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OCC news

the official newsletter of The Options Clearing Corporation

Winter 2006



Options industry reaches new heights Volume records set in 2005

The options industry enjoyed a record year, when total volume reached 1,184,267,123 contracts on Oct. 24. Total volume for 2005 is on track to reach more than 1.5 billion contracts.

On Sept. 16, options trading volume surpassed 1 billion contracts for only the second time in history, reaching this milestone two months faster than last year.

"Achieving this volume milestone in less than nine months reflects the terrific value that both individuals and institutions see in making options an important part of their investment strategies," said Wayne P. Luthringshausen, OCC Chairman and CEO. "We look forward to continuous growth in the options marketplace and to reaching even greater heights."

Year-to-date average daily volume is currently at an all-time high of 6.0 million contracts, compared to the previous record of 4.7 million contracts set in 2004. Additionally, all 10 of the top 10 volume days occurred in 2005.



OCC Participates in Industry-Wide Business Continuity Test

On Oct. 15, OCC participated in an industry-wide disaster recovery test, co-sponsored by the Securities Industry Association (SIA), Futures Industry Association (FIA) and Bond Market Association (BMA). The test exercised and verified the ability of firms, markets and utilities to interact and operate in an emergency using back-up sites, recovery facilities and back-up communications capabilities.

The test, "Phase 2," was part of an ongoing securities industry testing initiative that has to date included "Phase 1" connectivity testing, tabletop exercises and participation in Department of Homeland Security exercises. "Phase 2" was the first test of the initiative that simultaneously engaged the equities, fixed income, futures and options sectors of the financial services industry in a coordinated test.

"It was essentially a connectivity test with data," said Dave Engaldo, First Vice President of Business Continuity for OCC. "We wanted to confirm that communication would be possible with everybody working from their back-up facilities." Participants included more than 150 securities firms, 30 exchanges and other industry utilities as well as four service bureaus.

The test required participants to send and receive messages working from their back-up sites. Firms submitted two orders for two valid symbols to the exchanges and then received confirmation reports from the

exchanges. OCC received position adjustments from member firms and trade files from the options exchanges and then OCC sent test data back to both participant groups. Establishing a two-way interaction was key to successful testing.

Options component test participants enjoyed excellent results as 97 percent of OCC's participating firms were successful and the six options exchanges had similar outcomes. "No doubt about it, the test was a success," said Engaldo.

The impressive results would not have been possible without diligent planning. OCC's team, comprised of Member Services representatives and a variety of technical groups, began preparations in May. Efforts included weekly conference calls, internal meetings and participation in industry question and answer sessions. Additionally, OCC played the role of sector coordinator for the entire options industry. This included pre-testing activities that established basic connectivity for participants, ensuring a smooth and successful test.

While the business continuity testing is scheduled annually, it is too early to predict details for next year's activities. "I imagine next year's test will be similar but will vary in terms of scope," said Engaldo. "The connectivity component will still be present but there may be an element of processing that we haven't seen before."

Symbology project to eliminate OPRA codes

In July 2005, OCC's board of directors initiated a project pairing OCC staff with industry representatives to eliminate the use of OPRA codes in the listed options markets and ensure that strike price formats are represented in decimal format. Once a plan is initiated, the committee will set a date when OPRA codes will no longer be generated.

All vendors, options exchanges, exchange members, OCC, OCC members and related parties will be asked to eliminate the use of OPRA codes for exchange listed options in all aspects of the trading and clearance cycle and represent strike prices in decimal formats.

Benefits of the initiative will include elimination of confusion over the LEAPS® rollover process and wrap symbols, reduced

corporate action symbol(s) conversions, reduced frequency of coordination with NYSE for symbol elections, and decreased back office errors and trading errors by having the standard (100-share) option symbol share the same symbology as its underlying.

The committee is developing a set of tools to help market participants conduct analysis on the impact of this project and help firms properly assess the undertaking. The representatives are currently developing an implementation plan for market participants to review. OCC staff is working with industry forums to develop a way to communicate project information efficiently. More information will follow early 2006.

