

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-54748; File No. SR-OCC-2006-01)

November 14, 2006

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Amended Filing of Proposed Rule Change to Revise Option Adjustment Methodology

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> notice is hereby given that on January 12, 2006, 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 by OCC. On March 9, 2006, the Commission published notice of the proposed rule change to solicit comments from interested parties.<sup>2</sup> The Commission received ten comment letters.<sup>3</sup> To address the concerns raised by the commenters, OCC amended the proposed rule change on September 25, 2006. The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested parties.

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

<sup>2</sup> Securities Exchange Act Release No. 53400 (March 2, 2006), 71 FR 12226.

<sup>3</sup> Joseph Haggemiller (March 8, 2006); Erik A. Hartog, Operating Manager, Allagash Trading LLC (March 21, 2006); Jeffrey Woodring (March 22, 2006); Adam Besch-Turner (March 23, 2006); Christopher Nagy, Chairman, Options Committee, Securities Industry Association (March 24, 2006); Mike Ianni (April 5, 2006); Mike Ianni (April 5, 2006); Peter van Dooijeweert, President, Alopex Capital Management, LLC (April 26, 2006); Bob Linville and Deborah Mittelman, Service Bureau Committee Co-Chairs, Financial Information Forum (May 2, 2006); and William H. Navin, Executive Vice President, General Counsel, and Secretary, The Options Clearing Corporation (September 29, 2006).

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

OCC is seeking to amend Article VI (Clearance of Exchange Transactions), Section 11A of OCC's By-Laws to (1) eliminate the need to round strike prices and/or units of trading in the event of certain stock dividends, stock distributions, and stock splits and (2) provide for the adjustment of outstanding options for special dividends (i.e., cash distributions not declared pursuant to a policy or practice of paying such distributions on a quarterly or other regular basis). The proposed rule change would also add a \$12.50 per contract threshold amount for cash dividends and distributions to trigger application of OCC's adjustment rules.

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 these statements.<sup>4</sup>

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

A. Changes relating to Adjustments for Certain Stock Dividends, Stock Distributions, and Stock Splits

OCC's By-Laws currently specify two alternative methods of adjusting for stock dividends, stock distributions, and stock splits. In cases where one or more whole shares are

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<sup>4</sup> The Commission has modified the text of the summaries prepared by OCC.

issued with respect to each outstanding share, the number of outstanding option contracts is correspondingly increased and strike prices are proportionally reduced.<sup>5</sup> In all other cases, the number of shares to be delivered under the option contract is increased and the strike price is reduced proportionately.<sup>6</sup>

Although these two methods have been used since the inception of options trading, in certain circumstances either method can produce a windfall profit for one side and a corresponding loss for the other due to rounding of adjusted strike prices. These profits and losses, while small on a per-contract basis, can be significant for large positions. Because equity option strike prices are currently stated in eighths, OCC's By-Laws require adjusted strike prices to be rounded to the nearest eighth. For example, if an XYZ \$50 option for 100 shares were to be adjusted for a 3-for-2 split, the deliverable would be increased to 150 shares and the strike price would be adjusted to \$33.33, which would then be rounded up to \$33-3/8. Prior to the adjustment, a call holder would have had to pay \$5,000 to exercise ( $\$50 \times 100$  shares). After the adjustment, the caller has to pay \$5,006.25 for the equivalent stock position ( $\$33.375 \times 150$  shares). Conversely, an exercising put holder would receive \$5,006.25 instead of \$5,000. The

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<sup>5</sup> For example, in the event of a 2-for-1 split, an XYZ \$60 option calling for the delivery of 100 shares of XYZ stock would be subdivided into two XYZ \$30 options, each calling for the delivery of 100 shares of XYZ stock.

<sup>6</sup> For example, in a 3-for-2 split, an XYZ \$60 option calling for the delivery of 100 shares would be adjusted to call for the delivery of 150 shares and the strike price would be reduced to \$40.

