

# May 2007 Supplement to Characteristics and Risks of Standardized Options

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The February 1994 edition of the booklet entitled *Characteristics and Risks of Standardized Options* (the “Booklet”) is amended as follows to reflect certain changes in OCC’s rules as well as the rules of certain options markets.

The changes in Part I reflect modifications made to the definition of “ordinary cash dividend or distribution” (*i.e.*, cash dividends and distributions for which no adjustment is made). The changes in Part II reflect changes made to eliminate the need to round adjusted exercise prices in certain circumstances and to provide more precise compensation for fractional shares eliminated by rounding.

Parts III-V of this Supplement supersede and replace the February 2003 Supplement to the Booklet. Part III pertains to options on interests in investment companies and similar entities. Part IV pertains to special exercise settlement procedures or restrictions that may be imposed upon the occurrence of certain extraordinary events. Part V discloses that a registration statement and prospectus for the options covered by the Booklet are no longer available.

Part VI pertains to an expansion of OCC’s authority to adjust the multiplier for yield-based Treasury options and to fix the cash settlement amount for such options in certain circumstances. Part VII reflects the adoption of rules by certain options markets that permit, in very limited circumstances, the cancellation or adjustment of a transaction entered into at a premium based on an erroneously reported value for the underlying interest. Part VIII, which supersedes paragraph 1 of the March 2000 Supplement to the Booklet, pertains to the acceleration of the expiration date of options on equity securities in certain circumstances.

## **Part I. Definition of Ordinary Cash Dividend or Distribution.**

*The fourth paragraph on p. 19 is amended to read as follows:*

As a general rule, no adjustment is made for ordinary cash dividends or cash distributions. A cash dividend or distribution announced *prior to* February 1, 2009, will generally be considered “ordinary” unless it exceeds 10% of the aggregate market value of the underlying security outstanding as of the close of trading on the declaration date. The same rule will continue to apply on and after that date with respect to options series designated by OCC as “grandfathered” for purposes of this rule (*i.e.*, series opened prior to publication of this supplement that remain outstanding on February 1, 2009). In the case of all other options series, a cash dividend or distribution announced *on or after* February 1, 2009, will generally be considered “ordinary,” regardless of size, if OCC believes that it was declared pursuant to a policy or practice of paying such dividends or distributions on a quarterly or other regular basis (and no adjustment will normally be made for any cash dividend or distribution that amounts to less than \$12.50 per contract). As an exception to the general rule, options on fund shares will

generally be adjusted for capital gains distributions even if made on a regular basis, and adjustments may be made for certain other distributions in respect of fund shares in special circumstances described in OCC's rules, provided in each case that the amount of the adjustment would be \$.125 or more per fund share. Determinations whether to adjust for cash dividends or distributions not covered by the preceding rules, or when other special circumstances apply, are made on a case-by-case basis.

## **Part II. Adjustment of Exercise Prices.**

*The first seven paragraphs on p. 20 of the Booklet are deleted in their entirety, and the following material is inserted in lieu thereof.*

Stock dividends, stock distributions and stock splits may result in an adjustment of the number of options held or written or the number of underlying shares, and in some cases may also result in an adjustment of the exercise price.

### **Stock Options with Exercise Prices Stated in Fractions**

As of the date of this Supplement, exercise prices for stock options are stated in points and fractions of a point (*e.g.*, 20-3/8 or 30-1/2). The smallest fraction is 1/8. The following adjustment rules apply to any series of stock options whose exercise price is stated in points and fractions of a point:

As a general rule, a 2 for 1 or a 4 for 1 stock split, stock distribution or stock dividend will result in the number of outstanding options being proportionately increased and the exercise price being proportionately decreased.

**EXAMPLE:** Before a 2 for 1 stock split, an investor holds an option on 100 shares of XYZ stock with an exercise price of \$60. After adjustment for the split, he will hold two XYZ options, each on 100 shares and each with an exercise price of \$30.

A stock dividend, stock distribution or stock split other than a 2 for 1 or a 4 for 1 distribution or split will normally result in an adjustment in the number of shares deliverable upon exercise, while the aggregate exercise price for the contract remains unchanged.

**EXAMPLE:** An investor holds a call option covering 100 shares of XYZ stock with an exercise price of \$50 resulting in an aggregate exercise price for the contract of \$5,000 (\$50 x 100). After a 3 for 2 split, the deliverable could be increased to 150 shares while the nominal exercise price remained \$50. In that case, upon exercise of the adjusted option, the investor would still pay \$5,000 (\$50 x 100, not \$50 x 150), but would receive 150 shares of XYZ stock instead of 100.

Note in the preceding example that, although the number of shares deliverable was adjusted to be 150, the number by which the unadjusted exercise price of \$50 was multiplied to determine the total exercise price continued to be 100 rather than 150. Similarly, premium

quotations would continue to be multiplied by 100 to obtain the total premium to be paid for a single option.