ECMI system terminates: OCC requires Internet back-up

About eight years ago, OCC introduced ECMI (Enhanced Clearing Member Interface) for clearing members and escrow banks to access C/MACS, OCC's post-trade processing system. All members and escrow banks were required to have ECMI either as their primary access method or as a back-up to a T1 line.

When ENCORE replaced C/MACS, clearing members were able to access OCC anytime, anywhere via the Internet with appropriate security devices in place to process transactional data. With the deployment of ENCORE Release 4.5, all escrow bank activity can also be accomplished via an Internet connection. Since the current ECMI dial-up does not provide the high speed and performance level necessary for ENCORE activity, most members and banks have adopted the Internet as their primary access method.

OCC's Board of Directors has voiced concern about the reliance on the Internet and requested that management

secure alternatives for a back-up system to be utilized in the event of an Internet outage. As a result, OCC has determined that firms relying on the Internet for primary ENCORE access must also use an OCC-approved back-up access method. OCC has identified several secure, cost-effective alternatives. In addition to the back-up system, each clearing member will be required to have two Internet service providers. The access method for clearing members is determined by the firm's cleared volume and type of business mix.

OCC will offer current ECMI equipment free to members and banks for their business or personal use. A reduction in ancillary services fees will reflect the termination of ECMI and partially offset the additional cost of the Internet back-up system.

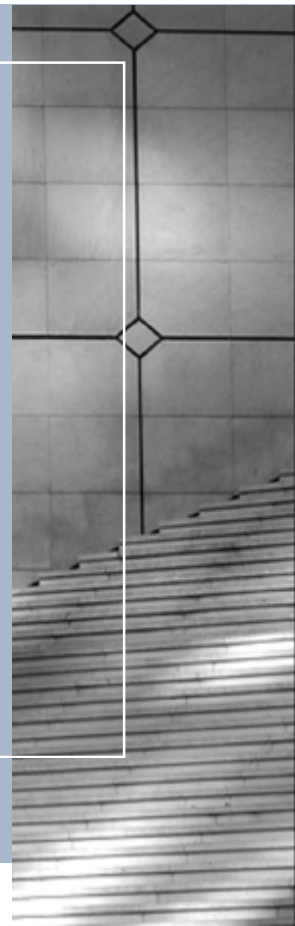
Clearing member and escrow bank notification began in early December. Clearing members should contact their Member Services representative with questions.

High volume testing successful

OCC recently completed high volume systems testing to evaluate the ability to process approximately double the highest transaction volume day. The goal of the test determined transaction volume capacity, helped document a game plan for extreme volume days, and exposed opportunities for performance improvements.

Using data from the highest volume day on record at the time of the test (April 15, 2005), OCC determined the most congested two hour processing period to create a test base, and then created test files by doubling the April 15 data.

Results indicated OCC was successfully able to increase processing capabilities in high-pressure situations with no material impact on response time. Additionally, since completing the test, OCC used results to identify high impact performance enhancements. OCC has already installed many of these performance improvements. A spring 2006 test will be scheduled as part of an ongoing effort to manage increasing volume. "We were pleased at the success of the test and the fabulous teamwork exhibited in the undertaking," said Michael E. Cahill, OCC President and Chief Operating Officer.



industry insight:

Rich Lewandowski on the progress of portfolio margining for securities



Rich Lewandowski began his career at Paine Weber in 1961 as regional head of their margin area. In 1973, he became an examiner at the Chicago Board Options Exchange (CBOE), one of the original employees of the exchange. Lewandowski then co-founded

Brandt & Associates, a clearing firm that was

later sold out to First Options of Chicago. He returned to CBOE to head up the examination staff, and two years later, joined OCC to head up the risk and membership areas. In 1988, Lewandowski was named Executive Vice President at Gelderman Securities. In 1989, he joined CBOE to work on portfolio haircuts and retired in February 2005 as vice president in charge of financial and sales practice compliance in the regulatory area. He is now a consultant for the securities industry, working primarily with CBOE on portfolio margining implementation.