\$6.25 difference represents a loss for call holders and put writers and a windfall for put holders and call writers.

A loss/windfall can also occur when the split results in a fractional deliverable (e.g., when a 4-for-3 split produces a deliverable of 133.3333 shares). In those cases, OCC's By-Laws currently require that the deliverable be rounded down to eliminate the fraction, and if appropriate, the strike price be further adjusted to the nearest eighth to compensate for the diminution in the value of the contract resulting from the elimination of the fractional share. However, even if these steps are taken, small rounding inequities may remain.

The windfall profits and correspondent losses resulting from the rounding process have historically been accepted as immaterial. Due to recent substantial increases in trading volume and position size, however, they have become a source of concern to exchanges and market participants. In addition, OCC has been informed that some traders may be exploiting announcements of splits and similar events by quickly establishing positions designed to capture rounding windfalls at the expense of other market participants.

The inequity that results from the need to round strike prices can be eliminated by using a different adjustment method: namely, adjusting the deliverable but not the strike prices or the values used to calculate aggregate exercise prices and premiums. As an illustration of the proposed adjustment methodology, in the XYZ \$50 option 3-for-2 split example described above, the resulting adjustment would be a deliverable of 150 shares of XYZ stock while the strike price would remain at \$50. In this case, the presplit multiplier of 100, used to extend aggregate strike price and premium amounts, is unchanged. For example, a premium of 1.50 would equal \$150 ( $\$1.5 \times 100$ ) both before and after the adjustment. An exercising call holder

would continue to pay \$50 times 100 (for a total of \$5,000) but would receive 150 shares of XYZ stock instead of 100.<sup>7</sup> This is the method currently used for property distributions such as spin-offs and special dividends large enough to require adjustments under OCC's By-Laws.

The inequity that results from the need to eliminate fractional shares from the deliverable and to compensate by further reducing the strike price to the nearest eighth can be eliminated by adjusting the deliverable to include cash in lieu of the fractional share. As an illustration, consider a 4-for-3 split of the stock underlying an XYZ \$80 option with a 100 share deliverable. Employing the proposed adjustment method, the deliverable would be adjusted to 133.3333 shares, which would be rounded down to 133 shares, and the strike price would remain \$80. However, instead of compensating for the elimination of the .3333 share by reducing the strike prices, the strike prices would be left unchanged, and the deliverable would be adjusted to 133 shares plus the cash value of the eliminated fractional share (.3333 x the post-split value of a share of XYZ stock as determined by OCC). The adjusted option would also continue to use 100 as the multiplier to calculate aggregate strike and premium amounts.

The proposed revised adjustment methodology would not generally be used for 2-for-1 or 4-for-1 stock distributions or splits (since such distributions or splits normally result in strike prices that do not require rounding to the nearest eighth). In addition, the revised adjustment methodology would not generally be used for stock dividends, stock distributions, or

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<sup>7</sup> The same adjustment methodology would apply to reverse stock splits or combination of shares. For example, in a 3-for-4 reverse stock split on a XYZ \$50 option calling for the delivery of 100 shares, the resulting adjustment would be a deliverable of 75 shares of XYZ stock while the strike price would remain at \$50.

stock splits with respect to any series of options having exercise prices stated in decimals.<sup>8</sup> For those options, the existing adjustment rules would continue to apply. The reason for this is that once the market has converted to decimal strikes, the rounding errors created by rounding to the nearest cent would be immaterial even given the larger positions taken in today's markets and the other factors discussed above. Because conversion to decimal strikes might be phased in rather than applied to all series of equity options simultaneously, the rule has been drafted to cover both methods of expressing exercise prices, applying the appropriate rule to each.

