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For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>13</sup>

**Florence E. Harmon,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-55264; File No. SR-NYSE-2006-45]

### Self-Regulatory Organizations; New York Stock Exchange LLC.; Order Approving Proposed Rule Change Relating to Amendments to Exchange Rule 638 Concerning Mediation

February 9, 2007.

#### I. Introduction

On June 22, 2006, the New York Stock Exchange LLC ("NYSE" or the "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change relating to amendments to Exchange Rule 638 concerning mediation. The proposed rule change was published for comment in the *Federal Register* on December 21, 2006,<sup>3</sup> and the Commission received one comment on the proposal.<sup>4</sup> This order approves the proposed rule change.

#### II. Description

The proposal would delete references in NYSE Rule 638 to the mediation pilot program that expired on January 31, 2003. The proposed amendments would also codify or, in some cases, recodify certain existing mediation procedures, including that: (1) The mediator's fees and method of payment are subject to agreement of the parties and the mediator, and all such fees and costs incurred in mediation are the parties' responsibility; (2) an adjournment fee will be assessed if an arbitration hearing is adjourned for purposes of the parties

pursuing mediation unless the fee is waived under Exchange Rule 617; (3) a mediator may not represent a party or act as an arbitrator in an arbitration relating to the matter mediated, nor be called to testify regarding the mediation in any proceeding;<sup>5</sup> and (4) the mediation is confidential and no record is kept of the proceeding,<sup>6</sup> and, except as may be required by law, the parties and mediator agree not to disclose the substance of the mediation without the prior written authorization of all parties to the mediation.

In addition, the proposed rule change would clarify that any party may withdraw from mediation at any time prior to the execution of a settlement agreement upon written notification to all other parties, the mediator, and the Director of Arbitration. It also would clarify that parties may select a mediator on their own or request a list of potential mediators from the Exchange, and that, upon request of any party, the Director of Arbitration would send the parties a list of five potential mediators together with the mediators' biographical information described in Rule 608.<sup>7</sup>

Finally, the proposed rule change would provide that the parties will advise the Exchange as to the name of the agreed-upon mediator. In addition, it would clarify that once the parties agree to mediate, the Exchange would facilitate the mediation, if requested, by contacting the mediator selected and by assisting in making necessary arrangements, as well as that parties to mediation may use the Exchange meeting facilities in New York, when available, without charge.

#### III. Summary of Comment

The Commission received one comment on the proposal.<sup>8</sup> The commenter objected to the provision of the proposed rule change that would prohibit a mediator from acting as an arbitrator in an arbitration related to the matter mediated.<sup>9</sup> The NYSE responded that because the provision is substantially the same as in the current rule this comment is outside the scope of this rule filing.<sup>10</sup> The Commission finds the NYSE's determination that these comments are beyond the scope of the rule filing to be reasonable because they suggest substantive changes from

<sup>5</sup> See current NYSE Rule 638(a)(4).

<sup>6</sup> *Id.*

<sup>7</sup> See current NYSE Rule 638(a)(2).

<sup>8</sup> Hochman.

<sup>9</sup> *Id.*

<sup>10</sup> See letter from Mary Yeager, Assistant Secretary, NYSE, to Katherine A. England, Assistant Director, Division of Market Regulation, dated February 7, 2007.

the current mediation rules that were not intended to be addressed by this rule filing. Thus, the Commission finds the NYSE's determination not to amend the proposed rule change in connection with this comment at this time to be reasonable.

#### IV. Discussion and Findings

After careful review, the Commission finds that the proposed rule change is consistent with the Act and, in particular, with Section 6(b)(5) of the Act, which requires, among other things, that the NYSE's rules be designed to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.<sup>11</sup> The Commission believes that the proposed rule change will bring greater clarity to the mediation process by deleting outdated references to the expired mediation pilot program and codifying certain existing mediation procedures.

#### V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act<sup>12</sup> that the proposed rule change (SR-NYSE-2006-45), be, and hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>13</sup>

**Florence E. Harmon,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-55258; File No. SR-OCC-2006-01]

### Self-Regulatory Organizations; The Options Clearing Corporation; Order Approving Proposed Rule Change as Modified by Amendment No. 1 To Revise Option Adjustment Methodology

February 8, 2007.

#### I. Introduction

On January 12, 2006, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") proposed rule change SR-OCC-2006-01 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act").<sup>1</sup> On March 9, 2006, the Commission published notice of the proposed rule

<sup>11</sup> 15 U.S.C. 78f(b)(5).

