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Via E-Mail

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: File No. SR-OCC-2006-01

To the Members of the Commission:

We are writing to respond to a further comment letter regarding the captioned rule change filing. The filing was made on January 12, 2006 and published for comment on March 2, 2006.[1] It proposes to amend Article VI, Section 11A of OCC's By-Laws (i) to revise the definition of "ordinary dividends and distributions" to eliminate the so-called "10% rule" and (ii) to eliminate the need to round adjusted strike prices and units of trading when outstanding options are adjusted to reflect a stock dividend, stock split, or similar event.

The filing was amended on September 25, 2006, and the amended filing was published for comment on November 14, 2006.[2] One comment letter was filed in response to the amended rule change (although it related to aspects of the original filing that were not amended).[3] The author, James E. Knight, agreed that the adjustment methodology for stock dividends, etc. needs to be changed, but

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[1] Rel. No. 34-53400 (Mar. 2, 2006).

[2] Rel. No. 34-54748 (Nov. 14, 2006).

[3] James E. Knight (Dec. 12, 2006). Mr. Knight is a Vice President of Raymond James & Associates. His letter was cosigned by Gary M. Franklin, a Managing Director of Morgan Keegan Co. and Dennis Moorman, a Manager at J.J.B. Hilliard, W.L. Lyons, Inc.

maintained that the changes proposed by OCC would be confusing for retail investors. His letter proposes an alternative methodology.

The Problem

OCC's existing adjustment methodology for stock dividends, stock splits, and similar events is imprecise because option strike prices are expressed in eighths rather than in decimals. When an adjustment for a stock dividend, stock split, or similar event produces an adjusted strike price that includes cents as well as dollars, the adjusted strike price has to be rounded to the nearest eighth. For example, an adjusted strike price of $20.31 has to be rounded down to $20 1/4. Rounding of strike prices may also be required when an adjustment produces a deliverable that includes fractional shares. The fractional shares are eliminated and the strike price is reduced to compensate, but the reduced strike price may also need to be rounded to the nearest eighth.

The rounding process creates a windfall profit for one side of the contract and a corresponding loss for the other. For example, a holder of a call on 1,000 shares whose adjusted strike price is reduced from $20.31 to 20 ¼ can buy the underlying stock for $20,250 instead of $20,310. These profits and losses, while small on a per-contract basis, can be significant for large positions.

OCC's Proposed Solution

OCC proposes to eliminate the windfall profits and losses associated with strike price adjustments by adjusting only the deliverable and not the strike price. For example, under OCC's current rules, in the event of a 3 for 2 stock split, an option with a strike of $50 would be adjusted by increasing the deliverable to 150 shares and reducing the strike to $33.33, which would be rounded up to $33-3/8. Under the proposed rule change, the deliverable would also be adjusted to 150 shares; but the strike price would be left unchanged, and the original deliverable of 100 shares would continue to be used as the multiplier for purposes of calculating premiums and exercise prices. As a result, instead of increasing to $5,006.25 (150 x $33-3/8), the extended strike price would remain at $5,000 (100 x $50), thus eliminating the $6.25 windfall to put holders and call writers. (This is the method currently used for property distributions and special dividends large enough to require an adjustment under OCC's By-Laws.)

OCC also proposes to eliminate inequities associated with the elimination of fractional shares by adjusting the deliverable to include cash in lieu of the eliminated fraction and leaving the strike price unchanged. For example, in the case of a 4-for-3 stock split, under both the current and the proposed rules, an option with a strike of $80 would be adjusted to call for delivery of 133.3333 shares, which would be rounded down to 133 shares. Under the current rules, the strike would first be reduced to $60 (3/4 x $80), and then, if necessary, further reduced to compensate for the value of fractional shares lost. Under the proposed rule change, if the ex-date stock price was $60, the strike price would be left unchanged as explained above and $20.00 ($60 x .3333 = $19.998, then rounded to the nearest penny) would be added to the deliverable to compensate for the eliminated fractional share. Because the strike prices and strike multipliers are not changed, an exerciser will always pay exactly the same amount after the adjustment as he did before and will receive a combination of stock and cash constituting the precise economic equivalent of the underlying stock position on the ex-date.

The Alternative Methodology

Mr. Knight's alternative proposal would retain rounding of strike prices, but would eliminate the resulting windfalls by including a cash adjustment factor as part of the option deliverable. His comment letter does not give examples of how the proposal would work, but OCC understands from conversations with Mr. Knight that it would work as follows:

<u>Example of a 3 for 2 Split</u>

Original Strike	40	35	30
Adjusted Strike	26 5/8	23 3/8	20
Original Extended Strike Price	$4,000 ($40 x 100)	$3,500 ($35 x 100)	$3,000 ($30 x 100)
Adjusted Extended Strike Price	$3,993.75 ($26 5/8 x 150)	$3,506.25 ($23 3/8 x 150)	$3,000 ($20 x 150)
Difference	$6.25	($6.25)	$0
Required Adjustment Factor	$6.25	($6.25)	$0