How does customer portfolio margining (CPM) compare to our current margining methodology?

Currently the industry uses strategy-based margining, and the exchanges have uniform rules pertaining to strategy-based margining. There are 30-plus approved strategies. The firms take each customer's positions and optimize them by identifying which of these strategies they best fit into to produce the lowest margin requirement. It's tedious and cumbersome.

Portfolio margining does away with all of that. When you take the positions, move the market and remark the positions based on the market move, you actually get the risk in that portfolio, regardless of strategy.

The other big difference is that strategy margining is cumulative. For example, if you have a credit call spread and debit call spread on the same underlying, they're on opposite sides of the market. Under strategy margining, you have to margin the credit call spread separate from the debit call spread. Under portfolio margining, it doesn't make any difference what they are; they will automatically hedge each other. So, profits and losses across this array of a market move will tend to be

more in line with the actual risk of the position. Under portfolio margining, there is a margin reduction on positions that offset each other.

Who benefits from CPM?

The customer benefits from not having to pigeon-hole strategies. Taking longs against shorts and credits against debits, regardless of time frames, is a benefit. Especially if there are positions that don't currently fit into existing strategies, but are similar with differences in strikes or expirations. Taking that into account, margin will be less. First, because we're allowing shorts versus longs regardless of strategy, and second, because margin is currently based on a 20 percent market move, and we are proposing a 15 percent market move.

In order to benefit, the proposal says that you'll have to be approved for uncovered writing. So it's not a \$2,000 account we're talking about; it's an account with some where-with-all that each broker-dealer has a parameter for, much higher than a normal account.

What is the history of portfolio margining?

Back in 1986, OCC's margin methodology for firms was strategy-based. We changed this to portfolio margining for clearing firms. So from 1986 to 1994 when the risk-based haircut rule was approved for market makers, we were gathering experience with this methodology.

In 1988, the CME introduced SPAN (Standard Portfolio Analysis of Risk) portfolio margining at the customer and clearing level for futures.

In 1989, when I was working on changes to the Net Capital Rule with respect to options, we changed the methodology for deductions to capital, commonly called "haircuts" to a portfolio style system.

In Europe and Asia, margin has been figured under a portfolio basis for many years, although their methodology is more complicated than what we are proposing.

What is the current status of CPM with regulators?

In mid-2005, the SEC approved portfolio margining and cross-margining of broad-based index options for customers. There are still obstacles attached to cross-margining that deal with SIPC (Securities Investor Protection Corporation) coverage and general customer protection.

After the 1987 crash, the presidential task force and governmental groups recommended portfolio margining and cross-margining. It would've helped customers that held positions in opposite sides of the market hedging each other that didn't get any credit for those positions.

Currently under portfolio margining for indexes, there's a \$5 million minimum account equity requirement. Some believe this is prudent; others feel it's overkill. SPAN has no minimum requirement, so the requirement is not competitive; it's on one side of the market but not the other, especially now that you can expand to single stock futures.

Many people feel that broker-dealers should know their customer and be the ones to dictate further margin based on their comfort level.

What other regulatory concerns exist?

Regulators are concerned about how to know what the theoretical

value should be as you're moving the market. The Federal Reserve determines the margin requirement for securities, currently set at 50 percent of the value of the underlying. There is no rhyme or reason for that number. The SEC determines the margin requirement for options, currently set at a 20 percent market move. Our proposal will be for a 15 percent market move. Is that the right number or not? In reality, it should probably go from one percent or two percent up to 100 percent depending on historical volatilities of the underlying security.

What is the plan, and who else is involved in CPM implementation?

The plan is to have portfolio margining for equities in nine months. There's pressure on the SEC from firms, as well as on Congress and their various committees. It's past due.

The larger broker dealers have been very interested in bringing back business that they lost to overseas mainly because of margining. So, they are extremely interested in bringing equity options under a portfolio scenario. They've hired consultants to help them, they've gone through the SIA committees, they've started their own ad-hoc committee and have been very involved.

