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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 comments filed with the Commission regarding the captioned rule change filing. The filing was made on January 12, 2006 and published for comment on March 2, 2006.[1] It proposed 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.

Nine comment letters were filed with respect to the proposed rule change. Of the nine, six commented only on the proposed elimination of the 10% rule;[2] one commented only on the proposed change in adjustment methodology for stock dividends;[3] one commented on both;[4] and one expressed opposition but failed to state what aspect(s) of the filing he found objectionable.[5]

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

[2] Joseph Haggenmiller (Mar. 8, 2006); Allagash Trading LLC (Mar. 21, 2006);Jeffrey Woodring (Mar. 22, 2006); Adam Besch-Turner (Mar. 23, 2006); Mike Ianni (two letters) (Apr. 5, 2006); and Alopex Capital Management LLC (Apr. 26, 2006).

[3] Financial Information Forum (May 2, 2006).

Elimination of the 10% Rule

Background

Article VI, Section 11A(c) of OCC's By-Laws provides: "It shall be the general rule that there shall be no adjustments to reflect ordinary cash dividends or distributions . . . by the issuer of the underlying security." Interpretation .01 under that Section states:

> 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 11A.

This rule is generally referred to as the "10% rule." The principal purpose of the 10% rule was to avoid, or at least minimize, the series proliferation that would result from repeatedly adjusting outstanding contracts for quarterly cash dividends. However, the 10% rule also has the effect of barring adjustments for all but the largest special dividends.

When an issuer pays a special dividend below the 10% level, holders of calls on the issuer's stock cannot obtain the dividend unless they exercise their calls, thereby sacrificing the remaining time value. Conversely, writers of puts on the issuer's stock who are assigned exercises after the ex-date for the dividend will receive stock that has been reduced in value by the amount of the dividend. (The same is true with respect to regular quarterly dividends; but because regular dividends are predictable, market participants can readily factor them into their pricing models.)

As we noted in the captioned filing, the 10% rule predated a number of significant developments, including the introduction of LEAPS, the huge growth in open interest in listed options, the large contract volume associated with modern trading and spreading strategies, and tax law changes favoring dividends. Because LEAPS may have remaining terms of as much as 2-1/2 years, the time value that a

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[4] SIA Options Committee (Mar. 24, 2006).

[5] Joseph Haggenmiller's entire comment was "I do NOT wish for this to go through." [Emph. in orig.]

holder would have to sacrifice in order to capture a dividend can be much greater than in the case of conventional options.[6] Because positions today can be extremely large, the losses sustained by call holders who must choose between exercising and foregoing the dividend and by put writers who can be required to purchase devalued stock, and the corresponding windfalls to investors on the other side of the market, can be very large. These losses, and the corresponding windfalls, could be especially large if a special dividend were paid on a high-priced stock like CME or GOOG. The 10% rule would preclude adjusting for special dividends as large as $40/share, or $4,000 per option contract, on those stocks.

Because of these mounting inequities, OCC concluded that the operational efficiencies of not adjusting for special cash dividends below the 10% level were outweighed by the adverse effects on market participants. Under the proposed rule change, a cash dividend or distribution would be considered "ordinary," regardless of size, if OCC determined that it was paid pursuant to a policy or practice of paying such dividends or distributions on a quarterly or other regular basis. This would continue OCC's policy of not adjusting for regular dividends, but would allow adjustments for special cash dividends (above a de minimis level of $12.50 per contract).

Comments

Because a number of the comment letters made similar comments regarding the proposed elimination of the 10% rule, we have summarized those comments below and will respond to the comments rather than to each letter individually.

1. Unfair to Eliminate the 10% Rule for Outstanding Contracts.

A number of commenters argued that it would be unfair to eliminate the 10% rule for outstanding contracts. They maintained that it is common for market participants to estimate the probability that an issuer will pay a special dividend of less than 10% during the life of an option and to factor these estimates into their pricing models on the assumption that OCC will not adjust for such dividends.[7] They argued that eliminating the 10% rule for outstanding contracts would adversely affect the value of certain existing positions while producing windfalls for holders of the opposite positions.

[6] Flexibly structured ("flex") options can have even longer terms.

[7] *See* Allagash Trading LLC, Adam Besch-Turner, Mike Ianni, Alopex Capital Management LLC.

