THE OPTIONS CLEARING CORPORATION

#22686

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SUBJECT: UPDATE: APPROVAL OF PROPOSED CHANGES TO CASH DIVIDEND ADJUSTMENT POLICIES – THE "10% RULE"

The Securities and Exchange Commission (SEC) has approved the proposed changes to the OCC By-Laws for adjusting option contracts in response to cash dividends or distributions. The proposed changes would repeal what has come to be known as the "10% Rule" (see SEC Release No. 34-55258 dated February 8, 2007 and OCC Information Memos 22210 and 21333). The proposed changes **include an implementation plan to allow open interest that exists when the changes become effective to continue to be subject to the 10% Rule, thereby "grandfathering" these positions under the 10% Rule.** The proposed changes and the implementation plan will become effective when a supplement to the Options Disclosure Document (ODD), Characteristics and Risks of Standardized Options, can be published. OCC expects this ODD supplement will be published before May 29, 2007 (when 2010 LEAPS series would normally begin trading).

The proposed changes are summarized below. The proposal and implementation plan are **unchanged** from that described in the previous OCC Information Memo 22210 of October 24, 2006. In some instances, more detailed information (symbols and dates) is provided.

Review of Proposed Changes to Cash Dividend Adjustment Policies

The "10% Rule"

Under the OCC By-Laws and associated Interpretations, options are not adjusted to reflect "ordinary" cash dividends or distributions. A cash dividend is considered ordinary unless it is greater than 10% of the value of the underlying security on the dividend declaration date. Dividends greater than 10% under this definition usually trigger an option contract adjustment. The criterion for adjustment is the **size** of the cash dividend.

The Definition of "Ordinary" Cash Dividends – The "New Method"

Under the changes to the OCC By-Laws approved by the SEC, **a cash dividend or distribution would be considered ordinary (regardless of size) if it was declared pursuant to a policy or practice of paying such dividends on a quarterly or other regular basis. Dividends paid outside such practice would be considered extraordinary. OCC would normally adjust for extraordinary dividends unless the amount was less than $12.50 per contract.** The determination of whether a given cash dividend is "ordinary" according to this definition would be made by the adjustment panels of the OCC Securities

Committee. (These adjustment panels are convened for the purpose of determining the appropriate contract adjustment under the OCC By-Laws in response to corporate events. They are composed of two representatives of each exchange that trades the affected option and a representative of OCC who votes only in the event of a tie. The adjustment panels consider each corporate event on a case by case basis.)

Minimum Size Threshold

In the interest of providing some limit on option symbol proliferation arising from adjustments, cash dividends that are determined to be "extraordinary" will also be subject to a size test before a contract adjustment is effected: **the per contract value of the dividend must be at least $12.50.** This size threshold will be applied at the option contract level. That is, an extraordinary dividend attributable to any component of an option deliverable must yield at least $12.50 in value for that option. (It would thus be possible for a dividend to trigger a contract adjustment for one option on a given stock but not trigger an adjustment for a another option on the same stock with a smaller deliverable.)

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 do a percentage calculation based on the closing price of the underlying shares on the declaration date, as is currently the case under the "10% Rule". The simple calculation of the value of the dividend on a per contract basis can even be applied to proposed or contingent (not yet declared) dividends, thus eliminating a lot of uncertainty that exists under the current method.

"Initial" Dividends and Dividend Increases

Under the new method for handling cash dividends, an *initial* dividend, afterwards to be paid according to a regular schedule, declared by a company that previously did not pay dividends, will **not** be considered "extraordinary" and will not be adjusted for even though it may not have been foreseeable. Likewise, increases to regular dividends will not be deemed "extraordinary".

Threshold Consistency Across Relevant Interpretations: Fund Shares

Interpretation .08 to Article VI, Section 11A of the OCC By-Laws carves out an exception to the policy of not adjusting for "ordinary" cash distributions for fund share capital gains distributions. Under Interpretation .08, there is a zero threshold for fund share capital gains distributions. To provide consistency, the same $12.50 per contract size threshold will be applied to all adjustments for cash distributions: **in addition to other criteria, all cash distributions, including fund share capital gains distributions, must yield at least $12.50 per contract value in order to trigger adjustment.**

The "Grandfathering Plan"

The objective of the "grandfathering plan" is that all equity option positions which exist at the time the required ODD supplement is published will continue to be subject to the current 10% Rule for cash dividends. These positions will never be subject to the proposed new method for cash dividends. In order to achieve this overall objective, separate operational plans are required for I.) Standard and LEAPS equity options and II.) Flex equity options.

I. Standard and LEAPS Equity Options

The implementation plan specifies that the new method will apply only to cash dividends announced on or after February 1, 2009.

At the time this Information Memo is published, the most distant expiration date for equity standard or LEAPS options is January 2009 (note: see exception for "Certain ETF LEAPS Options" below). Setting the effective date for the new method to occur after January 2009 will thus ensure that all standard and LEAPS positions which exist when the ODD supplement is published will have expired before the new policy becomes effective. By definition, positions established after the ODD supplement is published (which would include all positions in expiration months February 2009 and thereafter) will have been created with knowledge of the effective date of the new method.

Members should note the new method will be effective for cash dividends which are ***announced*** on or after February 1, 2009. Thus, for any cash dividend, all options (standard and LEAPS) on the affected stock will be subject to the same adjustment policy. There will not be different adjustment policies for different expiration months. Several examples will illustrate this point:

- If a cash dividend is announced on September 1, 2008, **all** expiration months will be subject to the 10% Rule with respect to that dividend, including those expiration months which extend into 2009 and beyond.
- If a cash dividend is announced on January 31, 2009, **all** expiration months will be subject to the 10% Rule with respect to that dividend, including those expiration months which extend into February, 2009 and beyond.
- If a cash dividend is announced on February 1, 2009, all expiration months will be subject to the new adjustment policy with respect to that dividend.

