

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-56875; File No. SR-OCC-2007-08)

November 30, 2007

Self-Regulatory Organizations; The Options Clearing Corporation; Order Granting Approval of a Proposed Rule Change Relating to Binary Options

I. Introduction

On June 28, 2007, The Options Clearing Corporation (“OCC”) filed with the Securities and Exchange Commission (“Commission”) proposed rule change SR-OCC-2007-08 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”).¹ Notice of the proposal was published in the Federal Register on September 26, 2007.² No comment letters were received. For the reasons discussed below, the Commission is granting approval of the proposed rule change.

II. Description

The proposed rule change permits OCC to clear and settle binary options, including fixed return options (“FROs”) to be listed and traded by Amex³ and binary options on broad-based indexes proposed to be listed and traded by CBOE.⁴ Binary options (sometimes referred to as “digital” options) are all-or-nothing options that pay a fixed amount if exercised in the money and otherwise pay nothing. Until recently, OCC did not clear any binary options other than credit default options (“CDOs”) traded on CBOE. The Commission recently granted approval of proposed rule changes filed by OCC and CBOE so that CBOE could trade and OCC could clear

¹ 15 U.S.C. 78s(b)(1).

² Securities Exchange Act Release No. 56471 (September 19, 2007), 72 FR 54705.

³ Securities Exchange Act Release No. 56251 (August 14, 2007), 72 FR 46523 (August 20, 2007) (File No. SR-Amex-2004-27).

⁴ File No. SR-CBOE-2006-105.

related products called credit default basket options (“CDBOs”).⁵ General characteristics of binary options, excluding features unique to CDOs and/or CDBOs that were already described in OCC’s prior rule filings, are described below followed by an explanation of the specific rule changes now being made by OCC.

Description of Binary Options. Binary options are cash-settled options that have only two possible payoff outcomes, either a fixed exercise settlement amount or nothing at all. They are subject to automatic exercise. The underlying interest of a binary option may be one or more securities, an index of securities, or some other measure; however, OCC presently intends to clear only binary options that are within the definition of a “security” as determined by the Commission. In its capacity as a “derivatives clearing organization” regulated by the Commodity Futures Trading Commission (“CFTC”), OCC may in the future propose to clear binary options that are commodity options subject to the jurisdiction of the CFTC.

A binary option, other than a CDO or CDBO, is in the money and will be automatically exercised if its underlying interest value as measured against its exercise price is determined to meet the criteria for automatic exercise as specified in the Exchange Rules of the listing Exchange.⁶ For example, in the case of a “finish high fixed return option,” such option will be automatically exercised and settled for a fixed amount of cash if its underlying interest value is above its exercise price at expiration. In the case of a “finish low fixed return option,” such

⁵ Securities Exchange Act Release Nos. 56275 (August 17, 2007), 72 FR 47097 (August 22, 2007) (File No. SR-CBOE-2007-026) and 56288 (August 20, 2007), 72 FR 49034 (August 27, 2007) (File No. SR-OCC-2007-06).

⁶ CDOs and CDBOs, on the other hand, do not have exercise prices. A CDO or CDBO is deemed to be in the money and is automatically exercised if a “credit event” occurs at any time prior to the last day of trading.

option will be automatically exercised and settled for a fixed amount of cash if its underlying interest value is below its exercise price at expiration. The rule changes in this current filing for binary options are intended to be sufficiently generic to be the basis for clearing binary options to be listed by Amex and proposed to be listed by CBOE as well as other binary options in the future.

By-Law and Rule Amendments Applicable to Binary Options. In order to provide a framework of rules that can accommodate the clearance and settlement of various kinds of binary option products, OCC is broadening the By-Law Article and Rule Chapter covering CDOs and CDBOs.

(1) Terminology—Article I, Section 1 and Article XIV, Section 1

“Binary option” is defined in Article XIV, Section 1 of the By-Laws, and the definition is cross-referenced in Article I of the By-Laws.