OCC believed, as we stated in our filing, that "[b]y definition, . . . special dividends cannot be anticipated in advance and therefore cannot be integrated into option pricing models." However, discussions with market participants have convinced us that at least some traders do estimate the probability of special dividends by selected issuers and factor those estimates into their pricing models. We agree that it would be unfair to those traders to eliminate the 10% rule with respect to outstanding contracts.

We have spent considerable time and effort working with exchanges and clearing members to devise a grandfathering plan for outstanding contracts that would not entail unacceptable operational burdens for industry participants.[8] We have reluctantly concluded that the only practicable way to exempt outstanding contracts from the rule change is to defer implementation of the rule change until after the expiration of substantially all outstanding options series. Accordingly, OCC has amended and restated its rule change filing to eliminate the 10% rule only with respect to dividends announced on and after February 1, 2009.[9] The few outstanding options series with expirations beyond that date would be grandfathered and assigned separate trading symbols.

We believe that this amendment fully addresses the concerns expressed regarding fairness to holders and writers of outstanding contracts.

2. Uncertainty as to whether particular dividends will be treated as ordinary or special; too much discretion vested in OCC Securities Committee.

Three commenters expressed concern that elimination of the 10% rule would create uncertainty as to whether OCC would classify particular dividends as ordinary or non-ordinary, and market liquidity would be adversely affected pending announcement of OCC's decision.[10]

Under the proposed rule change, a cash dividend would be classified as "ordinary," and therefore not adjusted for, if OCC believed that it was declared

[8] The principal difficulty is that grandfathered options series would have to be identified by separate trading symbols. This would involve an unacceptable degree of symbol proliferation if all outstanding series were to be grandfathered. This would be true even if elimination of the 10% rule were to be deferred until after the expiration of all conventional options series, because new symbols would still have to be assigned to thousands of LEAPS series.

[9] Amendment No. 1 to File No. SR-OCC-2006-1.

[10] *See* Allagash Trading LLC, Mike Ianni, Alopex Capital Management, LLC.

"pursuant to a policy or practice of paying such dividends or distributions on a quarterly or other regular basis." Issues as to whether particular dividends or distributions fit that description would be determined by a panel of the OCC Securities Committee consisting of two representatives of each exchange that lists options on the underlying stock and one representative of OCC, who would vote only to break ties.

Most special dividends are in such amounts and/or payable on such dates that it will be immediately obvious to the market, without waiting for a decision by OCC, that they are not being declared "pursuant to a policy or practice of paying such dividends on a quarterly or other regular basis." Moreover, issuers normally classify a dividend as regular or special when the dividend is announced. While OCC's determination of whether a dividend is ordinary or non-ordinary would not be controlled by the issuer's classification of the dividend as regular or special, in the vast majority of cases a dividend classified by the issuer as special would not fit OCC's definition of "ordinary cash dividends or distributions," and OCC could therefore be expected to classify the dividend as non-ordinary.

Two commenters cited the case of Nucor Corporation (NUE), which for the last two years has announced early in the year that it intends to pay a "supplemental" dividend, in addition to its regular quarterly dividend, in four quarterly installments over the course of the year. Nucor states that the supplemental dividend is "based primarily" on Nucor's results for the previous year, and the payment of supplemental dividends in future years will depend on a variety of factors. As a result, there may be substantially less assurance that the supplemental dividend will carry over into future years than the regular dividend.

There will always be special cases like Nucor as to which an exercise of judgment will be required. That is why OCC has a Securities Committee. However, those cases will be the exception rather than the rule, and uncertainty (as well as the amount of discretion vested in the Securities Committee) will diminish over time as OCC publishes interpretations and policies and a body of precedent develops. OCC and the exchanges intend to publish informational material indicating how special situations like Nucor and issuers that pay regular but highly variable distributions (e.g., REITs and some natural resource companies) will be handled. Given that the new rule will only apply to dividends announced on and after February 1, 2009, there will be ample time to identify special situations and address them in published informational materials.

In the few cases where it is not obvious whether OCC will classify a dividend as ordinary, the market will look to the Securities Committee for a decision. The Securities Committee has historically acted promptly after the announcement of events calling for an exercise of judgment, and can be expected to continue to do so following repeal of the 10% rule.