The key to grandfathering existing open interest in standard and LEAPS equity options is to set an effective date for announced dividends that occurs after the expiration of all existing standard and LEAPS option open interest. At the present time, January 2009 is the most distant expiration month for these products. Normally, 2010 LEAPS would not be listed until after the standard equity option expiration in May 2007. The grandfathering plan assumes that the ODD supplement can be published **before** the listing of 2010 LEAPS options (this date would normally be May 29, 2007). If that is not the case, the grandfathering plan will need to be revised.

Certain ETF LEAPS Options

Most equity LEAPS options expire in the month of January. A small number of "fund share" or "ETF" LEAPS options have been introduced which expire in the month of December (specifically, the SPY LEAPS and the S&P 100 iShare LEAPS). At the present time, the most distant expiration month for these products is December **2009**. **These option series will also be grandfathered under the 10% Rule**. This will be accomplished by specifically identifying these options – *by symbol* – as permanently subject to the 10% Rule. (Currently, the symbols

affected are FYN, FYS, and OXO.) Positions under these symbols would not roll into their base option symbols as normally occurs.

(Note: "Fund share" or "ETF" options are equity options and as such are covered by the proposed changes to cash dividend adjustment policies. Currently, fund share cash distributions sometimes present decisions for contract adjustments when a cash dividend or portion of a cash dividend on the underlying ETF is attributable to an "extraordinary" cash dividend on a component security as defined by the 10% Rule (e.g., fund share option adjustments made in response to the Microsoft $3.00 special dividend and similar subsequent events). Until the 10% Rule is replaced, fund share option adjustments must continue to be guided by precedent developed in these cases. In some cases, adjustment decisions guided by these precedents could be different from those that would be made under the new method. This is why existing ETF option open interest must also be grandfathered under the 10% Rule.)

II. Flex Equity Options

As with standard and LEAPS equity option positions, **all Flex positions which exist at the time the required ODD supplement is published will continue to be subject to the current 10% Rule for cash dividends.** However, since expiration dates for Flex equity options extend far beyond 2009, it is not feasible to defer effectiveness of the new method until after the most distant Flex expiration date. Thus, a different implementation plan is required to grandfather Flex option open interest under the 10% Rule.

Equity Flex options that exist at the time the required ODD is published *and* that expire on or after February 1, 2009, will be designated as permanently subject to the current 10% Rule by changing their option symbol. **All other Flex options will be subject to the new method for cash dividends announced on or after February 1, 2009.**

OCC expects that contract adjustments changing the Flex option symbols (described below) will be effected soon after the ODD supplement is published (on a date to be announced). As mentioned above, OCC expects the ODD supplement to be published before May 29, 2007.

Flex options employ a symbol convention that uses a "1" or "2" in the symbol to designate American or European exercise style, respectively. When the ODD supplement is published, symbols will be changed for all equity Flex options that expire February 1, 2009 or thereafter, changing "1" and "2" into "7" and "8" respectively. The "7" or "8" will designate the option as American/European ***10% Rule*** options. Such options will always remain subject to the 10% Rule, never the new method. (Flex open interest that exists when the ODD is published and expires before February 1, 2009 will have expired before the new policy is effective. Thus, there is no need to change the symbols of these options.)

After this symbol change is effected, trading may continue in existing "7" or "8" Flex series, but ***new*** "7" or "8" series will not be allowed. Trading in "1" or "2" Flex series will also continue. But after the symbol change, any Flex position established with the regular Flex convention of "1" or "2" will designate positions that will be subject to the new method for cash dividends announced on or after February 1, 2009. For example:

7ACN01	American Style **10% Rule**	No new series allowed
8ACN01	European Style **10% Rule**	No new series allowed

1ACN01	American Style	**New Method Effective 2-1-2009**
2ACN01	European Style	**New Method Effective 2-1-2009**

Members should note it will be important to accurately designate Flex trades as "7" or "8" or "1" and "2", because trades in a "7" or "8" (10% Rule) will not be fungible with trades in a "1" or "2" Flex option.

Also, **unlike standard and LEAPS equity options, the same adjustment rules may not apply to all Flex options outstanding at a given time** (see example (d) below).

Several examples will illustrate how Flex options will be handled:

- (a) Any Flex option expiring before February 1, 2009 will bear a "1" or "2" designation and will remain subject to the current 10% Rule, never the new method (because the new policy will apply only to cash dividends announced on or after February 1, 2009).
- (b) A Flex option converted into a "7" or "8" (e.g., a 7ACN15 expiring Feb 10, 2011) will always be subject to the 10% Rule, never the new method.
- (c) A Flex option expiring after February 1, 2009 which did not exist when FLEX options were converted into a "7" or "8" (e.g., a 1ACN15 expiring Feb 10, 2011 which represents a series opened *after* the symbol conversion), will be subject to the 10% Rule for cash dividends ***announced*** before February 1, 2009; and will be subject to the new method for dividends announced on or after that date.
- (d) In illustration of how different adjustment rules could apply to options existing at the same time: a cash dividend announced after February 1, 2009 could trigger an adjustment to Flex option 1ACN15 expiring Feb 10, 2011 under the new policy but not to Flex option 7ACN15 expiring Feb 10, 2011 (since this option was permanently grandfathered under the 10% Rule after the ODD supplement was published).

For questions regarding this memo, call 1-888-OPTIONS or email options@theocc.com.