<sup>12</sup> 15 U.S.C. 78s(b)(2).

<sup>13</sup> 17 CFR 200.30-3(a)(12).

<sup>14</sup> 15 U.S.C. 78s(b)(1).

<sup>13</sup> 17 CFR 200.30-3(a)(12).

<sup>14</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Exchange Act Release No. 54917 (Dec. 11, 2006), 71 FR 76714 (Dec. 21, 2006).

<sup>4</sup> See letter from Stephen A. Hochman to Nancy Morris, dated January 16, 2007 ("Hochman").

change to solicit comments from interested parties.<sup>2</sup> The Commission received ten comment letters upon publication of the notice.<sup>3</sup> To address the concerns raised by the commenters, OCC amended the proposed rule change on September 25, 2006. On November 21, 2006, the Commission published notice of the amended proposed rule change to solicit comments from interested parties.<sup>4</sup> The Commission received four additional comment letters.<sup>5</sup> For the reasons discussed below, the Commission is approving the proposed rule change.<sup>6</sup>

## II. Description

OCC is amending Article VI (Clearance of Exchange Transactions), Section 11A of its By-Laws to (1) Eliminate the need to round strike prices and/or units of trading in the event of certain stock dividends, stock distributions, and stock splits and (2) provide for the adjustment of outstanding options for special dividends (*i.e.*, cash distributions not declared pursuant to a policy or practice of paying such distributions on a quarterly or other regular basis). The proposed rule change also adds a \$12.50 per contract threshold amount for cash dividends and distributions to trigger application of OCC's adjustment rules.

<sup>2</sup> Securities Exchange Act Release No. 53400 (March 2, 2006), 71 FR 12226.

<sup>3</sup> Joseph Haggemiller (March 8, 2006); Erik A. Hartog, Operating Manager, Allagash Trading LLC (March 21, 2006); Jeffrey Woodring (March 22, 2006); Adam Besch-Turner (March 23, 2006); Christopher Nagy, Chairman, Options Committee, Securities Industry Association (March 24, 2006); Mike Ianni (April 5, 2006); Mike Ianni (April 5, 2006); Peter van Dooijeweert, President, Alopex Capital Management, LLC (April 26, 2006); Bob Linville and Deborah Mittelman, Service Bureau Committee Co-Chairs, Financial Information Forum (May 2, 2006); and William H. Navin, Executive Vice President, General Counsel, and Secretary, The Options Clearing Corporation (September 29, 2006).

<sup>4</sup> Securities Exchange Act Release No. 54748 (November 14, 2006), 71 FR 67415.

<sup>5</sup> James Knight, Vice President, Manager, Options Trading Strategies, Raymond James Associates, Gary Franklin, Manager of Option Trading, Managing Director, Senior Options Principal, Morgan Keegan Co., and Dennis Moorman, Manager-Options Department, J.J.B. Hilliard, W.L. Lyons, Inc. (December 12, 2006); William H. Navin, Executive Vice President, General Counsel, and Secretary, The Options Clearing Corporation (December 21, 2006); Erik A. Hartog, Operating Manager, Allagash Trading LLC (January 8, 2007); and William H. Navin, Executive Vice President, General Counsel, and Secretary, The Options Clearing Corporation (January 9, 2007).

<sup>6</sup> OCC filed a companion proposed rule change seeking to revise its stock futures adjustment methodology in a manner consistent with the revised option adjustment methodology. Securities Exchange Act Release No. 54898 (December 8, 2006), 71 FR 75287 (December 14, 2006) (File No. SR-OCC-2006-08).

### *A. Changes Relating to Adjustments for Certain Stock Dividends, Stock Distributions, and Stock Splits*

Prior to this rule change, OCC's By-Laws specified two alternative methods of adjusting for stock dividends, stock distributions, and stock splits. In cases where one or more whole shares are issued with respect to each outstanding share, the number of outstanding option contracts is correspondingly increased and strike prices are proportionally reduced.<sup>7</sup> In all other cases, the number of shares to be delivered under the option contract is increased and the strike price is reduced proportionately.<sup>8</sup>

Although these two methods have been used for many years, in certain circumstances either method can produce a windfall profit for one side and a corresponding loss for the other side due to rounding of adjusted strike prices. These profits and losses, while small on a per contract basis, can be significant for large positions. Because equity option strike prices are currently stated in eighths, OCC's By-Laws require adjusted strike prices to be rounded to the nearest eighth. For example, if an XYZ \$50 option for 100 shares were to be adjusted for a 3-for-2 split, the deliverable would be increased to 150 shares, and the strike price would be adjusted to \$33.33 and then be rounded up to \$33<sup>3</sup>/<sub>8</sub>. Prior to the adjustment, a call holder would have had to pay \$5,000 to exercise (\$50 × 100 shares). After the adjustment, the caller would have to pay \$5,006.25 for the equivalent stock position (\$33.375 × 150 shares). Conversely, an exercising put holder would receive \$5,006.25 instead of \$5,000. The \$6.25 difference represents a loss for call holders and put writers and a windfall for put holders and call writers.