The definitions of “option contract” and “type of option” in Article I of the By-Laws is amended to include a binary option.

OCC is redefining the term “class” in Article XIV, Section 1 so that it will apply to binary options generally. To be within the same class, binary options other than CDOs or CDBOs must cover the same underlying interest and have otherwise identical terms except for exercise price (if any) and expiration date.

The definition of “exercise price” in Article I is replaced with respect to binary options with a revised definition in Article XIV, Section 1 that will recognize that binary options will be settled by a fixed cash payment. The exercise price of a binary option neither is an amount that is paid in exchange for an underlying interest nor is used to determine the exercise settlement amount as in the case of other cash-settled options. In

the case of a binary option other than a CDO or CDBO, the exercise price of a binary option is simply a defined value or range of values for the underlying interest. If the underlying interest value falls within the defined range at expiration of such binary option, the option will be automatically exercised; otherwise, the option will expire unexercised. A CDO or CDBO is said to have no exercise price.

OCC is redefining the term “underlying interest” in Article XIV, Section 1 so that it will apply to binary options generally. In the case of a binary option other than a CDO or CDBO, the underlying interest is the underlying security, securities, index, basket, or measure whose value is compared to such option’s exercise price to determine whether the option is in the money and will be automatically exercised. In conjunction with the revised definitions of “exercise price” and “underlying interest,” OCC is also adding a new defined term, “underlying interest value,” to Article XIV, Section 1. When used with respect to a binary option other than a CDO or CDBO, underlying interest value means the value or level of the unit of trading of the underlying interest at any point in time as reported by the reporting authority. A new definition for the term “unit of trading” states “unit of trading” when used with respect to a binary option means the quantity of the underlying interest on which the underlying interest value is based and is ordinarily a single share in the case of binary options on individual equity securities or one (1) in the case of binary index options. The terms “unit of trading” and “underlying interest value” will not be applicable to CDOs and CDBOs.

Other terms that were created or amended for CDOs and CDBOs are modified to apply to binary options generally.

(2) Terms of Cleared Contracts—Article VI, Section 10(e)

Paragraph (e) of Article VI, Section 10 are further amended to apply to binary options generally.

(3) General Rights and Obligations—Article XIV, Section 2B

Article XIV, Section 2B defines the general rights and obligations of holders and writers of binary options other than CDOs or CDBOs. As noted above, the holder of a binary option that is automatically exercised will have the right to receive the fixed exercise settlement amount from OCC, and the assigned writer will have the obligation to pay that amount to OCC.

(4) Adjustments of Binary Options Other than CDOs or CDBOs—Article XIV, Section 3A; Unavailability or Inaccuracy of Final Underlying Interest Value—Article XIV, Section 5; Determination of Final Underlying Interest Value—Article XIV, Section 6

Article XIV, Section 3A describes the methods by which binary options other than CDOs or CDBOs generally will be adjusted if adjustments are deemed to be necessary. Special adjustment rules are needed because of the fixed, cash-settlement feature of binary options. For instance, under Article VI, Section 11A(d), which governs adjustment of other equity options, if there is a stock dividend, distribution, or split whereby a whole number of shares of the underlying security is issued for each outstanding share, the exercise price is proportionately reduced, and the number of option contracts is increased by the number of shares issued with respect to each share of the underlying security. This adjustment would be inappropriate for binary options where the underlying interest is an equity security. For example, an XYZ option with an exercise price of \$50 would be adjusted to become two XYZ options, each with an

exercise price of \$25. While the fixed exercise settlement amount of such binary option would be intended to remain at \$100, such an adjustment would increase the total payout upon exercise to \$200. To avoid this result, Article XIV, Section 3A(a)(4) will provide that the number of option contracts will not proportionally increase and only the exercise price will be adjusted. The other provisions of Article XIV, Section 3A are similar to Article VI, Section 11A with appropriate modifications for binary options. In order to maintain consistency with adjustment policies for physically settled stock options where such consistency is appropriate, certain changes in the treatment of dividends that were approved in SR-OCC-2006-01 and were to become effective at a future date will become effective on the same date for binary options on single stocks.

