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# OCC news

the official newsletter of The Options Clearing Corporation

*Winter 2007*



## 2 billion contract milestone reached in 2006

The options industry celebrated a tremendous milestone in 2006, surpassing the 2 billion contract mark for the first time ever and setting a new annual volume record. By year-end, 2,027,847,586 contracts were traded, representing a 35 percent increase over last year's record.

"This remarkable achievement confirms the appeal of options as an important component to the strategies of individual and institutional investors," said Wayne P. Luthringshausen, OCC Chairman and Chief Executive Officer. "OCC's commitment to making ongoing system upgrades enabled us to meet the needs of the industry and successfully process the soaring volume."

It was clear that 2006 would be an exciting year when trading volume surpassed 1 billion contracts on June 29, taking only 124 trading days to reach this mark, compared to 179 trading days in 2005.



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The trend of high volume growth has been apparent in recent years, with record-setting volume occurring in the past four consecutive years and nine of the last ten years. Over the last two years, options volume has doubled in size as 1 billion contracts were traded for the first time in 2004.

Building on this momentum, 2007 began with a new one-day record on January 5 when 15.8 million contracts were traded

— the most ever in a single trading day. Equity options trading also set a new record on January 5 with 15,068,634 contracts traded, a 13.5 percent increase over the previous record set on January 20, 2006. As of mid-February, year-to-date average daily options volume was at 9.6 million contracts.

## oic news

- In January, Susan Milligan was named Executive Director of The Options Industry Council (OIC). Milligan, Senior Vice President, Government Affairs and Communications at OCC, has been working closely with OIC to bring options education to legislators, regulators and their staffs in Washington, D.C. since she joined OCC in 2001.
- Results of an OIC-supported study of the performance of a buy-write strategy on the Russell 2000 Index show that returns on the strategy can outperform the index. Investors can view the study results at the new [www.OICoptions.com](http://www.OICoptions.com) Web site, which is now home to options information and education aimed at institutional investors.
- In March, OIC will participate in the Using Options in Fund Management conference at the Cass Business School in London. This one-day conference will examine the latest developments in using options and derivatives in fund management and is aimed at financial advisors. Participants will learn how options work, risks and returns, how to use options to add value to portfolios, and which products are most suitable to participants' clients.
- Representatives from the U.S. options exchanges and from the broker-dealer community recently joined OIC on Capitol Hill and at the SEC to educate key legislative and regulatory staff on industry issues. Twenty-four congressional staff, including top aides to the Chairmen of the Senate Banking and House

Financial Services Committees, as well as staff from the SEC's Division of Market Regulation and Office of Compliance, Inspections and Examinations, participated in learning more about significant industry developments. In particular, the SEC event included an exchange roundtable, which allowed all six exchanges the unique opportunity to share their views with SEC staff on topics such as portfolio margining, demutualization, Regulation NMS, new product development and globalization.



# industry insight

## occ senior vice president, michael mcclain



*Michael McClain is Senior Vice President, Production Operations at OCC. He also oversees the corporation's remote business center. He has been with OCC for nearly six years and prior to that worked for more than a decade in the consulting industry, first with IBM, then with Andersen Consulting. OCC News recently asked McClain about his role at OCC.*

What areas of OCC are you responsible for?

I focus mainly on the Applications area in IT. I manage OCC's applications work. I also run our remote business center. That's more of an operational job where I not only oversee the day-to-day office administration, but also the business continuity of the center. If circumstances resulted in a business interruption at our corporate office, OCC would run out of the remote business center. At that point, my role would take on a whole new realm of responsibilities.

How has your previous work experience helped you with your current position at OCC?

I think that my consulting experience has probably been most valuable in my applications role because I have to communicate with many departments about their different needs. Consulting taught me how to be effective in a variety of management styles and cultures. My experience in mission-critical production support during our ENCORE system installs has also been valuable in preparing for a business interruption.

You oversee Application Development. How is this area affected by a growing options market with respect to new systems and products and even new market participants? What kinds of challenges do these present?

The rising popularity of options as a financial instrument has driven many new and creative exchange products. OCC has designed

a flexible system to accommodate these new products and to enable our operational areas to administer the change to clearing through the use of screens. However, the competitive nature of our business has created products that do not fit the standard mold. This makes programming changes necessary.