That said, it is impossible to eliminate uncertainty entirely. There is uncertainty today as to whether particular issuers will pay special dividends, and, if they do, whether the amount will be greater or less than 10%. Even in the case of announced special dividends, there may in some cases be uncertainty as to whether the dividend will exceed 10% of the closing stock price on the declaration date. While the proposed rule may cause brief periods of uncertainty in rare cases for which there is no applicable precedent, it would also make the existing uncertainties irrelevant.

Moreover, while market professionals value certainty, certainty is not the only admissible consideration. A balance needs to be struck between certainty and fairness. Certainty of an unfair result can be as harmful to the markets as uncertainty. The 10% rule is arbitrary, and, like all arbitrary rules, raises issues of fairness. Is it fair for market participants to be visited with large losses in the case of a 9.9% special dividend but be made whole if the dividend exceeds 10%? As was noted above, the 10% rule was devised at a time when option terms were relatively short and positions were much smaller. As expirations have lengthened and position size has increased, the economic impact of unanticipated special dividends on market participants has been greatly magnified.

Although OCC does not believe that elimination of the 10% rule will materially increase market uncertainty, we believe that any increased uncertainty would diminish over time and would be substantially outweighed by increased fairness and rationality in the treatment of special dividends.

3. Symbol Proliferation

Four commenters noted that adjusting for more special dividends would exacerbate trading symbol proliferation.[11] This is true, at least in the short run. More adjustments would require more trading symbols. However, the number of additional symbols would not be material; the need for additional symbols would end when the industry converts to decimal strike prices; and OCC believes that the inequities caused by the 10% rule outweigh any operational burdens associated with the incremental symbol proliferation.

[11] *See* Allagash Trading LLC, Jeffrey Woodring, Adam Besch-Turner, Alopex Capital Management, LLC.

When a corporate event causes an adjustment to the unit of trading, adjusted options series are assigned an adjusted trading symbol.[12] The exchanges then open new series with a standard trading unit under the old trading symbol. For example, if XYZ Corp. spun off shares of its subsidiary ABC Corp. on a 1-for-1 basis, XYZ options (symbol XYZ) would be adjusted to call for the delivery of 100 shares of XYZ plus 100 shares of ABC. The symbol for the adjusted series would be changed from XYZ to, say, XYX, and the exchanges would open new series under the old XYZ symbol calling for the delivery of 100 shares of XYZ. Although special cash dividends are paid in cash, they usually require an adjustment to the unit of trading (i.e., adding the amount of the dividend to the deliverable) because the dividend amount would have to be rounded to the nearest eighth, thereby causing windfall profits and losses, if it were to be subtracted from the exercise price.

Since the beginning of 2006, OCC has been tracking special dividends that were too small to trigger an adjustment under the 10% rule but large enough to cause an adjustment under the proposed rule change. To date in 2006, there have been a total of 22 such dividends, so potentially 22 additional symbols would have had to be assigned for conventional equity options. In some cases, new symbols would also have had to be assigned for LEAP and flex contracts. The number is not negligible, but certainly not large relative to the hundreds of adjusted and wrap symbols already assigned.

In the longer run, OCC is leading an industry initiative to replace fractional strike prices with decimal strikes. The current plan is to begin converting fractional strikes to decimal strikes in November, 2009, less than a year after the repeal of the 10% rule takes effect. When strike prices are denominated in decimals, it will be possible to adjust for special dividends by subtracting the exact amount of the dividend from the strike price (because there will then be no need for rounding of anything but pennies), and there will no longer be any need to assign adjusted symbols.

4. Strike Proliferation

Almost every adjustment results in a non-standard strike price or trading unit. Following such adjustments, the exchanges have historically introduced new

[12] A number of the comment letters refer to adjusted trading symbols as "wrap" symbols. Technically, a wrap symbol is a symbol assigned because of a strike overflow—*i.e.*, more strikes than there are letters in the alphabet. Wrap symbols are sometimes necessitated by strike price adjustments, but they may also be necessitated by volatility in the underlying stock causing the exchanges to follow the market up or down with additional strikes. Thus there may be adjusted symbols that are not wrap symbols, and vice versa.

series with standard strike prices and/or trading units, and the bulk of the liquidity tends to pass from the adjusted series to the new ones.

Citing experience with European markets, one commenter claimed that adjusting for special cash dividends below the 10% level could cause liquidity to "disappear" for adjusted options.[13] Despite the thousands of contract adjustments made over the 33+ years of options trading on U.S. markets, we know of no case where a market has ceased to exist for an adjusted series. We cannot speak for European markets, but market-makers on U.S. options exchanges are numerous, highly competitive, quick to exploit arbitrage opportunities, and in many cases obligated by exchange rules to make markets in every series of every class in which they quote.[14] We have never heard of a complaint that adjusted series (including series adjusted for special cash dividends above the 10% level) have become illiquid to the point of harming investors. We therefore believe that this concern is misplaced.