### **Stock Options with Exercise Prices Stated in Decimals**

In the future, the exchanges may introduce stock options with exercise prices stated in points and decimals (*e.g.*, 20.15 or 30.80). The following adjustment rules would apply to any series of stock options whose exercise price is stated in points and decimals:

When a stock distribution, stock split or stock dividend results in the issuance of one or more whole shares of stock for each outstanding share—such as a 2 for 1 or a 3 for 1 stock split—as a general rule the number of underlying shares will not be adjusted. Instead, the number of outstanding options will be proportionately increased and the exercise price will be proportionately decreased. (See the example of a 2 for 1 stock split under “Stock Options with Exercise Prices Stated in Fractions” above.)

Other stock dividends, stock distributions and stock splits may result in an adjustment in the number of underlying shares and the exercise price.

**EXAMPLE:** An investor bought an XYZ 50 option—either a call or a put—and XYZ Corporation subsequently effected a 3 for 2 stock distribution. Instead of covering 100 shares of stock at an exercise price of \$50 a share, each outstanding option could be adjusted to cover 150 shares at an exercise price of \$33.33 per share. The aggregate exercise price remains substantially the same before and after the adjustment ( $\$50 \times 100 = \$5,000$  and  $\$33.33 \times 150 = \$4,999.50$ ).

### **All Stock Options**

As a general rule, adjustments in exercise prices are rounded to the nearest exercise price increment ( $1/8$  or one cent, as the case may be), and adjustments in the number of underlying shares are rounded down to eliminate fractional shares. In the latter case, the property deliverable upon exercise may be adjusted to include the value of the eliminated fractional share, as determined by OCC.

Note that in the preceding example where the exercise price of the adjusted XYZ option was rounded down, the exercising put holder or assigned call writer would lose \$.50 as a result of the rounding. Rounding up could result in losses to exercising call holders and assigned put writers.

A reverse stock split, combination of shares, or similar event will generally result in an adjustment in the number of shares deliverable upon exercise, while the aggregate exercise price remains unchanged.

**EXAMPLE:** An investor holds a call option covering 100 shares of XYZ stock with an exercise price of 50 resulting in an aggregate exercise price for the contract of \$5,000 ( $\$50 \times 100$ ). After a 1 for 10 reverse split, the deliverable could be reduced to 10 shares while the

nominal exercise price remained \$50. In that case, upon exercise of the adjusted option, the investor would still pay \$5,000 (\$50 x 100, not \$50 x 10), but would receive 10 shares of XYZ stock instead of 100.

As a general rule, no adjustment is made for ordinary stock dividends or distributions. A stock dividend or distribution will generally be considered “ordinary” if (i) the number of shares distributed does not exceed 10% of the number of shares outstanding on the declaration date and (ii) it is declared pursuant to a policy or practice of paying such dividends or distributions on a quarterly basis.

Distributions of property other than the underlying security may result in the adjustment of outstanding options to include the distributed property.

### **Part III. Options on Fund Shares.**

*To reflect a broadening of the definition of “fund shares,” the Booklet is amended as follows:*

*The first full paragraph on page 2 of the Booklet is amended to read:*

Each options market selects the underlying interests on which options are traded on that market. Options are currently available covering four types of underlying interests: equity securities (which term includes “fund shares” described in Chapter III), stock indexes, government debt securities, and foreign currencies. Options on other types of underlying interests may become available in the future.

*The first paragraph of Chapter III, appearing on page 18 of the Booklet, is amended to read:*

The term “stock options” is used broadly in this Booklet to include not only options on common stocks but also options on all other types of equity securities, such as limited partnership interests, “American Depositary Receipts” and “American Depositary Shares” representing interests in foreign entities, preferred stocks, and fund shares. The term “fund shares” includes interests in exchange-traded funds and other entities holding or trading in one or more types of investments, and as used in this Booklet the term “equity securities” includes fund shares.

*The first paragraph under the caption “FEATURES OF STOCK OPTIONS” on page 18 of the Booklet is amended to read:*

As a general rule, a single stock option covers 100 shares of the underlying security, although in the case of options covering fund shares, options covering 100 or 1000 shares may be available. Other stock options departing from the general rule may be introduced in the future. The number of underlying shares covered by any stock option may be adjusted after the option is issued if certain events occur, as described below.