The proposed changes in adjustment methodology would not be implemented until the exchanges have conducted appropriate educational efforts and definitive copies of an appropriate supplement to the options disclosure document, Characteristics and Risks of Standardized Options, were available for distribution.<sup>9</sup>

B. Changes to the Definition of "Ordinary Dividends and Distributions"

Article VI, Section 11A(c) of OCC's By-Laws currently provides that as a general rule, outstanding options will not be adjusted to compensate for ordinary cash dividends. Interpretation and Policy .01 under Section 11A of Article VI provides that a cash dividend will generally be deemed to be "ordinary" if the amount does not exceed 10% of the value of the underlying stock on the declaration date ("10% Rule"). The OCC Securities Committee is authorized to decide on a case-by-case basis whether to adjust for dividends exceeding that

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<sup>8</sup> Although there are currently no decimal strikes for equity options, OCC wants to avoid the need for further amendments to its By-Laws and the options disclosure document in the event that such strikes are introduced in the future.

<sup>9</sup> OCC will notify the Commission and issue an Important Notice when the proposed adjustment methodology is implemented.

amount. As a result, OCC historically has not adjusted for special cash dividends unless the amount of the dividend was greater than 10% of the stock price at the close of trading on the declaration day.

The 10% Rule predated a number of significant developments, including, the introduction of Long-term Equity Anticipation Security (“LEAPS”) options, the sizeable open interest seen today, the large contract volume associated with trading and spreading strategies, and modern option pricing models that take dividends into account. When open interest and individual positions were smaller, not adjusting for dividends of less than 10% did not have the pronounced impact it does today. Additionally, changes to the tax code which now tax dividends more favorably have provided an incentive for companies to pay more dividends, including special dividends. In light of these considerations, it is appropriate that the 10% Rule now be revised.

Under the revision proposed by OCC, a cash dividend or distribution would be considered ordinary (regardless of size) if the OCC Securities Committee determines that such dividend or distribution was declared pursuant to a policy or practice of paying such dividends or distributions on a quarterly or other regular basis. In addition, as a general rule, a cash dividend or distribution that is less than \$12.50 per contract would not trigger the adjustment provisions of Article VI, Section 11A.

1. No Adjustment for Regularly-Scheduled Dividends Needed

Dividends declared by an issuer pursuant to a policy or practice of such issuer are known and can thus be priced into option premiums. By definition, however, special dividends

cannot be anticipated in advance and therefore cannot be integrated into option pricing models.<sup>10</sup> If adjustments are not made in response to special dividends (i.e., by calling for the delivery of the dividend) call holders can capture the dividends only by exercising their options. Often in these cases, especially with LEAPS options or FLEX options which can exist for 5 to 10 years, early exercise would sacrifice substantial option time value. This economic disadvantage would be further magnified if the option position is large, as is often the case today. Conversely, put holders often receive a windfall benefit from the increase in the in-the-money value on the ex date. To the extent that equity options can be priced accurately and consistently without dislocations due to unforeseen special dividends, these economic disadvantages can be avoided. Moreover, because special dividends are one-off events, adjusting for them would not cause the proliferation of outstanding series that would result from adjusting for regular dividends as explained below.

## 2. De Minimis Threshold

Adjusting for dividends can cause a proliferation of outstanding option symbols and series.<sup>11</sup> In the interest of providing some limit on option symbol proliferation, the proposed

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<sup>10</sup> OCC has been told that some traders form judgments as to the likelihood that certain issuers may declare special cash dividends and factor those judgments into their pricing models. However, that is clearly not the case with all traders or all issues.

<sup>11</sup> Symbols proliferate when adjustments are made because often the dividend amount must be added to the deliverable yielding a non-standard option. The exchanges then introduce standard options with the same strikes.



rule change includes a de minimis threshold of \$12.50 per contract. Special dividends smaller than these amounts would not trigger an adjustment.