A loss/windfall can also occur when the split results in a fractional deliverable (*e.g.*, a 4-for-3 split produces a deliverable of 133.3333 shares). In those cases, OCC's By-Laws required that the deliverable be rounded down to eliminate the fraction, and if appropriate, the strike price be further adjusted to the nearest eighth to compensate for the diminution in the value of the contract resulting from the elimination of the fractional share. However, even if these steps are taken, small rounding inequities often remain.

<sup>7</sup> For example, in the event of a 2-for-1 split, an XYZ \$60 option calling for the delivery of 100 shares of XYZ stock would be subdivided into two XYZ \$30 options, each calling for the delivery of 100 shares of XYZ stock.

<sup>8</sup> For example, in a 3-for-2 split, an XYZ \$60 option calling for the delivery of 100 shares would be adjusted to call for the delivery of 150 shares and the strike price would be reduced to \$40.

The windfall profits and correspondent losses resulting from the rounding process have historically been accepted as immaterial. However, due to recent substantial increases in trading volume and position size, they have become a source of concern to exchanges and market participants. In addition, OCC has been informed that some traders may be exploiting announcements of splits and similar events by quickly establishing positions designed to capture rounding windfalls at the expense of other market participants.

The inequity that results from rounding strike prices can be eliminated by using a different adjustment method whereby the deliverable is adjusted but the strike prices or the values used to calculate aggregate exercise prices and premiums are not. As an illustration of the new adjustment methodology, in the XYZ \$50 option 3-for-2 split example described above, the resulting adjustment would be a deliverable of 150 shares of XYZ stock while the strike price would remain at \$50. In this case, the presplit multiplier of 100, used to extend aggregate strike price and premium amounts, is unchanged. For example, a premium of 1.50 would equal \$150 ( $1.5 \times 100$ ) both before and after the adjustment. An exercising call holder would continue to pay \$5,000 (\$50 times 100) but would receive 150 shares of XYZ stock instead of 100.<sup>9</sup> This is the method currently used for property distributions such as spin-offs and special dividends large enough to require adjustments under OCC's By-Laws.<sup>10</sup>

The inequity that results from the need to eliminate fractional shares from the deliverable and to compensate by further reducing the strike price to the nearest eighth can be eliminated by adjusting the deliverable to include cash in lieu of the fractional share. As an illustration, consider a 4-for-3 split of the stock underlying an XYZ \$80 option with a 100 share deliverable. Employing the new adjustment method, the deliverable would be adjusted to 133.3333 shares, which would be rounded down to 133 shares, and the strike price would remain \$80. However, instead of compensating for the elimination of the .3333 share by

<sup>9</sup> The same adjustment methodology will apply to reverse stock splits or combination of shares. For example, in a 3-for-4 reverse stock split on a XYZ \$50 option calling for the delivery of 100 shares, the resulting adjustment would be a deliverable of 75 shares of XYZ stock while the strike price would remain at \$50.

<sup>10</sup> The adjustment methodology used for spin-offs, mergers, and special cash dividends is to adjust the unit of trading while leaving the strike price unchanged.

reducing the strike prices, the strike prices would remain unchanged, and the cash value of the eliminated fractional share (.3333 x the post-split value of a share of XYZ stock as determined by OCC) would be the deliverable along with the 133 shares. The adjusted option would also continue to use 100 as the multiplier to calculate aggregate strike and premium amounts.

The revised adjustment methodology will not be applied to 2-for-1 or 4-for-1 stock distributions or splits (since such distributions or splits normally result in strike prices that do not require rounding to the nearest eighth) unless the split requires rounding of the strike price, which may occur where the strike price was previously adjusted due to an earlier stock distribution or split. In addition, the revised adjustment methodology will not generally be used for stock dividends, stock distributions, or stock splits with respect to any series of options having exercise prices stated in decimals.<sup>11</sup> For those options, the existing adjustment rules will continue to apply. The reason for this is that once the market has converted to decimal strikes, the rounding errors created by rounding to the nearest cent would be immaterial even given the larger positions taken in today's markets and the other factors discussed above. Because conversion to decimal strikes might be phased in rather than applied to all series of equity options simultaneously, the rule has been drafted to cover both methods of expressing exercise prices.

