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OCC news

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Spring 2007



occ opens options industry conference with highlights of recent activities

San Antonio, Texas, was the setting for the 25th Annual Options Industry Conference in late April, at which nearly 400 industry professionals and exchange and firm representatives attended. The three-day event was kicked off with updates from various industry committees prior to the opening night reception. Three OCC representatives made the following reports.

Gina McFadden, Executive Vice President, Business Operations, made the first presentation of the conference with an overview of projects underway at OCC. McFadden explained that projects are the result of OCC Board directives, product development requests from the exchanges or requests from any of three key groups: the OCC Operations Roundtable, the Options Operations Committee and the SIFMA Options Committee.

McFadden addressed member requested projects such as Accelerated Cash Settlements and Partial Deliveries related



to corporate actions. Implementation is planned for both initiatives in January 2008 and June 1, 2007 respectively.

McFadden also reported on several clearing member enhancements. Streamlining Daily and Expiration Processing is OCC's version of STP, or straight through processing, and includes a number of projects to help members reduce risk and expedite their back-office work. "We have a long history of making improvements to both daily and expiration processing timeframes," McFadden said. "Our goal on expiration Saturday is to close the window at 11 a.m. CT and, with everyone's cooperation and support, we're getting closer to meeting that target on a regular basis. The reduction in the Ex-by-Ex threshold and the elimination of Saturday out-trade sessions at the exchanges were key contributors to this success."

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The biggest boost for daily processing is that now all exchanges give OCC real-time trades throughout the day, which are quickly transmitted around to members, putting them in position for reconciliation on trade date.

Projects that are part of the effort to streamline processing include: Customer and Firm Sub-accounts that allow members to segregate positions at the customer level; Customer and Branch Identification on Trades; Penny Threshold for Ex-by-Ex Processing; Earlier Exchange Trade Input and Earlier Close of Post-Trade Window; and Adoption of Real-Time Clearing Data.

McFadden also noted some broader industry initiatives being addressed in OCC projects, including the Options Symbology Initiative which is detailed further in this issue of OCC News.

Mary Savoie, Vice President, Options Industry Services, followed with highlights of recent accomplishments by The Options Industry Council (OIC). One key OIC objective is increasing web-based options education. On-demand webcasts were introduced in 2006 and have since received nearly 50,000 visits. Podcasts were also introduced last year and there have been more than 105,000 downloads, resulting in frequent rankings in the top 25 business downloads on iTunes.

OIC's live seminar program continues to be well received as 92 percent of attendees find them extremely valuable. The live seminar program is also increasing its partnerships with organizations that have similar goals and philosophies, such as universities, securities firms and industry organizations. For example, OIC will again partner with the Futures Industry Association to host its second annual New York Equity Options Conference in September.

Industry outreach is being expanded with efforts targeting institutional investors, including academic studies and a new web

site, www.OICOptions.com. A demand for greater communication with European market participants has resulted in the formation of new roundtables. OIC is also improving its ability to track its effectiveness with new survey and web tools.

Susan Milligan, Senior Vice President, Government Relations and Communications, was the third OCC presenter and provided an update on activities on behalf of the industry in Washington, D.C. Milligan is also Executive Director of OIC and began her remarks noting the successful education event held by OIC for regulatory and legislative staff. This year, the event moved beyond just the basic options education to include a psychology of trading seminar and a panel on penny trading.

One key effort now underway in Washington involves the market maker exception to Reg. SHO, which governs short sales. The SEC reopened the comment period in late March following new information from the NASD. OCC and the exchanges filed a letter opposing SEC efforts to narrow the exception last fall. Plans are proceeding to file a new letter saying the NASD analysis supports the original contention that the options market maker exception is not a significant cause of fails to deliver and narrowing the exception would have costs to market liquidity.

While things are moving slowly, OCC also continues to monitor CFTC reauthorization and whether it will provide an opportunity to finish the job on portfolio margining by allowing index futures into securities customer portfolio margining accounts.