Article XIV, Section 3A(b) will govern adjustments of binary options for which the underlying interest is an index of equity securities and will be similar to Article XVII, Section 3, which governs index options, with appropriate modifications to reflect unique features of binary options. For instance, because binary options do not have an index multiplier, the Securities Committee will generally adjust the exercise price of a binary option of which the underlying interest is an index of equity securities to get the appropriate result.

Article XIV, Section 5, will give OCC the authority to fix the underlying interest value for a binary option other than a CDO or CDBO and to rely on that value for determining whether such binary option will be exercised under circumstances similar to those in which OCC may currently fix the exercise settlement amount for index options.

Article XIV, Section 6 will provide, in essence, that the underlying interest value of a series of binary options at expiration, other than CDOs or CDBOs, will be

determined by the Exchange or Exchanges on which such series is traded subject to any overriding provision of OCC's By-Laws and Rules. If a series of options is traded on more than one Exchange, OCC could use the underlying interest value received from the Exchange deemed by OCC to be the principal Exchange, or OCC could employ a procedure to derive a single value based on some or all of the values received.

(5) Exercise and Settlement—Chapter XV of the Rules and Rule 801

Binary options will not be subject to the exercise-by-exception procedures applicable to most other options under OCC's Rules but will instead be automatically exercised prior to or at expiration if the specified criterion for exercise is met. The procedures for the automatic exercise of binary options, as well as assignment and settlement of exercises (including provisions applicable to a suspended Clearing Member), will be set forth in Rules 1501 through 1505 of new Chapter XV and in revised Rule 801(b).

(6) Margin Requirements—Rule 601; Deposits in Lieu of Margin—Rule 1506

OCC will margin binary options through its usual "STANS" system. STANS has been modified to accommodate the particular binary options to be traded by Amex and the binary index product currently proposed by CBOE. CDOs and CDBOs will be margined as described in the applicable rule filings cited above.

OCC is not proposing to accept escrow deposits in lieu of clearing margin for binary options. Therefore, Rule 1506 will state that Rule 610, which otherwise would permit such deposits, does not apply to binary options.

(7) Acceleration of Expiration Date—Rule 1507(d)

This new provision will accelerate the expiration date of a binary option other than a CDO or CDBO when OCC determines in its discretion that the underlying interest value of such option has become fixed prior to the expiration of the option (e.g., where the equity security underlying a binary option has been converted by a merger into the right to receive a fixed amount of cash). If the option is out of the money, it will expire unexercised. Otherwise, it will be automatically exercised.

III. Discussion

Section 17A(b)(3)(F) of the Act requires, among other things, that the rules of a clearing agency be designed to promote the prompt and accurate clearance and settlement of securities transactions.⁷ After careful review the Commission finds that the proposed rule change meets the requirements of Section 17A(b)(3)(F) of the Act because, by amending OCC's By-Laws so that OCC may clear and settle options on binary options that have been approved to be listed and traded on Amex and that have been proposed to be listed and traded on CBOE, it should help promote the prompt and accurate clearance and settlement of such securities transactions.

IV. Conclusion

On the basis of the foregoing, the Commission finds that the proposed rule change is consistent with the requirements of the Act and in particular Section 17A of the Act and the rules and regulations thereunder.⁸

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (File No. SR-OCC-2007-08) be and hereby is approved.

⁷ 15 U.S.C. 78q-1(b)(3)(F).

⁸ In approving the proposed rule change, the Commission considered the proposal's impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

For the Commission by the Division of Trading and Markets, pursuant to delegated authority.⁹

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Deputy Secretary

⁹ 17 CFR 200.30-3(a)(12).