The changes in adjustment methodology will not be implemented until the exchanges have conducted appropriate educational efforts and definitive copies of an appropriate supplement to the options disclosure document, *Characteristics and Risks of Standardized Options*, are available for distribution.<sup>12</sup>

#### B. Changes to the Definition of "Ordinary Dividends and Distributions"

Currently, Article VI, Section 11A(c) of OCC's By-Laws provides that as a general rule, outstanding options will not be adjusted to compensate for ordinary cash dividends. Interpretation and Policy .01 under Section 11A of Article VI provides that a cash dividend will generally be deemed to be

"ordinary" if the amount does not exceed 10% of the value of the underlying stock on the declaration date ("10% Rule"). The OCC Securities Committee is authorized to decide on a case-by-case basis whether to adjust for dividends exceeding that amount. As a result, OCC historically has not adjusted for special cash dividends unless the amount of the dividend was greater than 10% of the stock price at the close of trading on the declaration day.

The 10% Rule predated a number of significant developments, including the introduction of Long-term Equity Anticipation Security ("LEAPS") options, the sizeable open interest seen today, the large contract volume associated with trading and spreading strategies, and the modern option pricing models that take dividends into account. When open interests and individual positions were smaller, not adjusting for dividends of less than 10% did not have the pronounced impact it does today. Additionally, changes to the tax code which now tax dividends more favorably have provided an incentive for companies to pay more dividends, including special dividends. In light of these considerations, OCC believes it is appropriate to now revise the 10% Rule.

Under OCC's revision, a cash dividend or distribution would be considered ordinary (regardless of size) if the OCC Securities Committee determines that such dividend or distribution was declared pursuant to a policy or practice of paying such dividends or distributions on a quarterly or other regular basis. In addition, as a general rule, a cash dividend or distribution that is less than \$12.50 per contract would not trigger the adjustment provisions of Article VI, Section 11A.

#### 1. No Adjustment for Regularly-Scheduled Dividends Needed

Dividends declared by an issuer pursuant to a policy or practice of such issuer are known and can thus be priced into option premiums. By definition, however, special dividends cannot be anticipated in advance and therefore cannot be integrated into option pricing models.<sup>13</sup> If adjustments are not made in response to special dividends, call holders can capture the dividends only by exercising their options. Often in these cases, especially with LEAPS options or FLEX options which can last for 5 to 10 years, early exercise would sacrifice substantial option time value.

<sup>13</sup> OCC has been told that some traders form judgments as to the likelihood that certain issuers may declare special cash dividends and factor those judgments into their pricing models.

This economic disadvantage is further magnified if the option position is large, as is often the case today. Conversely, put holders often receive a windfall benefit from the increase in the in-the-money value on the ex date. To the extent that equity options can be priced accurately and consistently without dislocations due to unforeseen special dividends, these economic disadvantages can be avoided. Moreover, because special dividends are one-off events, adjusting for them should not cause the proliferation of outstanding options series and symbols that would result from adjusting for regular dividends as explained below.

#### 2. De Minimis Threshold

Adjusting for dividends can cause a proliferation of outstanding option symbols and series.<sup>14</sup> In the interest of providing some limit on option symbol proliferation, the revised adjustment policy will include a de minimis threshold of \$12.50 per contract. Special dividends smaller than this amount will not trigger an adjustment.

OCC believes that a threshold that is a set dollar amount is preferable to one that is a percentage of the stock price (like OCC's 10% Rule) because there are operational problems with applying a percentage threshold. Under the 10% Rule, in order to determine whether the threshold is met, the per share dividend amount is added to the closing price of the underlying security on the dividend declaration date. The date the dividend is announced (by press release or by some other means) is not normally the "declaration date" when the dividend is officially declared by an issuer's board of directors. Until the actual declaration date, investors and traders may not know whether or not an announced dividend will trigger an adjustment based on the company's share price. In the interim, it is difficult for traders and investors to price their options because they do not know if an adjustment will be made.

The advantage of a fixed dollar threshold is the avoidance of uncertainty. The per contract value of the dividend can be immediately determined without the need to wait until the declaration date and without the need to do a calculation based on the closing price of the underlying shares.

<sup>14</sup> Symbols proliferate when adjustments are made because often the dividend amount must be added to the deliverable yielding a non-standard option. The exchanges then introduce standard options with the same strikes.