5. Other

While generally supporting the proposed rule change, one commenter urged OCC as a longer-range matter to consider adopting an alternative adjustment methodology for special cash dividends that the commenter believed to be more equitable to market participants and more consistent with the methodology used by Eurex and other non-U.S. exchanges. Under this alternative, the strike price of an option would be adjusted to be the same percentage of the spot price before and after the ex-date of a special dividend, and the share deliverable would be adjusted so that the notional value of the contract remained the same.[15]

This alternative adjustment methodology was discussed at a meeting of the OCC Operations Roundtable (a group that includes representatives of clearing members, exchanges, and industry organizations) earlier this month. The proponent firms were asked to come back with a request document, after which the members of the Roundtable will determine whether to proceed with the initiative.

OCC has an open mind about making further changes to its adjustment methodology for special cash dividends, and does not object in principle to the Eurex model or other methodologies designed to preserve notional value. However, as a practical matter, it would be impossible to fully adopt the Eurex

[13] *See* Alopex Capital Management, LLC.

[14] *See, e.g.,* CBOE Rules 8.7 and 8.85.

[15] *See* SIA Options Committee.

method without extensive systems changes by OCC, exchanges, members, and vendors. Among other things, the Eurex method requires decimal strikes, which cannot be achieved before 2009 at the earliest. Advocates of the Eurex method have always recognized that it would involve significant operational and systems issues.

Elimination of 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 captioned rule filing also proposed certain changes in OCC's adjustment methodology for certain stock dividends, stock splits, and similar events. The purpose was to eliminate the need to adjust strike prices in these situations, thus eliminating the need to round adjusted strikes, pending the industry's conversion to decimal strikes.

There were two comments on this portion of the filing. One commenter requested that OCC provide a minimum of six months' notice after approval of the revised methodology in order to allow sufficient time for the industry to prepare.[16] OCC will provide the requested notice.

The other comment appears to reflect a fundamental misunderstanding of the proposed rule change.[17] The commenter appears to believe that OCC is introducing a new adjustment methodology. In fact, OCC is simply applying to stock splits and stock dividends the same adjustment methodology used for over 30 years for spin-offs, mergers, and extraordinary cash dividends—namely, adjusting the unit of trading while leaving the strike price unchanged. See the example given in the second paragraph under "Symbol Proliferation" above.

The comment letter asserts that when an adjustment is made, "[t]he adjusted strike price immediately indicates to the investor that the option has been adjusted and therefore more information may be required to evaluate the quote." The letter states that if OCC's proposal is implemented and the strike price does not change, "some other indicator in the display must be changed to somehow alert the investor that the option represents 'old' (pre-corporate action) shares." We do not know what was meant by "old (pre-corporate action) shares," but if the commenter meant that there must be some indicator within the option symbol itself to identify adjusted contracts, the industry does not use that procedure today. If the terms of an option have changed, the industry's custom is to assign an

[16] Securities Industry Association.

[17] Financial Information Forum.

adjusted symbol (*e.g.*, change IBM to IBZ). Price vendors, service bureaus, and securities firms have been identifying adjusted contracts through the use of adjusted symbols since the inception of options trading. Also, adjusted strikes *per se* are not a reliable indicator of an adjusted option, as there are many classes of standard, unadjusted options that trade in one point or other strike increments. Thus there would be nothing unusual about using adjusted symbols to identify contracts whose trading unit has been adjusted (without changing the strike price) due to a stock split or stock dividend. As we have already observed, this method has been widely used for other kinds of adjustments for many years. (Parenthetically, we note that the previously mentioned industry initiative to replace fractional strike prices with decimals, starting in 2009, will include an indicator within the option symbol itself to specify an adjusted contract.)

We recognize that the rule change will increase the number of corporate events that will result in adjustment of the trading unit but not the strike price. This means that there will be more cases where investors comparing strike prices to the stock price will need to recognize that the contract has been adjusted and the strike price buys more than just 100 shares of the underlying stock. This is why, as the rule change notes, the exchanges plan to conduct appropriate educational efforts.

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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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