

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-50585; File No. SR-OCC-2004-18)

October 25, 2004

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change Relating to OCC's Adjustment Policies for Options and Stock Futures on Fund Shares

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> notice is hereby given that on September 27, 2004, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which items have been prepared primarily by OCC. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The proposed rule change codifies exceptions for options and stock futures on "fund shares" to OCC's adjustment policies recently made by panels of OCC's Securities Committee.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, OCC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. OCC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of such statements.<sup>2</sup>

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> The Commission has modified parts of these statements.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(1) Background

Article VI, Clearance of Exchange Transactions, Section 11, Adjustments, Paragraph (c) of OCC's By-Laws states:

It shall be the general rule that there will be no adjustments to reflect ordinary cash dividends or distributions . . . by the issuer of the underlying security.

Interpretation .01 of Article VI, Section 11 (sometimes referred to as the "10% rule") provides:

Dividends or distributions by the issuer of the underlying security in an aggregate amount per dividend or distribution which does not exceed 10% of the market value (as of the close of trading on the declaration date) of the underlying security outstanding will, as a general rule, be deemed to be 'ordinary dividends or distributions' within the meaning of paragraph (c) of Section 11.

However, Article VI, Section 11(j) provides:

Notwithstanding the general rules set forth in paragraphs (c) through (j) of this Section 11 or which may be set forth as interpretations and policies under this Section 11, the Securities Committee shall have the power to make exceptions in those cases or groups of cases . . . in which, applying the standards set forth in paragraph (b) hereof, the Securities Committee shall determine such exceptions to be appropriate. . . .

Panels of OCC's Security Committee recently determined to exercise their authority under Article VI, Section 11(j) to make exceptions to the 10% rule and adjust options on exchange traded funds ("ETFs") and Holding Company Depository Receipts ("HOLDRs") (collectively referred to in OCC's Rules as "fund shares") for dividends reflecting special one-time distributions on portfolio securities notwithstanding that the amounts of the dividends were not expected to exceed 10% of the market value of the fund shares themselves.<sup>3</sup> The proposed

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<sup>3</sup> In accordance with a preexisting commitment to report exercises of the Securities Committee's exception-making authority, these actions were reported to the Division of Market Regulation by letter dated August 9, 2004.

rule change amends Interpretation .08 under Article VI, Section 11 of OCC's By-Laws to call for such adjustments as a matter of course.

(a) The TRLY Decision

On July 20, 2004, Terra Networks S.A. ("TRLY") announced a cash return of capital distribution of \$2.48 per share, which represented approximately 42% of the stock price, payable to holders of record on July 27, 2004. Because the amount of the distribution exceeded 10% of the stock price, the 10% rule did not apply. On July 23, 2004, a panel of OCC's Securities Committee determined to adjust options on TRLY stock effective on the ex-date for the distribution by adjusting the underlying to include the amount of the distribution.<sup>4</sup>

The American Stock Exchange ("Amex") trades options on HOLDRs issued by the Europe 2001+ HOLDRS Trust ("Trust"). The Trust's portfolio includes TRLY American Depository Shares. In order to pass through the TRLY distribution, as it was obligated to do, the Trust declared its own distribution of approximately \$0.37 per HOLDR. This was less than 10% of the market price of the HOLDRs. Nevertheless, on July 26, 2004, a panel of the Securities Committee consisting of two representatives of the Amex and one non-voting representative of OCC determined to make an exception to the 10% rule and adjust for the Trust's distribution.<sup>5</sup>

The panel's decision was based on the special characteristics of HOLDRs. A HOLDR is a trust-issued receipt representing beneficial ownership of a basket of stocks. The owner of a HOLDR has the right to vote the shares in the basket, to receive dividends and other distributions on those shares, and to exchange the HOLDR at any time for the underlying basket of stocks. Given the purely derivative nature of HOLDRs, which are intended to function as exact

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<sup>4</sup> OCC Information Memo #19875 (July 20, 2004).

<sup>5</sup> OCC Information Memo #19877 (July 26, 2004).

surrogates for the underlying basket of stocks, the Securities Committee was of the view that it would be inappropriate to apply the 10% rule to a distribution on a HOLDR caused by a one-time distribution on a portfolio security of sufficient size to cause options on the latter to be adjusted.<sup>6</sup>

Existing Interpretation .08 of Article VI, Section 11 recognizes the special characteristics of HOLDRs and other fund shares by excluding capital gain distributions on fund shares from the 10% rule. Had the draftsmen of that Interpretation anticipated the possibility of distributions on fund shares reflecting on-time return of capital distributions on portfolio securities, they would have excluded those distributions as well. The Securities Committee concluded that adjusting for the Trust's distribution was consistent with the spirit of Interpretation .08.

(b) The MSFT Decision

On July 20, 2004, Microsoft Corporation ("MSFT") declared a special one-time cash dividend of \$3.00 per share, payable December 2, 2004, to holders of record on November 17, 2004, subject to approval of related amendments to MSFT's employee stock plans at its annual meeting in November. Because the amount of the dividend exceeded 10% of the market value of MSFT, the 10% rule did not apply and on July 20, 2004 a panel of OCC's Securities Committee determined to adjust options on MSFT stock effective on the ex-date by reducing stock prices by \$3.00 per share.<sup>7</sup>

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<sup>6</sup> The 10% rule does not apply to regular quarterly dividends on HOLDRs because adjusting for recurring dividends would require repeated readjustments of previously adjusted series, which would cause a proliferation of outstanding options series that would not be in the best interest of investors. Making a one-time adjustment for a one-time distribution does not have that effect.

