

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-54514; File No. SR-OCC-2006-05)

September 26, 2006

Self-Regulatory Organizations; The Options Clearing Corporation; Order Granting Approval of a Proposed Rule Change Relating to Expiration Date Exercise Procedures

I. Introduction

On April 6, 2006, The Options Clearing Corporation (“OCC”) filed with the Securities and Exchange Commission (“Commission”) proposed rule change SR-OCC-2006-05 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”).<sup>1</sup> Notice of the proposal was published in the Federal Register on August 18, 2006.<sup>2</sup> 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 will amend OCC Rule 805, Expiration Date Exercise Procedure, to reduce the threshold amounts used to determine which equity options are in the money for purposes of “exercise by exception” processing. A conforming change would also be made to OCC Rule 1106, Open Positions, which concerns the treatment of open positions following the suspension of a clearing member.

OCC has for years maintained an “exercise by exception” procedure. Under that procedure, options that are in the money at expiration by more than a specified threshold amount are exercised automatically unless the clearing member carrying the position instructs OCC otherwise. Equity options are determined to be in the money or not in the money based on the difference between the exercise price and the closing price of the underlying equity interest on the last trading day before expiration. In September 2004, in order to streamline expiration

---

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

<sup>2</sup> Securities Exchange Act Release No. 54306, (August 11, 2006), 71 FR 47853.

processing, OCC reduced the threshold amounts from \$.75 to \$.25 for equity options in a clearing member's customers' account and from \$.25 to \$.15 for equity options in any other account (i.e., firm and market makers' accounts).<sup>3</sup> The September 2004 change, which was implemented at the request of the OCC Roundtable,<sup>4</sup> immediately yielded significant benefits to both OCC and clearing members as evidenced by the fact that the time for submitting exercise instructions was reduced by one to three hours on an average expiration weekend.

Increasing options volumes in 2004 and 2005 prompted the OCC Roundtable to review the threshold amounts used for equity options in an effort to further reduce operational risks and improve expiration processing. Initially, the OCC Roundtable proposed that the threshold amount for all account types be set at \$.01, but an OCC survey of clearing members found that while 65% of responding clearing members supported such a change, 35% were against it. A second OCC survey determined that 75% of responding clearing members were in favor of and 25% were opposed to changing the threshold amount change to \$.05 for all account types. The OCC Roundtable then requested that OCC establish \$.05 as the threshold amount applicable to equity options exercises for all account types.

In response to this request, OCC analyzed equity options exercise information from the June 2004 through December 2005 expirations. OCC analysis determined from its members that 70% of equity option contracts carried in clearing members' customers' accounts that were in the money by amounts of \$.05 to \$.24 (i.e., the proposed change to the "in-the-money" amount

---

<sup>3</sup> Securities Exchange Act Release No. 50178 (August 10, 2004), 69 FR 51343 (August 18, 2004) [File No. SR-OCC-2004-04].

<sup>4</sup> The OCC Roundtable is an OCC sponsored advisory group comprised of representatives from OCC's participant exchanges, OCC, a cross-section of OCC clearing members, and industry service bureaus. The OCC Roundtable considers operational improvements that may be made to increase efficiencies and lower costs in the options industry.

represented by the proposed threshold change) were exercised. OCC analysis also determined from its members that exercise activity in other account types supported the proposed threshold amount change.

OCC surveyed all clearing members to obtain their views and comments on the proposed change to \$.05 as the threshold amount for equity options for all account types. Survey results demonstrated strong support across the membership for the change. Eighty-seven clearing members responded to the survey with sixty-five clearing members (75%) being in favor of the threshold change and 22 clearing members (25%) being opposed.<sup>5</sup> Clearing members supporting the change confirmed the OCC Roundtable's view that such a change would significantly reduce the number of instructions clearing members are currently required to submit at expiration and thereby would shorten the time frame for completing their instructions to OCC.

OCC contacted each firm that expressed opposition to the \$.05 threshold amount change. These firms are generally midsize to small retail clearing members. Their opposition to the change reflected their principal concern that they would have to submit more "do not exercise" instructions. Some indicated concerns about the need to educate customers and about the possibility that commission costs could make an exercise unprofitable.<sup>6</sup> However, all of these firms indicated that they could adapt to a \$.05 threshold amount if it was supported by the majority of clearing members. OCC further reviewed the positions carried by these firms and determined that, on average, they generally carry positions in fewer than 10 expiring series per

---

<sup>5</sup> OCC contacted clearing members that did not respond to its survey. These firms expressed no opinion on the matter.

<sup>6</sup> As noted, clearing members are able to instruct OCC not to exercise an expiring equity option.

expiration that are below the current threshold amount of \$.25. This review led OCC to conclude that the threshold amount change to \$.05 would result in only a slight increase in processing time for these firms and that they would not be unduly burdened by its implementation.

OCC's survey of clearing members also asked firms to provide an estimate of the time they would need to accommodate the threshold change based upon supplied time frames (e.g., 0-3 months or 4-6 months). The majority of firms indicated that they could complete the necessary systems development and customer notifications within six months. OCC contacted every firm that commented on the proposed time frames, and all expressed the view that their efforts would be completed in the six month time period.

The OCC Roundtable has recommended that this change be implemented for the October 2006 expiration. Therefore, OCC requests that the Commission approve the proposed rule change with an effective date of October 1, 2006, and that the Commission authorize OCC to implement the threshold change thereafter based upon its assessment of clearing member readiness. OCC would provide at least ten days advance notice to clearing members of the effective date for the new threshold amounts by information memoranda and by other forms of electronic notice such as email. Additionally, OCC would allow clearing members additional time to complete preparations for the threshold change if necessary.

### 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.<sup>7</sup> OCC Rule 805 is based on the assumption that when an option is in-the-money by

---

<sup>7</sup> 15 U.S.C. 78q-1(b)(3)(F).

at least a minimum fixed threshold level, most OCC members and their customers would choose to exercise the option. The rule has the effect, therefore, of reducing the number of exercise instructions that must be submitted to and processed by OCC. As OCC notes in its description of the proposed rule change, if a threshold amount is set too low, the result could be that some members would have to submit a greater number of “do not exercise” instructions than they would have to submit if the threshold amount was set at a higher amount. However, the Commission is satisfied that by consulting with an industry advisory group, by surveying its clearing members, and by its analysis, OCC has made a reasoned determination in deciding to set the threshold amount for equity options in all account types at \$.05. Furthermore, we note that OCC consulted with its clearing members to ensure that even those that did not actively support the proposed rule change would not be adversely affected in a significant manner by the new threshold amount. Accordingly, because the proposed rule change is designed to reduce the amount of processing required for in-the-money equity options, we find that it is designed to promote the prompt and accurate clearance and settlement of 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.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (File No. SR-OCC-2006-05) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>8</sup>

Nancy M. Morris  
Secretary

---

<sup>8</sup> 17 CFR 200.30-3(a)(12).