A key player throughout this initiative has been NYSE's Rule 431 margin committee. Most of the brokerage firms that carry customer accounts are members of NYSE, and those members have to comply with NYSE's margin rules. NYSE is on board and is filing its own rule changes allowing portfolio margining.

The futures exchanges are also interested in lowering margin for single stock futures, which a portfolio-based methodology could achieve.

What operational concerns exist?

A lot of customers do simple strategies and so CPM wouldn't necessarily be for everyone.

Operational issues will exist because there will be two different margin methodologies that need to run and interface with books and records.

There is some concern among the firms about bringing futures into a securities account. The rules state that if you end up with just a futures position, it must be transferred back to a futures account. The rules also state that if you're only long listed options, paid for, then those must go into a regular margin account. They can't continue to be carried in a portfolio account as a customer protection issue.

What do you see in the future of margining and this industry?

The future is portfolio margining. I believe that "vanilla" portfolio margining is probably a two-edged sword. It's simpler to understand, however, a 15 percent market move across the board probably isn't right. So there's still more work to be done. If you took volatility into account, I think you'd have a much more accurate system.

I think moving forward, there's not going to be as much of a line between futures and securities, and more customers are going to use both types of instruments. This is the only country where we have two regulators: the CFTC on the futures side and the SEC on the securities side. If we had one regulator for both sides, I believe that we could get things done in a much quicker timeframe.

OCC to administer customer portfolio margining pilot program

In July 2005, the Securities and Exchange Commission approved rule changes filed by the Chicago Board Options Exchange and New York Stock Exchange that permit the use of a portfolio margining methodology for qualifying customers and positions on a pilot basis. This methodology, based upon OCC's Theoretical Intermarket Margin System (TIMS), employs an options pricing model to differentiate the risk of options on a given underlying which have different strike prices and maturities, and provides for offsets between products relating to different, but highly correlated underlying instruments.

The TIMS methodology provides an alternative to the current strategy based margin requirement for customer accounts maintaining a minimum account equity of \$5 million, OCC clearing member affiliates, and the proprietary accounts of non-clearing broker-dealers not operating as a market maker or specialist. Products eligible for portfolio margining treatment under this pilot are limited to exchange listed broad based index derivative contracts and related exchange traded funds.

Prior to offering the TIMS methodology to clients, OCC clearing members must first establish a new clearing account to distinguish such activity from any accounts and/or positions not subject to portfolio margining. In addition, customers must be provided with a newly created disclosure document. Further information regarding this pilot program including the disclosure document, an eligible product listing and an online version of the TIMS margin engine is available at: <https://cpm.theocc.com/>. Questions regarding mechanics of the TIMS margin methodology and its execution may be directed to risksystems@theocc.com.

Volume and Directory FTP now available

Daily contract volume and the Directory of Products are now available in xml and csv formats on a secured FTP site. OCC also provides the previous 30 days of archived contract volume. Access to OCC's FTP site requires registration. For more information visit www.optionsclearing.com.

OIC offers Chinese Site

In October, OIC launched a mini Simplified Chinese options education Web site at www.888options.com. Content includes sections on what is an option, strategies, product specifications, index/equity options, a mini glossary and contact information.

"We have seen a good amount of traffic to the Web site—about 2,000 visitors within the first couple of months," said Dan Busby, Director, Internet and Investor Services. "In the future, plans include adding more Chinese content."

Based on visits OIC representatives made to Asia and in speaking with some of the firms, there was a clear demand for options education in foreign languages, particularly Simplified Chinese.

Clearing member lunches held

Clearing member luncheons were held on Oct. 3 in Chicago and Oct. 5 in New York. Nearly 60 clearing members attended the New York presentation and about 20 were at OCC's Chicago office.