Milligan also talked about efforts to raise the consciousness of Congressional staff on how two derivatives regulators in the U.S. slows down the ability of options exchanges to bring new products to market, such as exchange-traded credit derivatives.

corporate objectives include SOSA initiative

One of OCC's 2007 corporate objectives is a new multi-phased development designed to bring efficiencies to the process of exchange series adds within ENCORE. The Streamlined Options Series Adds (SOSA) is a system for automatically adding options series to the masterfile as market conditions dictate, which will ultimately provide cost savings to members and enhance exchange efficiency. The phases of SOSA will be planned in accordance with progress on the Options Symbology Initiative (OSI), an approach to eliminate the practice of representing listed options contracts with OPRA codes (tickers) and fractional strike prices by the end of November 2009.

Currently, all six OCC participant exchanges run separate processes to nominate and generate new series. Since many series are multiply listed, the existing method for series replacement creates numerous redundancies for OCC

and vendors, as well as breeds operational inefficiencies across entities, particularly at expiration when duplicate series and inconsistencies proliferate. With OSI underway, there is a need to adjust the series add process to align with these changes and to improve the current series add process. SOSA will allow exchanges better collaboration by providing view, sort, monitor and reporting capabilities on records as they flow through the series add process.

"SOSA will refine the quality of new series data entering ENCORE, eliminate current operational inefficiencies, and move towards series generation supported by OCC," said Mark Baumgardner, Vice President, Product and Business Development. "OCC's utility model is well suited for initiatives like SOSA that require the development and implementation of systems and processes benefiting the industry as a whole."



industry insight

william h. navin

William H. Navin is Executive Vice President, General Counsel and Chief Legal Officer at OCC. Prior to joining OCC in 1999, Navin was a partner at Schiff Hardin & Waite from 1975 to 1999 and an associate from 1972 to 1975. OCC News recently sat down with Navin to discuss his role as General Counsel and various issues affecting OCC and the options industry.

How did you get involved in the derivatives industry and OCC?

When the Chicago Board of Trade decided to pursue the idea of trading equity options on an organized exchange, they engaged my law firm, Schiff Hardin & Waite, to do the legal work.

At Schiff Hardin, I worked on Chicago Board Options Exchange (CBOE) and OCC matters before there was an OCC. At that time it was the Chicago Board Options Exchange Clearing Corporation. In fact, I was attending Board of Directors meetings for OCC when it opened its doors in 1973.

As Schiff Hardin represented both CBOE and OCC, there were times when that led to conflicts. The way it got resolved was for OCC to hire some other law firm to represent its interests, which was not an entirely satisfactory situation for OCC. In the late 1990's, it became apparent to OCC's senior management that the interests of the exchanges were beginning to diverge from the interests of members and OCC. It became evident that, over the long term, Schiff Hardin could not continue to represent both CBOE and OCC. At the end of the day, I left Schiff Hardin and came to OCC.

What do you see as some of the challenges currently facing OCC?

It's a major challenge for OCC to keep up with all of the product development that's going on at the exchanges, with another major exchange soon to come on board. It's a challenge from both an operational standpoint and a legal standpoint. Due to the nature of our business, we are largely reactive so we're trying to service the needs of our members and exchanges. They're the ones who tend to define our agenda. Part of the challenge is the reputation we've built. We're a hard act to follow, even for ourselves.

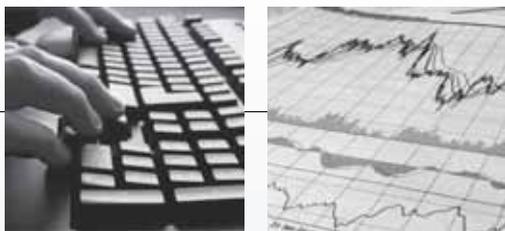
What issues arise during the process of introducing new products and how does OCC seek to mitigate any risk associated with this process?

