

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-50178; File No. SR-OCC-2004-04)

August 10, 2004

Self-Regulatory Organizations; The Options Clearing Corporation; Order Granting Approval of a Proposed Rule Change to Reduce the Thresholds Applied to Equity Options for Purposes of Exercise by Exception Processing on Expiration

I. Introduction

On March 19, 2004, The Options Clearing Corporation (“OCC”) filed with the Securities and Exchange Commission (“Commission”) proposed rule change File No. SR-OCC-2004-04 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”).<sup>1</sup> Notice of the proposed rule change was published in the Federal Register on July 2, 2004.<sup>2</sup> No comment letters were received. For the reasons discussed below, the Commission is now granting approval of the proposed rule change.

II. Description

The purpose of the proposed rule change is to amend OCC’s Rule 805, “Expiration Date Exercise Procedure,” which describes OCC’s expiration date exercise procedures including exercise by exception processing. Specifically, OCC will reduce the threshold amounts used in its exercise by exception processing to determine which equity options will be automatically exercised.

Background

OCC has for years maintained an “exercise by exception” procedure. Under that procedure, options that are in the money at expiration by more than a specified threshold amount

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> Securities Exchange Act Release No. 49929 (June 28, 2004), 69 FR 40449.

are exercised automatically unless the clearing member carrying the position instructs OCC otherwise. Equity options are determined to be in the money or not based on the difference between the exercise price and the closing price of the underlying equity interest on the last trading day before expiration. The current exercise by exception thresholds for equity options are \$.75 for options in a clearing member's customers' account and \$.25 for options in any other account (i.e., firm and market makers' accounts).

### Discussion

OCC's Roundtable has proposed that the threshold amounts for equity options be reduced to \$.25 for options in customers' accounts and \$.15 for options in all other accounts.<sup>3</sup> The Roundtable believes that reducing these thresholds will streamline expiration processing.

In response to the Roundtable's proposal, OCC analyzed equity options exercise information from the November 2003, December 2003, and January 2004 expirations. From its analysis, OCC determined that clearing members exercised 93% to 97% of equity option contracts carried in their customers' accounts that were in the money by \$.25 to \$.74 (i.e., the change in the "in the money" amount represented by the proposed customer account threshold). OCC's analysis also determined that exercise activity in the proposed "other account" range (i.e., with an in the money amount of \$.15 to \$.24) supported the proposed threshold change.

OCC also surveyed all clearing members to obtain their views and comments on the proposed change. Survey results demonstrated strong support across the membership for the

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<sup>3</sup> OCC's Roundtable is an OCC-sponsored advisory group comprised of representatives from OCC's participant exchanges, OCC, a cross-section of OCC clearing members, and industry service bureaus. The Roundtable considers operational improvements that may be made to increase efficiencies and to lower costs in the options industry.

change. Of 116 clearing members, 105 responded to the survey with 96 clearing members in favor of the threshold change.<sup>4</sup> Clearing members supporting the change confirmed the Roundtable's view that it would significantly reduce the number of instructions they are required to input on expiration and would thereby shortening the timeframe for completing instructions to OCC.

OCC contacted each firm that opposed the threshold change. These firms expressed a concern about having to input more "do not exercise" instructions. All of these firms agreed that they could adapt to the change if supported by the majority of clearing members. OCC reviewed the positions carried by these firms and determined that, on average, they carry position in fewer than ten expiring series that are below the current threshold of \$.75. This review led OCC to conclude that the threshold change would result in only a slight increase in processing time for these firms and that they would not be unduly burdened by its implementation.

The clearing member survey also asked firms to provide an estimate of the time needed to accommodate the threshold changes.<sup>5</sup> The majority of firms indicated that they could complete the necessary systems development and customer notifications within six months. OCC contacted any firm that commented on the proposed timeframes, and all expressed the view that their efforts would be completed in the six-month time period.

The Roundtable has requested of OCC that this change be implemented for the September 2004 expiration. If OCC determines that clearing members need additional time to

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<sup>4</sup> OCC also contacted clearing members that did not respond to its survey. These firms expressed no opinion on the matter.

<sup>5</sup> OCC used timeframes of zero to three months and four to six months in its survey.

complete preparations for the threshold change, OCC will implement the threshold change in accordance with such time needed. OCC anticipates implementation no later than for the October 2004 expiration. OCC will provide at least ten days' advanced notice to clearing members of the effective date for the new threshold amounts. Such notice will be provided through information memoranda and through other forms of electronic notice such as e-mail.

### III. Discussion

Section 17A(b)(3)(F) of the Act requires among other things that the rules of a clearing agency be designed to promote the prompt and accurate clearance and settlement of securities transactions.<sup>6</sup> The Commission finds that OCC's proposed rule change is consistent with this requirement because reducing the exercise by exception thresholds applicable to equity options should provide for greater efficiency in the processing of equity options by allowing members to focus less attention on exception processing. As a result, OCC's proposed rule change should promote the prompt and accurate clearance and settlement of securities transactions.

### IV. Conclusion

On the basis of the foregoing, the Commission finds that the proposed rule change is consistent with the requirements of the Act and in particular Section 17A of the Act and the rules and regulations thereunder.

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<sup>6</sup> 15 U.S.C. 78q-1(b)(3)(F).

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>7</sup> that the proposed rule change (File No. SR-OCC-2004-04) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>8</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>7</sup> 15 U.S.C. 78s(b)(2).

<sup>8</sup> 17 CFR 200.30-3(a)(12).