*The fourth paragraph on p. 19 of the Booklet is amended as set forth in Part I of this Supplement.*

#### **Part IV. Special Exercise Settlement Procedures / Restrictions.**

*Three new paragraphs are added on page 78 of the Booklet at the end of the section headed "8." The new paragraphs read:*

If OCC determines that the primary market(s) for one or more component securities of an underlying index did not open or remain open for trading, or that the component security or securities did not open or remain open for trading on the primary market(s), on a trading day at or before the time when the exercise settlement value for that trading day would ordinarily be determined, or that a current index value or other price or value needed to calculate the exercise settlement value for an index option is otherwise unreported, inaccurate, unreliable, unavailable or inappropriate for purposes of calculating the cash settlement amount, then OCC may suspend settlement obligations for exercised and assigned contracts of the affected series. In the event of such a suspension, OCC will fix a new settlement date after OCC determines that the exercise settlement value is available or after OCC fixes the exercise settlement value.

If OCC determines to fix the exercise settlement value, it will act through an adjustment panel that will use its judgment as to what is appropriate for the protection of investors and the public interest. For a description of adjustment panels, see "Adjustment and Adjustment Panels" in Chapter II. The panel may fix the exercise settlement value using the reported price or value of the relevant security or securities or index (i) at the close of regular trading hours (as determined by OCC) on the last preceding trading day for which a price or value was reported by the reporting authority, or (ii) at the opening of regular trading hours (as determined by OCC) on the next trading day for which a price or value was reported by the reporting authority. Alternatively, the panel may fix the exercise settlement value using a price or value for the relevant security or securities or index, or using a combination or average of such prices or values, at or during such time or times that the panel sees fit.

If an adjustment panel delays fixing an exercise settlement value for a series of index options past the last trading day before expiration of that series, normal expiration exercise procedures will not apply to the affected series. Instead, exercise settlement will be postponed until the next business day following the day when the adjustment panel fixes the exercise settlement value, and each long position in the affected series will be treated as having been exercised if the exercise settlement amount per contract for that series is \$1.00 or more. If the exercise settlement amount per contract is less than \$1.00, the option will be treated as having expired unexercised. As a result of these procedures, holders of expiring index options may not know whether their options have been exercised, and writers of such options may not know whether they have been assigned an exercise notice, until after the expiration date. An adjustment panel's determinations shall be conclusive, binding on all investors, and not subject to review.

*The first paragraph on page 41 of the Booklet is amended to read:*

If OCC should determine that foreign governmental restrictions or taxes would prevent the orderly settlement of delivery foreign currency option exercises or would result in undue burdens on OCC or its Clearing Members, OCC has the authority to impose special exercise settlement procedures. These could range from technical changes in delivery procedures to the fixing of U.S. dollar settlement prices. If special exercise settlement procedures are imposed, investors may determine the nature of such procedures from their brokers.

*The last paragraph on page 53 of the Booklet is amended to read:*

In certain unusual circumstances, an event may threaten to reduce the available supply of an underlying security to a level insufficient to allow settlement if all of the outstanding option contracts for the affected security were exercised. This could happen, for example, in the event of a successful tender offer for all or substantially all of the outstanding shares of an underlying security or if trading in an underlying security were enjoined or suspended. If OCC in its discretion determines that a situation of that type exists, OCC may impose special exercise settlement procedures. These special procedures, applicable only when an assigned call writer or an exercising put holder is unable to obtain the underlying security, may involve the suspension of the settlement obligations of the holder and writer and/or the fixing of cash settlement prices in lieu of delivery of the underlying security. When special exercise settlement procedures are imposed, OCC will announce to its Clearing Members how settlements are to be handled. Investors may obtain that information from their brokerage firms.

*On page 61 of the Booklet, the second paragraph of the section headed "5." is amended to read:*

Exercise restrictions imposed by OCC and the options markets affecting cash-settled options generally cannot be continued in effect beyond the opening of business on the last trading day before their expiration. Such exercise restrictions affecting physical delivery options generally cannot be continued beyond the opening of business on the tenth business day before their expiration.

#### **Part V. Exemption of Standardized Options from 1933 Act Registration.**

Effective January 2, 2003, the SEC exempted standardized options issued by a registered clearing agency and traded on a registered national securities exchange or association from the Securities Act of 1933, except for the antifraud provisions of Section 17 of that Act. Effective January 10, 2003, the SEC approved an amendment to OCC's most recent registration statement under that Act terminating the registration of all unsold put and call options. As a result of these actions, the standardized options covered by this Booklet are no longer required to be registered under that Act; an OCC registration statement will no longer be available for inspection at OCC's office; and copies of an OCC prospectus for standardized options will no longer be available from OCC or the U.S. options markets.

## **Part VI. Yield-Based Treasury Options.**

*The second full paragraph on page 34 is replaced with the following paragraph:*

If the U.S. Department of the Treasury ceases to issue, or changes the terms or the schedule of issuance of, Treasury securities on which underlying yields are based, an adjustment panel has discretion to adjust the terms of the series by substituting other Treasury securities or to make such other adjustment as the adjustment panel may determine. If the options market on which a particular yield-based option is traded should increase or decrease the multiplier for the option, the adjustment panel has discretion to adjust outstanding options affected by the change by proportionately consolidating or subdividing them or by taking other action.