<sup>11</sup> Although there are currently no decimal strikes for equity options, OCC wants to avoid the need for further amendments to its By-Laws and the options disclosure document in the event that such strikes are introduced in the future.

<sup>12</sup> OCC will notify the Commission and issue an Important Notice when the new adjustment methodology is implemented.

### 3. Consistency Across Relevant Interpretations

Interpretations and Policies .01 and .08 under Article VI, Section 11A apply to cash distributions. Interpretation and Policy .01 (as amended by this rule change) will apply in general to all cash distributions. Interpretation and Policy .08 currently carves out exceptions for fund share cash distributions and does not include a threshold minimum. In the interest of clarity and consistency with Interpretation and Policy .01, Interpretation .08 is being revised to provide for the same \$12.50 per contract threshold for fund share cash distributions. Clause (ii) of Interpretation and Policy .08 sets forth an exception to the 10% Rule and will be deleted when the 10% Rule is abolished.

### III. Comment Letters

The Commission received fourteen comment letters in response to the proposed rule change.<sup>15</sup> Eleven of the comment letters opposed the rule change. OCC submitted three letters responding to the comment letters. Seven of the comment letters opposed elimination of the 10% Rule.<sup>16</sup> Three of the comment letters opposed the adjustment methodology for stock dividends, stock distributions, and stock splits.<sup>17</sup>

#### A. Comments Opposing the 10% Rule

Those commenters opposing elimination of the 10% Rule did so for various reasons. First, they felt that elimination of the 10% Rule for existing contracts would be unfair to the contract traders who have priced adjustments into their pricing models based on their estimated probability that an issuer will pay a special dividend with the

<sup>15</sup> *Supra* notes 3 and 5. Joseph Haggemiller's comment letter objected to the entire proposed rule change but did not state why. Joseph Haggemiller (March 8, 2006). The comment letters received after OCC's amendment did not comment on the amendment.

<sup>16</sup> Erik A. Hartog, Operating Manager, Allagash Trading LLC (March 21, 2006); Jeffrey Woodring (March 22, 2006); Adam Besch-Turner (March 23, 2006); Mike Ianni (April 5, 2006); Mike Ianni (April 5, 2006); Peter van Dooijeweert, President, Alopex Capital Management, LLC (April 26, 2006); and Erik A. Hartog, Operating Manager, Allagash Trading LLC (January 8, 2007).

<sup>17</sup> Christopher Nagy, Chairman, Options Committee, Securities Industry Association (March 24, 2006); Bob Linville and Deborah Mittelman, Service Bureau Committee Co-Chairs, Financial Information Forum (May 2, 2006); and James Knight, Vice President, Manager, Options Trading Strategies, Raymond James Associates, Gary Franklin, Manager of Option Trading, Managing Director, Senior Options Principal, Morgan Keegan Co., and Dennis Moorman, Manager-Options Department, J.J.B. Hilliard, W.L. Lyons, Inc. (December 12, 2006).

assumption that OCC would adjust for special dividends based on the 10% Rule. OCC responded that it did not believe special dividends could be anticipated in advance and therefore could not be integrated into pricing models. However, OCC discussed the matter with market participants and now understands that some traders do estimate the probability of special dividends by selected issuers and do factor those estimates into their pricing models. In response, OCC amended the proposed rule change so that the 10% Rule would be eliminated and replaced with the dollar threshold test beginning with dividends announced on and after February 1, 2009. The few outstanding options series with expirations beyond that date will be grandfathered and will be assigned separate trading symbols.

Second, some commenters expressed their concerns that elimination of the 10% Rule would create uncertainty as to whether OCC would classify particular dividends as ordinary or special and that market liquidity for the affected options would disappear until OCC announced whether a dividend was ordinary or special. OCC responded that a dividend will be classified as ordinary if it is declared pursuant to a policy or practice of paying such dividends on a quarterly or other regular basis. The issue as to whether a particular dividend or distribution fits the criteria to be classified as ordinary or special would be determined by a panel of the OCC Securities Committee, which consists of two representatives of each exchange that lists options on the underlying security and one representative of OCC, who votes only in the event of a tie vote. OCC contends that most special dividends are in such amounts and/or payable on such dates that it will be immediately obvious to the market that they are not being declared pursuant to a policy or a practice of paying such dividends on a quarterly or other regular basis. In addition, issuers normally classify a dividend as special or ordinary when the dividend is announced. While this will not control OCC's determination of whether a dividend is ordinary or special, in the vast majority of cases a dividend classified by the issuer as special would not fit OCC's definition of ordinary cash dividends or distributions.