Topics of discussion included recent clearing member enhancements, as well as those scheduled for 2006. OCC staff presented an ENCORE Release 4.7 Margins overview, DDS information and timeline overview, comments on the SIA/FIA Industry-Wide Test on Oct. 15, the Expiration Threshold Survey and other relevant issues.

"Overall, I think the clearing members got a lot out of the meetings," said Joe Pellegrini, Vice President, Member Services. "They are always appreciative of OCC's efforts to keep them up to date on what we are doing."

Charitable donations among employees at all-time high

OCC employees contributed record amounts during charitable fundraising drives in 2005. Employees collected nearly \$27,000 for the American Red Cross efforts supporting Hurricane Katrina victims, more than \$22,000 to CARE (Cooperative Assistance & Relief for Everywhere) supporting tsunami relief efforts, and nearly \$17,000 for family support organizations in local communities. OCC matched totals for American Red Cross and CARE, resulting in a total of nearly \$98,000 contributed to these relief efforts. In addition, a portion of the proceeds from OCC's holiday cards benefit Hurricane Katrina victims.

Year successful for government relations activities

By Dana Wade, OCC Government Relations Associate

OCC's Washington, D.C. office was active in 2005, playing a leading role in the debate over CFTC (Commodity Futures Trading Commission) reauthorization. As part of this process, OCC and the options exchanges fought to maintain comparability between security options and security futures. We were instrumental in gaining the SEC and CFTC's commitment to implement portfolio margining rules on an equal basis for both of these products. We also helped facilitate the testimony of Philadelphia Stock Exchange Chairman Sandy Frucher, who served as a witness before the Senate Banking Committee on behalf of the options exchange coalition.

Early this year, the Chicago Mercantile Exchange introduced a provision in the Senate and House Agriculture Committees that would have eroded the parity established in the CFMA (Commodity Futures Modernization Act) between security futures and security options. OCC was successful in gaining the support of the Senate Banking and House Financial Services Committees to impede this provision's progress. We devoted efforts to educating key Congressional staff on portfolio margining—a new and complicated concept to many—and helped to make it front-and-center in the CFTC reauthorization debate. With the help of the options exchanges, we circulated a proposal to advance portfolio margining for security options and security futures. We also coordinated a letter from OCC and the options exchanges urging Senate Agriculture Chairman Saxby Chambliss to preserve parity.

In addition, the President's Working Group (PWG), which consists of the SEC, CFTC, Federal Reserve and Department of Treasury, released recommendations in early November that closely follow the options exchanges' proposal in the area of portfolio margining. The PWG supports a strict deadline of nine months for the SEC to approve portfolio margining rules for security options.

Efforts continue to provide ongoing education on options issues. In January and December of 2005, we hosted educational seminars in conjunction with The Options Industry Council. January's event, held for Congressional and SEC staff, featured a panel spotlighting liquidity provider Isabelle Benton from the Philadelphia Stock Exchange. The education session in December, presented to Congressional, SEC and CFTC staff, included a panel with Bill McGowan from Interactive Brokers and Ben Morof from optionsXpress entitled, "Growing the Options Business." Both events concluded with an Options Exchange Roundtable, where each exchange had the opportunity to give its perspective on competitive issues and other current topics.