The challenge for us in Application Development is accommodating programming changes to the clearing system to support new products in a short period of time. We do extensive testing for even minimal changes because accuracy and stability of the system is our top priority. It can be difficult to balance our quality assurance efforts with our desire to deliver quick turnaround on system change requests. Often, we are forced to find creative solutions to deliver support for the product, while maintaining a high level of system integrity.

From a sheer volume perspective, I am confident and pleased with the scalability of ENCORE. We've had explosive growth in options volume at about the same time we went near real-time with clearing. We find that our system grows naturally with the hardware. In other words, run the application on faster hardware, and it will provide more throughput. This makes volume growth a matter of increasing the hardware capacity rather than doing expensive software modifications.

So from an expanding options market, those are the two challenges we face – new products and the new functionality that we have to deliver, plus the sheer amount of volume and throughput. Since the end of 2005, we've been challenged with more and more new products.

Earlier this year, OCC set a new trading record, clearing more than 15.8 million options contracts in a single day. How do these high volume days affect systems capacity and stress testing?

Every record volume day sets a new target for our high volume test. We set the target at double the previous high volume day. The test not only proves that we can handle double the volume, but it shows us areas where we can improve. Based on this information, IT, including my team, set about installing performance improvements throughout the year. The capacity on January 5 was handled with very little effort on our part. If you weren't watching the volume, you probably wouldn't have noticed it. All areas of IT spend a lot of time preparing for high volume days, and it showed that day.

What additional responsibilities do you have as the highest ranking officer at your location?

We organized our staff in the remote business center to be key representatives of operational departments, but not duplicates. In other words, the staff in this center is actually involved in OCC's day-to-day operations. Location of our operational employees has become irrelevant. For this reason, the majority of employees have reporting chains that do not lead to me unless our business continuity plans are executed. I think that this structure is valuable because it assures us that our remote business center employees are involved in the operations. They have the knowledge and capabilities to take over in the case of a business interruption in our corporate office. Beyond office administration and my functional role, my primary role is the care and feeding of this structure.

I am careful to stay involved in structural, operational and procedural changes so that I can be sure they won't degrade the mission of our remote site. With each change made by senior or middle management, I determine the impact to our remote business center organization and employees, and keep our office top of mind. Not a day goes by where I don't think about that. We have to be able to perform in the event of the unthinkable.

What are the challenges of not only overseeing staff in multiple locations, but communicating with other OCC corporate officers?

Video conferencing and even phone conferencing have made overseeing staff in multiple locations and communicating with other OCC corporate officers much more efficient. It hasn't completely eliminated the challenge though. I think the challenge is more on the corporate office because of their larger size. They have to make sure that when they are having a hallway conversation or there is a quick meeting, they always think about the other OCC locations. Not only have employees realized the need to involve all offices, but we have a high level of talent and experience in our remote offices that are difficult to overlook. I am very proud of this fact.

## clearing member enhancements achieved, planned

OCC's Operations Roundtable realized several key member-driven requests in 2006 – all of which improved processing schedules and reduced cost and risk for the entire membership. These projects included: revamping the corporate action process by accelerating expiration of cash only options; reducing the Exercise-by-Exception threshold to \$.05; and working with the options exchanges to promote earlier submission of inbound real-time trades, now due by 6:30 p.m. CT, allowing OCC to process and disseminate data to firms more quickly and efficiently.

In addition, the Technology Subcommittee made progress toward more streamlined processing using the real-time nature of ENCORE and the outbound Data Distribution Services (DDS) and Financial Information eXchange Markup Language (FIXML) messages which will continue in 2007.

In 2007, OCC will lead various industry committees addressing system-wide improvements to daily and expiration processing. A key goal will be to achieve same day reconciliation – when all clearing members can reconcile trade activity on the trade date. Benefits of same day reconciliation include: reducing risk of intra-day trading errors; enabling near real-time risk management; enabling same day spreading for portfolio and customer margins; allowing member firms to leverage finance requirements for overseas clients; and allowing firms to better manage products that trade on expiration date.

# portfolio margining prospects expand with sec order

The Securities and Exchange Commission (SEC) recently approved much anticipated rule changes proposed by the Chicago Board Options Exchange (CBOE) and the New York Stock Exchange (NYSE) allowing broker-dealers to use a risk-based portfolio approach for margining for customer accounts effective April 2, 2007.