In certain cases the OCC Securities Committee will need to make a judgment as to whether to classify a dividend as ordinary or special. The uncertainty which may exist in such cases will diminish over time as OCC publishes interpretations and policies and a body of precedent develops. OCC intends to publish informational

material indicating how these situations will be handled. Pursuant to the amendment, the elimination of the 10% Rule will only be effective for dividends announced on and after February 1, 2009, which should allow ample lead time for OCC's educational effort to get under way.

OCC also responded that a balance needs to be struck between uncertainty and fairness in that under the 10% Rule, market participants incur large losses in the case of a 9.9% special dividend but are made whole if the special dividend exceeds 10% of the closing stock price on the declaration date.

The commenters' third major concern in opposing elimination of the 10% Rule was that the rule change would lead to symbol proliferation in that any special dividend greater than \$12.50 per contract would trigger a contract adjustment and a new symbol. The frequency of such adjustments could be very high, causing a sharp spike in symbol proliferation. OCC responded by acknowledging that this is true for the short term but that the need for additional symbols would end when the industry converts to decimal strike prices.<sup>18</sup> Also, OCC believes that the inequities caused by the 10% Rule outweigh any operational burdens associated with symbol proliferation.<sup>19</sup>

The fourth major concern raised by the commenters in opposing the 10% Rule was that the revised rule could reduce liquidity for adjusted options because investors are drawn to round increments in strike prices. The 10% Rule has always avoided liquidity loss by only creating odd strike prices when the dividend is so extraordinarily disproportionate as to require adjustment. OCC responded that despite the thousands of contractual adjustments made in over 33 years of options trading on U.S. markets, it knows of no case where liquidity was wiped out for an adjusted series. Market-makers on U.S. options exchanges are numerous, highly competitive, quick to exploit arbitrage opportunities, and in many cases obligated by exchange rules to make

<sup>18</sup> The current plan is to begin converting fractional strikes to decimal strikes in November 2009.

<sup>19</sup> Since the beginning of 2006, OCC has been tracking special dividends that were too small to trigger an adjustment under the 10% Rule but that would be large enough to cause an adjustment under the revised rule. Up to September 2006, there were a total of 22 more dividends which would have required additional symbols for conventional equity options. In some cases, new symbols would also have had to be assigned for LEAP and flex contracts. According to OCC, the number is not small but is certainly not large relative to the hundreds of adjusted and wrap symbols already assigned.

markets in every series of every class in which they quote.<sup>20</sup>

#### *B. Comments Opposing the Adjustment Methodology for Stock Dividends, Stock Distributions, and Stock Splits*

The commenters who opposed the revised adjustment methodology for stock dividends, stock distributions, and stock splits did so by suggesting alternative models such as those employed by Eurex and other non-U.S. exchanges.<sup>21</sup> OCC responded that while it has an open mind about making further changes to its adjustment methodology, it did not believe it would be feasible to adopt any of the alternative models proposed by the commenters because they would require extensive and onerous systems changes by OCC, exchanges, members, and vendors. One of the commenters who opposed the adjustment methodology argued that the adjustment methodology is new and will result in significant modifications to the systems which support the adjustment methodology OCC seeks to replace.<sup>22</sup> In addition, the commenter argued that if OCC's proposed adjustment methodology is implemented and the strike price does not change when an adjustment takes place, some other indicator in the displays used to trade options must be changed to somehow alert the investor that the option represents an adjusted contract. OCC responded that it is simply applying to stock dividends, stock distributions, and stock splits the same adjustment methodology used for over thirty years for spin-offs, mergers, and special cash dividends. In addition, OCC argued, price vendors, service bureaus, and securities firms currently do and have always identified adjusted contracts through the use of adjusted symbols.

#### **IV. Amendment**

To address certain concerns expressed in the comment letters and by others, OCC amended the proposed rule change. OCC understands that certain option traders may have integrated into their pricing models the probability of special dividends and their being adjusted based on the OCC rules

currently in effect and that eliminating the 10% Rule with respect to existing contracts may unfairly affect these options traders. To ensure that no options series that were opened before approval of the proposed rule change are affected by elimination of the 10% Rule, OCC's elimination of the 10% Rule and implementation of the fixed dollar threshold will take effect only for corporate events announced on or after February 1, 2009. OCC plans to provide ODD disclosure of this rule change before May 29, 2007, (after which date the exchanges would normally begin introducing LEAPS expiring in 2010 making a 2009 implementation impracticable). The delay in implementation will ensure that all options series opened before the ODD disclosure is made available (other than certain "flex" options that will be grandfathered under the old rule) will have expired before the change is effected.<sup>23</sup> While delaying the implementation until 2009 postpones the benefit of making this needed change, it addresses the concerns of firms that find the operational hurdles and fairness issues associated with an earlier implementation onerous.