<sup>7</sup> OCC Information Memo #19872 (July 20, 2004).

Options are traded on a total of 19 ETFs and HOLDERS whose portfolios include MSFT stock. When the MSFT special dividend is paid, it is anticipated that it will be passed through to holders of those fund shares in the form of dividends. The amounts of any such dividends are expected to be less than 10% of the funds' respective stock prices. Panels of OCC's Securities Committee nevertheless determined on July 27, 2004, to make an exception to the 10% rule and to adjust for fund share dividends reflecting the MSFT special dividend in those cases where the impact on the ETF or HOLDER equals or exceeds the de minimus amount of an eighth, or \$0.125 per share.<sup>8</sup>

There were a number of reasons for the decision to adjust. First, Nasdaq, Standard & Poor's, and Dow Jones had all announced that they intended to adjust the divisors of their respective indexes to compensate for the MSFT special dividend. As Dow Jones explained in its press release, "Divisor adjustments nullify the effect on the index values of the stock price being lowered by the value of the dividend."<sup>9</sup> A number of underlying ETFs, including the widely traded QQQ which tracks the Nasdaq-100 index, were designed to track indexes that will be adjusted for the MSFT special dividend. The effect of adjusting those indexes would be to nullify the effect of the special dividend not only on the indexes themselves but also on options overlying those indexes. Failing to adjust options on ETFs that track those indexes would have created an unfair and inequitable disconnect between the values of ETF options and the values of index options based on the same index.

Although this rationale applied only to some ETFs (i.e., those that tracked indexes that were being adjusted), it would have been inconsistent and potentially confusing not to adjust

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<sup>8</sup> OCC Information Memos #19883 (July 27, 2004) and #19892 (July 29, 2004).

<sup>9</sup> Dow Jones Indexes press release dated July 22, 2004.

options on other ETFs that also hold MSFT stock in their portfolios. Moreover, a precedent for adjusting options on fund shares for distributions reflecting special one-time distributions on portfolio securities notwithstanding the 10% rule had been set just the day before by the TRLY decision.

## (2) The Proposed Rule Change

The proposed rule change codifies the TRLY and MSFT decisions by revising Interpretation .08 under Article VI, Section 11 to exclude from the 10% rule distributions on fund shares other than capital gains distributions, which are currently excluded, if:

- (i) the fund tracks the performance of an index that underlies a class of index options or index futures, and the distribution on the fund shares includes or reflects a dividend or other distribution on a portfolio security that resulted in an adjustment of the index divisor; or
- (ii) the distribution in the fund shares includes or reflects a dividend or other distribution on a portfolio security:
  - (x) that results in an adjustment of options on other fund shares;<sup>10</sup> or
  - (y) in an aggregate amount exceeding 10% of the market value of the portfolio security.

No adjustment would be made, however, if the adjustment would amount to less than \$0.125 per share.

Conforming changes have been made to Interpretation and Policy .08 of Article XII, Futures and Futures Options, Section 3, which covers adjustments to stock futures on fund shares and parallels the provisions of Interpretation and Policy .08 of Article VI, Section 11. In addition, technical changes have been made to Interpretation .08 of Article VI, Section 3 to (i)

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<sup>10</sup> This would cover the situation, perhaps unlikely, where two ETFs, one of which tracks an index, hold the same portfolio security and a distribution of less than 10% of the value of the portfolio security nevertheless causes an adjustment of the index divisor. If options on the ETF that tracks the index are adjusted, this provision would allow options on the other to be adjusted as well.

fix garbled text as originally filed in SR-OCC-2001-07 and approved by the Commission<sup>11</sup> and (ii) delete the term “stock” as a modifier for “fund shares” in order to further conform the Interpretation to the changes proposed in SR-OCC-2002-22 and approved by the Commission.<sup>12</sup>

OCC believes that the proposed rule change is consistent with the purposes and requirements of Section 17A of the Act, as amended, because it codifies exceptions to OCC’s adjustment policies made by adjustment panels of the Securities Committee that were intended to promote fairness to buyers and sellers of options contracts, the maintenance of fair and orderly markets, and consistency of interpretation and practice.

(B) Self-Regulatory Organization's Statement on Burden on Competition

OCC does not believe that the proposed rule change would impose any burden on competition.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were not and are not intended to be solicited with respect to the proposed rule change, and none have been received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The foregoing rule change has become effective pursuant to Section 19(b)(3)(A)(iii) of the Act<sup>13</sup> and Rule 19b-4(f)(4)<sup>14</sup> promulgated thereunder because the proposal effects a change in an

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<sup>11</sup> See Securities Exchange Act Release No. 44727 (August 20, 2001), 66 FR 45351 (August 28, 2001).

<sup>12</sup> See Securities Exchange Act Release No. 46914 (November 26, 2002), 67 FR 72261 (December 4, 2002).

<sup>13</sup> 15 U.S.C. 78s(b)(3)(A)(iii).

<sup>14</sup> 17 CFR 240.19b-4(f)(4).

existing service of OCC that (A) does not adversely affect the safeguarding of securities or funds in the custody or control of OCC or for which it is responsible and (B) does not significantly affect the respective rights or obligations of OCC or persons using the service. At any time within sixty days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

##### Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>) or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-OCC-2004-18 on the subject line.

##### Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-OCC-2004-18. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your



comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of OCC and on OCC's Web site at [www.optionsclearing.com](http://www.optionsclearing.com). All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-OCC-2004-18 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>15</sup>

Jill M. Peterson  
Assistant Secretary

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<sup>15</sup> 17 CFR 200.30-3(a)(12).