The SEC first permitted the use of a portfolio margining approach for customer accounts in July 2005 as part of a two-year pilot program. Under the pilot, eligible asset classes included broad-based index options and related products. In July 2006, the list was expanded to include security futures and equity options and on April 2, the list will be further expanded to include: equity securities that have a ready market under SEC Rule 15c3-1 and certain other control restrictions; listed equity security futures contracts; listed equity options; listed equity index options, index warrants and index futures; listed equity futures options; equity exchange-traded funds; and OTC derivatives on the products approved for portfolio margins.

Prior to April 2, participation was minimal due to the limited number of eligible classes. It is anticipated that many more clearing firms will participate in the portfolio margin program given the expansion of eligible asset classes. This expansion helps U.S. equities markets take a major leap forward, allowing securities firms to participate on a level playing field with the futures and international equities markets as it relates to customer margining.

Current margin rules governing U.S. equity markets follow a strategy-based approach requiring broker-dealers to identify approved hedged positions (or strategies) and imposing a set margin requirement for each position. Portfolio margining allows broker-dealers to group products based on a related underlying asset into portfolios with the margin requirement based on the risk of the portfolio as opposed to a set amount.

This "risk-based" approach is based on OCC's TIMS methodology, which determines the maximum loss associated with a portfolio given a percentage move in an underlying asset. A portfolio containing an offsetting position in the derivative and underlying asset reflects less market risk and requires less equity to collateralize the account. This provides additional leverage to cus-

tomers' capital available for reinvestment. The approach has been the standard for U.S. futures and international securities markets for years.

Although the new CBOE and NYSE rules are a huge step forward, obstacles remain to having customers fully realize the efficiencies achievable through a risk-based portfolio approach. For example, the NYSE and CBOE rules permit futures to be carried in a portfolio margin account. Since the rules define a portfolio margin account as a securities account, there are several jurisdictional issues that must still be resolved given the separate futures and securities regulatory regimes.

One particular issue centers around the customer protection methodologies where securities accounts are supported by the Securities and Investors Protection Corporation and futures accounts are supported by the Commodity Futures Trading Commission's (CFTC) segregation requirements. These differences will need to be addressed before cross-margining of futures and securities can occur. Crossing this jurisdictional divide will require a commitment by both regulators.

While the SEC and the CFTC continue to examine the outstanding issues related to cross-margining, it is only a matter of months before investors and the equities markets will be able to benefit from portfolio margining. According to OCC's President and Chief Operating Officer, Michael Cahill, "We believe this robust approach to risk management for customers' derivatives portfolios will both strengthen and allow for the expansion of the marketplace."

## OCC employees give back in 2006

In 2006, OCC employees contributed more than \$32,000 to support two charitable organizations – Rebuilding Together Metro Chicago and The Miracle League. OCC employees in Chicago and at the remote business center raised funds by selling raffle tickets, holding silent auctions, having monthly jeans days, and producing and selling an OCC cookbook.

Rebuilding Together Metro Chicago is an organization that refurbishes and improves homes of Chicago area low-income, disabled and elderly residents. Besides raising more than \$23,000 for paint, hardware, plumbing and carpentry supplies, smoke detectors and lumber, employees in Chicago will have a chance this April to put their hard work into action as part of a team to help refurbish homes on Chicago's south side on National Rebuilding Day 2007.

Employees at the remote business center raised more than \$9,000 to support the Miracle League, an organization that provides opportunities to all children to play baseball regardless of their ability. Founded in the late 1990s, the Miracle League is now located in more than 140 locations across the U.S. The funds raised by OCC will help purchase a special Protraxx playing surface to be built in a new Miracle League field.

## Save the date for the annual Options Industry Conference



Planning for the 2007 annual Options Industry Conference is underway with NYSE Arca™ serving as this year's host exchange. The event will take place April 26 - 28 at the Hyatt Regency Hill Country Resort and Spa in San Antonio, Texas. For details or registration, visit [www.optionsconference.com](http://www.optionsconference.com).

# OCC news

[www.optionsclearing.com](http://www.optionsclearing.com)

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