#### **V. Discussion**

After carefully considering the proposed rule change as amended and all of the written comments received, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder and particularly with the requirements of Section 17A(b)(3)(F).<sup>24</sup> Section 19(b) of the Act directs the Commission to approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to such organization. Section 17A(b)(3)(F) of the Act requires that the rules of a clearing agency be designed, in general, to protect investors and the public interest.

<sup>23</sup> OCC intends to take a "snapshot" of flex series expiring after January 31, 2009, that are outstanding at the time when ODD disclosure of the rule change is made. Those series will be assigned distinctive trading symbols and "grandfathered" under the old rule. Trading will continue normally in grandfathered series until their expiration, but the exchanges would be free to open otherwise identical non-grandfathered series, which would be identified by conventional flex trading symbols. If ODD disclosure is not made until after the December 2006 expiration, it may also be necessary to grandfather two classes of LEAPs with December expirations (SPY and S&P 100 i-Shares) because the exchanges would ordinarily introduce new series expiring in December 2009 after the December 2006 expiration.

<sup>24</sup> 15 U.S.C. 78q-1(b)(3)(F).

The Commission believes that OCC's rule change is consistent with this Section because (1) it is intended to eliminate inequities that result from certain rounding practices currently required by OCC's By-Laws and thus should protect investors and (2) it is intended to make more predictable when cash distributions by an issuer will result in an adjustment to an option contract and thus should make the process for adjustments more equitable for all investors.

OCC has amended the rule change in response to many of the commenters that opposed various portions of the rule change for various reasons.

Some commenters expressed concern that elimination of the 10% Rule would create uncertainty as to whether OCC would classify particular dividends as ordinary or special and that market liquidity for the affected options would disappear until OCC made an announcement whether a dividend is ordinary or special. The Commission feels that OCC's proposed rule is clear as to the procedure that will be used to classify a dividend as ordinary or special. A dividend will be classified as ordinary if it is declared pursuant to a policy or practice of paying such dividends on a quarterly or other regular basis. The Commission finds persuasive OCC's argument that most special dividends are in such amounts and/or payable on such dates that it will be immediately obvious to the market that they are not being declared pursuant to a policy or a practice of paying such dividends on a quarterly or other regular basis. In addition, issuers normally classify a dividend as special or ordinary when the dividend is announced, and in the vast majority of cases a dividend classified by the issuer as special would not fit OCC's definition of ordinary cash dividends or distributions. Any uncertainty which may exist in cases where the OCC Securities Committee will need to be to make a judgment as to whether a dividend is ordinary or special should diminish over time as OCC publishes interpretations and policies and a body of precedent develops. In addition, the Commission is not convinced, considering that adjusted options have shown no lack of liquidity in the past, that the elimination of the 10% Rule will wipe out liquidity for adjusted options.

Some commenters stated that the elimination of the 10% Rule for existing contracts would be unfair to those traders that have built into their pricing models the possibility that an issuer would declare a special dividend and the effect of that dividend under the

<sup>20</sup> See, e.g., CBOE Rules 8.7 and 8.85.

<sup>21</sup> Christopher Nagy, Chairman, Options Committee, Securities Industry Association (March 24, 2006) and James Knight, Vice President, Manager, Options Trading Strategies, Raymond James Associates, Gary Franklin, Manager of Option Trading, Managing Director, Senior Options Principal, Morgan Keegan Co., and Dennis Moorman, Manager-Options Department, J.J.B. Hilliard, W.L. Lyons, Inc. (December 12, 2006).

<sup>22</sup> Bob Linville and Deborah Mittelman, Service Bureau Committee Co-Chairs, Financial Information Forum (May 2, 2006).

10% Rule. In response, OCC amended the filing so that the 10% Rule will be eliminated and the new dollar threshold implemented only for dividends announced on and after February 1, 2009, so that the majority of existing options contracts will not be affected.

Some commenters also argued that elimination of the 10% Rule would lead to symbol proliferation in that any special dividend greater than \$12.50 per contract would trigger a contract adjustment and a new symbol. The Commission believes that any symbol proliferation should be short lived as the industry is planning to convert from fractional strikes to decimal strikes in November 2009 and that the benefits of the change outweigh any burdens.

