*, assume that 1 constituent in an index of 32 equally-weighted names experiences a credit event with  $NV=\$100,000$ , and  $F=60\%$ , then  $FSV=\$1,875$ . If 2 constituents experience credit events with  $F=60\%$  then  $FSV=\$3,750$ ; if 5 experience credit events then  $FSV=\$9,375$ . If 0 credit events are experienced then  $FSV=\$0$ .

**Credit Event Protocol** – Protection buyers may deliver defaulted corporate bonds to protection sellers upon declaration of a credit event at par per a standard OTC single-name CDS. Sometimes, more CDSs are outstanding than corporate bonds, resulting in a squeeze. This is often addressed in the context of the OTC indexes per the 2005 ISDA protocol, providing for a cash-settlement of defaulted names. But this process may be cumbersome and time consuming. CME Credit Index Event Contracts are streamlined by assigning a Final Settlement Rate of  $F\%$  for each individual name in satisfaction of a credit event. CME Credit Index Event Contracts are triggered by a bankruptcy of the Reference Entity.

**Accounting Treatment** - In order to conform these contracts with bookkeeping practices, they are quoted in terms of the total remaining value of the credit protection. *E.g.*, a contract with a 5-year term quoted as 250 bps implies an annualized quote of approximately 50 bps. Daily mark-to-market procedures ensure that the value of credit protection is transferred from buyer to seller as the contract approaches expiration in the absence of a credit event. Or, that the value of any accumulated payouts are transferred from seller to buyer as contracts approach expiration.

<b>Digital Final Settlement</b>	Final Settlement Value (FSV) = $NV \times [\sum E_i \times W_i \times F_i]$ where NV=contract Notional Value; $E_i=1$ if credit event occurs for index constituent $i$ or $E_i=0$ in absence of credit event; $W_i$ =Weight for constituent $i$ ; $F_i$ =Final Settlement Rate for constituent $i$ . <i>E.g.</i> , IF one constituent of 32 equally-weighted names ( $W=3.125\%$ ) experiences credit event with $NV=\$100,000$ , and $F=60\%$ THEN $FSV=\$1,875$ . IF 2 constituents experience credit events with $F=60\%$ THEN $FSV=\$3,750$ ; IF 5 experience credit events THEN $FSV=\$9,375$ . If no credit events are realized, contract settles on Final Settlement Date at $FSV=\$0$ .
<b>Index Constitution</b>	Initial index comprised of 32 North American Investment Grade High-Volatility Reference Entities ("CME North American Investment Grade High-Volatility Index Series 1") and associated Reference Obligations
<b>Credit Event</b>	Credit Event deemed to occur in the event of: 1) Bankruptcy, or 2) Failure to Pay, of Reference Entity/Obligation
<b>Quotation Convention</b>	Quoted as total price of credit protection for remainder of term, expressed as fraction of Notional Value in basis points (bps). <i>E.g.</i> , contract worth 50 bps per annum with 5 years to expiration may be quoted at ~250.0 bps. The "time decay" in total price allows buyer effectively to compensate seller for cost of credit protection over time.
<b>Tick Size</b>	0.5 Basis Points (bps), IF Notional Value = \$100,000 THEN 0.5 bps = \$5.00
<b>Contract Months</b>	Listed five (5) years out in March, June, September and December
<b>Last Trading Day</b>	Trading terminates at 12:00 noon on the Final Settlement Date.
<b>Final Settle Date</b>	The 2 <sup>nd</sup> Business Day preceding the third Wednesday of the contract month.
<b>Trading Hours</b>	Offered exclusively on CME Globex <sup>®</sup> electronic trading platform on Sundays thru Thursdays from 5:00 pm-4:00 pm (Chicago time) the following day.



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**Initial Index** – The initial “CME North American Investment Grade High-Volatility Index, Series 1” is comprised of 32 Reference Entities as shown in the table below. “High-Volatility” Reference Entities generally include investment grade corporate names with ratings of BBB- or better (or equivalent rating) from rating agencies such as Standard & Poor’s and Fitch. These names are considered “Hi-Vol” in the sense that they may be close to the investment grade/high-yield rating barrier and as such have

experienced high volatility and activity in the OTC CDS markets. The specific corporate names are selected based upon a survey of liquidity in the CDS marketplace.

**Reconstituted Series** - New index series to be constituted semi-annually in March and September with original terms up to 5 years. Further indexes may be introduced reflecting other market segments, *e.g.*, investment grade (IG), crossover (XO), high-yield (HY), etc.

### CME North American Investment Grade High-Volatility Index, Series 1

	Reference Entity	Rating	Industry Sector	Weight (W)	Final Settlement Rate (F)
1	Arrow Electronics Inc	BBB	Consumer Cyclical	3.125%	60%
2	Autozone Inc	BBB	Consumer Cyclical	3.125%	60%
3	CBS Corporation	BBB	Communications and Technology	3.125%	60%
4	Centex Corp	BBB	Communications and Technology	3.125%	60%
5	CenturyTel Inc	BBB	Consumer Cyclical	3.125%	60%
6	Cox Communications Inc	BBB	Communications and Technology	3.125%	60%
7	Embarq Corp	BBB-	Consumer Cyclical	3.125%	60%
8	Expedia Inc	BBB-	Consumer Cyclical	3.125%	60%
9	Federated Department Stores	BBB	Consumer Cyclical	3.125%	60%
10	InterActiveCorp	BBB	Consumer Cyclical	3.125%	60%
11	International Paper Co	BBB	Communications and Technology	3.125%	60%
12	JC Penney Co	BBB-	Consumer Cyclical	3.125%	60%
13	Jones Apparel Group Inc	BBB	Consumer Cyclical	3.125%	60%
14	Kroger Co	BBB	Consumer Cyclical	3.125%	60%
15	Lennar Corp	BBB	Communications and Technology	3.125%	60%
16	Limited Brands	BBB	Consumer Cyclical	3.125%	60%
17	MeadWestvaco Corp	BBB	Materials	3.125%	60%
18	Pulte Homes Inc	BBB	Consumer Cyclical	3.125%	60%
19	R R Donnelley & Sons Co	BBB	Industrial	3.125%	60%
20	RadioShack Corp	BBB	Industrial	3.125%	60%
21	Residential Capital Corp	BBB	Consumer Cyclical	3.125%	60%
22	Safeway Inc	BBB	Consumer Stable	3.125%	60%
23	Sara Lee Corp	BBB	Consumer Stable	3.125%	60%
24	Sherwin-Williams Co	A-	Materials	3.125%	60%
25	Sprint Nextel	BBB+	Communications and Technology	3.125%	60%
26	Starwood Hotels & Resorts Worldwide Inc	BBB	Consumer Cyclical	3.125%	60%
27	Temple-Inland Inc	BBB	Materials	3.125%	60%
28	The Gap Inc	BBB	Consumer Cyclical	3.125%	60%
29	Time Warner Inc	BBB	Consumer Cyclical	3.125%	60%
30	Toll Brothers Inc	BBB	Consumer Cyclical	3.125%	60%
31	Viacom	BBB	Communications and Technology	3.125%	60%
32	Whirlpool Corp	BBB	Industrial	3.125%	60%

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