OCC believes that a threshold that is a set dollar amount is preferable to one that is a percentage of the stock price (like OCC's existing 10% Rule) because there are operational problems with applying a percentage threshold. Under the existing 10% Rule, in order to determine whether this threshold is met, the per share dividend amount is applied to the closing price of the underlying security on the dividend declaration date. The date the dividend is announced (by press release or by some other means) is not normally the "declaration date" when the dividend is officially declared by an issuer's board of directors. Until the actual declaration date, investors and traders may not know whether or not an announced dividend will trigger an adjustment based on the company's share price. In the interim, it is difficult for traders and investors to price their options because they do not know if an adjustment will be made.

The advantage of a fixed dollar threshold is avoiding uncertainty. The per contract value of the dividend can be immediately determined without the need to wait until the declaration date and without the need to do a calculation based on the closing price of the underlying shares.

### 3. Consistency Across Relevant Interpretations

Interpretations and Policies .01 and .08 under Article VI, Section 11A apply to cash distributions. Interpretation and Policy .01 (as proposed to be amended) would apply in general to all cash distributions. Interpretation and Policy .08 currently carves out exceptions for fund share cash distributions and does not include a threshold minimum. In the interest of clarity

and consistency with Interpretation and Policy .01, Interpretation .08 would be revised to provide for the same \$12.50 per contract threshold. Clause (ii) of Interpretation and Policy .08 would be deleted because it is an exception to the 10% Rule and would no longer be needed when the 10% Rule is abolished.

#### 4. The Amendment

OCC understands that certain option traders may have integrated into their pricing models the probability of special dividends based on the OCC rules currently in effect and that eliminating the 10% Rule with respect to existing contracts may unfairly affect these options traders. To ensure that no options series that were opened before disclosure of the rule change are affected by elimination of the 10% Rule, OCC will delay eliminating the 10% Rule and replacing it with the fixed dollar threshold so that these changes will be implemented only for corporate events announced on or after February 1, 2009. OCC plans to provide ODD disclosure of this rule change before May 29, 2007 (after which date the exchanges would normally begin introducing LEAPS expiring in 2010 making a 2009 implementation impracticable). The delay in implementation will ensure that all options series opened before the ODD disclosure is made available (other than certain “flex” options that will be grandfathered under the old rule) will have expired before the change is effected.<sup>12</sup> While delaying the implementation until 2009

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<sup>12</sup> OCC intends to take a “snapshot” of flex series expiring after January 31, 2009, that are outstanding at the time when ODD disclosure of the rule change is made. Those series will be assigned distinctive trading symbols and “grandfathered” under the old rule. Trading will continue normally in grandfathered series until their expiration, but the exchanges would be free to open otherwise identical non-grandfathered series, which would be identified by conventional flex trading symbols. If ODD disclosure is not made until after the December 2006 expiration, it may also be necessary to grandfather two classes of LEAPs with

postpones the benefit of making this needed change, it accommodates the many firms that find the operational hurdles and fairness issues associated with an earlier implementation onerous.

OCC believes that the proposed rule change is consistent with the requirements of Section 17A of the Act<sup>13</sup> and the rules and regulations thereunder applicable to OCC because (1) it is intended to eliminate inequities that result from certain rounding practices currently required by OCC's By-Laws and thus protect investors and (2) it is intended to make more predictable when cash distributions by an issuer will result in an adjustment to an option contract and thus make the process for adjustments more equitable for all investors.

(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

Within thirty-five days of the date of publication of this notice in the Federal Register or

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December expirations (SPY and S&P 100 i-Shares) because the exchanges would ordinarily introduce new series expiring in December 2009 after the December 2006 expiration.

<sup>13</sup> 15 U.S.C. 78q-1.

within such longer period (i) as the Commission may designate up to ninety days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve such proposed rule change or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, 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-2006-01 on the subject line.

##### Paper comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-OCC-2006-01. 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, 100 F Street, NE, 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.theocc.com](http://www.theocc.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-2006-01 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>14</sup>

Nancy M. Morris  
Secretary

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<sup>14</sup> 17 CFR 200.30-3(a)(12).