Of particular concern to the Commission is the inequitable economic impact of unanticipated special dividends on market participants when the 10% Rule is applied. The Commission believes that OCC's rule change makes appropriate changes to the way that OCC handles special dividends to address this problem.

Those commenters that disagreed with the adjustment methodology for stock dividends, stock distributions, and stock splits suggested changes that would require major systems revisions. The Commission believes that such systems changes would be a tremendous burden on the industry and the costs would not outweigh any benefits.

Finally, it was argued that major systems changes would need to be undertaken and symbols changed to somehow alert investors that an option represents an adjusted contract. The Commission is not persuaded by this argument because the adjustment methodology OCC is going to apply to stock dividends, stock distributions, and stock splits is the same adjustment methodology it has used for over thirty years for spin-offs, mergers, and extraordinary cash dividends and identification of these adjusted contracts does not appear to have presented a problem.

## VI. 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.<sup>25</sup> In approving the proposed rule change, the Commission considered the proposal's impact on efficiency, competition and capital formation.

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act, that the

proposed rule change (File No. SR-FICC-2006-01), as modified by Amendment No. 1, be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>26</sup>

**Florence E. Harmon,**

*Deputy Secretary.*

[FR Doc. E7-2792 Filed 2-15-07; 8:45 am]

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-55261; File No. SR-Phlx-2007-01]

### Self-Regulatory Organizations; Philadelphia Stock Exchange, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change and Amendment No. 1 Thereto Relating to Calculation and Dissemination of PHLX/KBW Bank Index Values

February 8, 2007.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on January 18, 2007, the Philadelphia Stock Exchange, Inc. ("Phlx" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I and II below, which Items have been substantially prepared by the Phlx. On February 2, 2007, the Phlx filed Amendment No. 1 to the proposed rule change. The Phlx filed the proposed rule change as a "non-controversial" rule change pursuant to Section 19(b)(3)(A) of the Act<sup>3</sup> and Rule 19b-4(f)(6) thereunder,<sup>4</sup> which renders the proposal effective upon filing with the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.<sup>5</sup>

### I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The Phlx proposes that Dow Jones & Company, Inc. ("Dow Jones") will

<sup>26</sup> 17 CFR 200.30-3(a)(12).

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

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>4</sup> 17 CFR 240.19b-4(f)(6).

<sup>5</sup> Certain additions and technical corrections were made throughout the discussion of the proposed rule change pursuant to conversations with Phlx staff. Telephone conversation between Jurij Trypupenko, Director and Counsel, Phlx, and Kate Robbins, Attorney, Division of Market Regulation, Commission, on February 5, 2007.

replace the Exchange as the party solely responsible for the calculation and dissemination of the current index values<sup>6</sup> of the PHLX/KBW Bank Index ("Bank Index" or "Index").<sup>7</sup>

### II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Phlx included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Phlx has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

#### A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

##### 1. Purpose

The purpose of the proposed rule change is to provide that Dow Jones, rather than the Exchange, will calculate and disseminate the current index values of the Bank Index. No other changes are proposed in respect of the Index.

Options on the Bank Index, a narrow-based (industry) index, were originally listed in 1992.<sup>8</sup> The Commission's Approval Order regarding the Bank Index and options on it contains the following language about the calculation of the underlying current index value:

Even though the Index will be maintained by KBW, the Phlx represents that the Exchange will be solely responsible for the calculation of the Index and that the Index value will be calculated and disseminated in such a way that neither KBW nor any other party will be in receipt of the Index value prior to the public dissemination of the

<sup>6</sup> Bridge Data, which merged into Reuters, at various times has calculated and disseminated relevant index values on behalf of the Exchange.

<sup>7</sup> KBW is a registered broker-dealer that, among other things, specializes in U.S. bank stocks and is recognized as the "financial services industry authority." The Bank Index (BKX), also known as the KBW Bank Index and as a sector index, is a European-style modified-capitalization-weighted index composed of 24 geographically dispersed companies representing national money center banks and leading regional institutions. KBW has informed the Exchange that an independent third party, Dow Jones, on behalf of KBW will calculate and publicly disseminate the current values of the Bank Index and will follow necessary procedures such as publicly reporting the current underlying index values at least once every 15 seconds during the periods that options on the Bank Index are traded.

<sup>8</sup> See Securities Exchange Act Release No. 31145 (September 3, 1992), 57 FR 41531 (September 10, 1992) (SR-Phlx-91-27) ("Approval Order").

<sup>25</sup> 15 U.S.C. 78c(f).