Strike prices would be adjusted and rounded to the nearest eighth as they are under OCC's current methodology. The multiplier for strike extensions would be 150 after the adjustment, also as under the current methodology. In order to assure that the aggregate exercise settlement amount remains the same after the adjustment as before, thereby avoiding the windfalls resulting from rounding, an adjustment factor would be included in the calculation of the extended strike price. However, as the examples show, the adjustment factor would be different for each adjusted strike price: An exerciser of a 26 5/8 call would be required to pay $6.25 ***more*** than the calculated exercise amount. An exerciser of a 23 3/8 call would pay $6.25 ***less*** than the calculated exercise amount. And some strikes (as the 20 strike above) would not need any adjustment factor.

Mr. Knight's proposal accomplishes the intended result of avoiding inequities due to rounding of strike prices. However, OCC does not regard the proposal as feasible or desirable:

- OCC and clearing member systems have never utilized a strike-specific adjustment factor like the one that Mr. Knight is suggesting. These systems also have never had to incorporate negative amounts in strike price calculations. Systems changes would be required, and OCC believes these changes would be onerous.

- Mr. Knight observes that OCC's proposal would provide for the delivery of cash in lieu in certain situations, and asserts that this supports his proposal. However, the cash component in OCC's proposal is very different than in Mr. Knight's. In OCC's proposal, in the case of a 4 for 3 split, the cash that would be added to the deliverable represents cash in lieu of fractional shares. Requiring payment of cash in lieu corresponds to what the issuer of the underlying stock is doing for its own shareholders. (Note that a 3 for 2 split would not involve fractional shares, but Mr. Knight's proposal would still require an adjustment factor.) And most significantly, the cash in lieu amount under OCC's proposal for 4 for 3 splits is the same for each strike price, and always accrues to the buyer. Because it compensates for fractional shares of the option deliverable, it is never used as part of the calculation of the extended strike price. Mr. Knight's adjustment factors are adjustments to the extended strike price. Finally, OCC's use of a cash component that substitutes for fractional shares is a long-established practice and would not require any systems changes for firms. As was noted above, Mr. Knight's proposal is quite different and would require significant systems changes.

- Mr. Knight contends that his proposal would avoid "strike prices that are disconnected from the current price of the stock." (OCC acknowledges the need for education to prepare investors for the new adjustment method.) However, Mr. Knight's proposal does not solve the problem of strike prices that are disconnected from the underlying stock price. For example, going back to the illustration above, if the stock price is $26.63, a 26 5/8 call would appear to be marginally in the money. However, this option would actually be ***out of the money*** by $6.25 because an investor would be required to pay $6.25 more than the strike price indicates if he exercised this option. In order to determine whether an adjusted option with a close-to-the-money strike price was in or out of the money, an investor would have to know the amount of the adjustment factor for the particular strike.

- Mr. Knight's proposal would create a related problem for expiration processing. In OCC's expiration processing, options that are in the money by a specified threshold are automatically exercised unless the clearing member instructs otherwise. Although Mr. Knight's adjustment factors are relatively small, automatic exercise thresholds in OCC's expiration processing are also small ($.05). Thus, in the preceding example, a closing stock price of $26.68 would trigger automatic exercise of the 26 5/8 call, but the call would actually be out of the money because the exercising holder would have to pay $2,668.75 (extended strike price of $2662.50 plus adjustment factor of $6.25). In order to prevent this from happening, OCC and clearing member expiration systems would have to be modified to take into account the proposed series-specific adjustment factors. OCC believes that these would also be extensive systems changes.

OCC recognizes that its proposal creates a disconnect between the strike price and the underlying stock price that investors will have to take into account (as they do today where an option has been adjusted for a property distributions or a special dividend). However, Mr. Knight's proposal creates its own disconnect, which could be even more confusing for investors because they would have to be aware of the specific adjustment factor for a particular series. As mentioned, the adjustment factors would be different for each strike, adding to the potential confusion.

OCC vetted the proposed changes to its adjustment methodology with industry participants on numerous occasions, both prior to and after the rule filing. The topic was included on the agendas of several OCC Operations Roundtable and Options Operations Committee meetings. The proposal was also discussed at meetings of the SIA (now SIFMA) Options Committee, the SIA Data Management Division (DMD), and the SIA Securities Operations Division (SOD), as well as with members of the Cashiers Association. OCC issued two Information Memos detailing the proposed changes. Additionally, OCC sponsored two ninety minute conference calls in March, 2006, one for back-office operations staff and the other for trading desks. Based on these discussions, OCC is satisfied that its proposed changes enjoy overwhelming industry support.

In summary, OCC believes its current proposal is the best way to address the objective of eliminating inequities associated with the rounding of strike prices in contract adjustments.

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Questions regarding this response may be addressed to John Peplinski at 312-322-6290, Gina McFadden at 312-322-6294, or the undersigned.

Very truly yours,

William H Navin

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