*The paragraph numbered 9. on page 82 is replaced with the following:*

9. If OCC determines that the exercise settlement value of the underlying yield for any series of yield-based options is unreported, inaccurate, unreliable, unavailable, or inappropriate for purposes of calculating the cash settlement amount of such series, OCC has the authority to suspend the settlement obligations of the exercising and assigned Clearing Members of options of such series or to fix the cash settlement amount for exercised options of such series or to do both. In the event of such a suspension, OCC will fix a new settlement date after OCC determines that the exercise settlement value is available or after OCC fixes the cash settlement amount.

If OCC determines to fix the cash settlement amount, it will act through an adjustment panel that will use its judgment as to what is appropriate for the protection of investors and the public interest. For a description of adjustment panels, see “Adjustment and Adjustment Panels” in Chapter II. The panel may fix the cash settlement amount using the reported value of the underlying yield (i) at the close of regular trading hours (as determined by OCC) on the last preceding trading day for which such a value was reported by the reporting authority or (ii) at the opening of regular trading hours (as determined by OCC) on the next trading day for which such a value was reported by the reporting authority. Alternatively, the panel may fix the cash settlement amount using the value for the underlying yield, or using a combination or average of such values, at or during such time or times that the panel sees fit.

If an adjustment panel delays fixing a cash settlement amount for a series of yield-based options past the last trading day before expiration of that series, normal expiration exercise procedures will not apply to the affected series. Instead, exercise settlement will be postponed until the next business day following the day when the adjustment panel fixes the cash settlement amount, and each long position in the affected series will be treated as having been exercised if the cash settlement amount per contract for that series is \$1.00 or more. If the cash settlement amount per contract is less than \$1.00, the option will be treated as having expired unexercised. As a result of these procedures, holders of expiring yield-based options may not know whether their options have been exercised, and writers of such options may not know whether they have been assigned an exercise notice, until after the expiration date. An adjustment panel’s determinations shall be conclusive, binding on all investors, and not subject to review.

## **Part VII. Erroneously Reported Index Levels.**

*The paragraph numbered 5. on page 76 is replaced with the following paragraph, which omits a statement that a person who buys or sells an index option at a premium based on an erroneously reported index level is bound by the trade and has no remedy. The omission reflects the adoption of rules by certain options markets that permit, in very limited circumstances, the cancellation or adjustment of a transaction entered into at a premium based on an erroneously reported value for the underlying interest:*

5. 5. Holders and writers of index options generally bear the risk that the reported current index level may be in error. Persons who exercise cash-settled index options or are assigned exercises based on erroneously reported index levels will ordinarily be required to make settlement based on the exercise settlement value as initially reported by the official source of the index, even if a corrected value is subsequently announced. References herein to index values “as initially reported” refer to the values initially reported by the source of the index as definitive, and not to any tentative or preliminary values that may be announced at an earlier time subject to adjustment. In extraordinary circumstances (*e.g.*, where an exercise settlement value as initially reported is obviously wrong and inconsistent with values previously reported, and a corrected value is promptly announced), OCC has discretion to direct that exercise settlements be based on a corrected exercise settlement value. Ordinarily, however, the exercise settlement value as initially reported by the official source of the index will be conclusive for exercise settlement purposes.

## **Part VIII. Accelerated Expiration of Certain Equity Options.**

*The second paragraph after the “EXAMPLE” on page 21 of the Booklet, as amended by paragraph 1 of the March 2000 Supplement to the Booklet, is further amended to read:*

When an underlying security is converted into a right to receive a fixed amount of cash, options on that security will generally be adjusted to require the delivery upon exercise of a fixed amount of cash, and trading in the options will ordinarily cease when the conversion becomes effective. As a result, after such an adjustment is made all options on that security that are not in the money will become worthless and all that are in the money will have no time value. If the option is European-style, the expiration date of the option will ordinarily be accelerated to fall on or shortly after the date on which the underlying security is converted into a right to receive cash. After January 1, 2008, the same treatment will be extended to American-style options. Holders of an in-the-money option whose expiration date is accelerated must be prepared to exercise that option prior to the accelerated exercise cut-off time in order to prevent the option from expiring unexercised. See the discussion in Chapter VIII under “How to Exercise.” Writers of options whose expiration date is subject to being accelerated bear the risk that, in the event of such an acceleration, they may be assigned an exercise notice and be required to perform their obligations as writers prior to the original expiration date. When the expiration date of an option is accelerated, no adjustment will be made to compensate for the accelerated expiration date. There is no assurance that the exercise settlement date for an accelerated option will coincide with the date on which the cash payment to the holders of the underlying security becomes

available from the issuer. Covered writers of an accelerated option may therefore be required to pay the cash amount in respect of the option before they receive the cash payment on the underlying security.