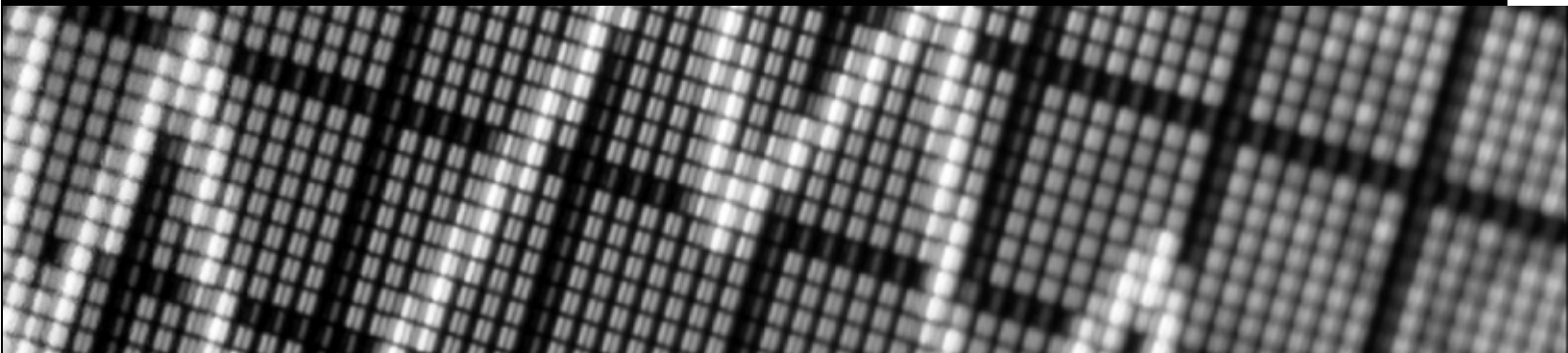
Contract adjustment rule changes approved

On Dec. 6, OCC's Board of Directors approved two rule changes for contract adjustments. The first revises the so-called "10 Percent Rule", which applies to cash dividends. Currently, "ordinary" dividends do not trigger adjustments, but cash dividends greater than 10 percent are deemed to be non-ordinary or "special" and eligible for contract adjustment. The new approach abandons the percent criteria and substitutes the definition of "special" as those cash dividends paid outside the regular dividend paying practice of the company. Such a dividend would be eligible for adjustment, even if less than 10 percent. However, in order to limit option symbol proliferation reasonably, special dividends are also subject to a \$12.50 per contract size test as well. In other words, in order to trigger a contract adjustment, a given cash dividend must be "special" and also must result in a per contract value of at least \$12.50.

OCC anticipates that contract adjustments for special cash dividends will be much more frequent under this new approach. The change is also significant because the current "10 Percent Rule" is a long standing precedent. For this reason, before the change is effective, the SEC will need to approve the rule change which also requires a supplement to the Options Disclosure Document. This process should take a minimum of several months.

The second approved rule change is intended to eliminate inequities resulting from the rounding of adjusted strike prices. Currently, stock splits or stock distributions frequently yield adjusted strike prices which must be rounded to the nearest eighth. When this occurs, gains or losses in terms of the in-the-money value of the option inevitably result—inequities are often magnified when the option position is large. To eliminate these rounding inequities, the Board approved a new approach. With the exception of 2-for-1 and 4-for-1 splits, all adjustments in response to splits or stock distributions will be made by adding the new shares to the option deliverable without changing strike prices, the number of contracts, or the multiplier used to calculate extended strike amounts or premiums.

This new approach to stock splits and stock distributions also represents a significant change from long established precedent. Here, too, SEC approval and an Options Disclosure Document supplement will be necessary before the new method is effective. OCC and the exchanges recognize that an extensive education effort will be needed to adequately prepare the public for the new adjustment method. OCC also observes that this approach will hopefully be temporary, until such time as the options industry can accommodate strikes in decimals (thereby eliminating rounding to the nearest fractional strike).



Options track successful at annual FIA conference

OCC was well-represented at the Futures Industry Association (FIA) Futures & Options Expo held Nov. 8-10, 2005 at the Hyatt Regency in Chicago.

OCC served as a sponsor of the event, and helped plan the whole-day options track on Nov. 9. Michael Walinskas, Senior Vice President, and Susan Milligan, Senior Vice President, served on the FIA Options Committee that organized the options panels which brought together a wide variety of views on the topics under discussion.

Walinskas also chaired a session on market structure while Phil Gocke, The Options Industry Council's institutional consultant, chaired a panel on institutional options trading trends. Mary Savoie, Vice President, Options Industry Services served on a panel about growing the options business. Attendance was high for the options panels, particularly for a futures-oriented conference. OCC's booth was also a popular stop on the floor of the Expo's exhibit hall.



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OCC news

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Editor/Designer: Jennifer Saputo