By the time we see a new product, in most cases, it's pretty well-defined. The amount of thought that's devoted to it can vary from one product to another. In situations where not as much thought has been devoted at the exchange level, we find ourselves playing a role by asking questions. This forces the exchanges to focus on issues they may not have focused on in their own development efforts and sometimes the product changes as a result of that dialogue. OCC has a structured way of analyzing these things from a legal standpoint. We and our outside counsel have a checklist that asks a series of questions, like, "Is this a product that requires separate board approval?; Is this a product that's going to require rule changes or an ODD supplement?; Are there jurisdictional issues and if so, what do we think of those?" If we spot an issue while asking these questions, we have fairly well established paths for addressing it, ones that we've developed over the years.

Changes to OCC's stock adjustment rules were recently approved (not yet implemented). Can you explain what considerations led to the changes of the "10% rule," and how input from market participants impacted the proposal?

The 10% rule was a very arbitrary thing, but largely innocuous so long as option terms were short and positions were small. Call holders could often exercise to capture a special dividend without losing too much time value, and where that was not feasible, losses were relatively small. However, as longer-term options were introduced and positions grew in size, call holders and put writers started to incur substantial losses, and we began to hear of people who were figuring out ways to profit at their expense. The exchanges and OCC concluded that this needed to be addressed.

The problem wasn't the special dividend that was above 10% of the stock price—we already adjust for that. It was the special dividend that was 7% or 5%, which was below our threshold, but could still mean a lot of money for someone with a very large position. We decided to define special dividends not in terms of size, but rather whether it was a dividend that we determined was declared outside of a company's regular policy of paying recurrent dividends. The underlying premise was that the market can price in regular dividends, whereas special dividends are unpredictable and therefore unhedgeable.



We filed a rule change and it drew a number of comments from trading firms. Some asserted that there are situations where traders can and do predict that a given company is going to pay a special dividend within a certain period of time and they price their trades accordingly. After hearing this, we interviewed a number of firms and traders and confirmed that there were some who did exactly that. We decided it would not have been fair to change the rules of the game with respect to positions they already had in place. It was therefore determined to make the rule effective only prospectively, only with respect to positions that were put on after a supplement to the Options Disclosure Document disclosing the upcoming repeal of the 10% rule had been distributed.

In your opinion, what are the benefits of customer portfolio margining?

The major benefit of portfolio margining is efficiency. Strategy-based margin rules grossly over-margin positions because they don't take into account the risk-reducing effects of widely followed hedge strategies. Portfolio margining, instead of looking at individual positions, looks at the risks in the account as a whole, which, when you do this, typically reduces the amount of margin that's required because you're recognizing hedges that you otherwise wouldn't.

What is a key industry event that you think has positively impacted the growing volume of options?

I think the biggest factor was multiple listing of options. Once the exchanges started competing for order flow, that competition took the form of reduced costs. The effect was a reduction in clearing costs as well as market participants reducing spreads and commissions. Every time trading costs went down, volume went up.

What, in your opinion, makes OCC unique?

Part of it is structural; part of it has to do with people. Structurally, we're a monopoly, at least as far as options are concerned, but we're a benign one because we're user-controlled. That's not unique—DTCC has a similar structure. However, it's rare. As a monopoly, we can realize significant operating efficiencies and we can manage risk without being concerned about losing business to less responsible competitors. At the same time, user control protects our customers against the abuses commonly associated with monopolies. It's also rare for an institution to have the same CEO for almost 35 years. Wayne [Luthringshausen] has been a major part of OCC's DNA, and continuity of leadership and vision has been a major factor in making OCC what it is today.

options symbology announces first deliverable

The Options Symbology Initiative (OSI) made strides in the industry-wide effort to simplify the current listed options symbol methodology. In March, OCC announced OSI's first major deliverable, which is the availability of published technical specifications for record layout changes.

This publication constitutes specifications for both inbound and outbound data changes and comprises the tools necessary for market participants to determine the impact to their exchange and clearing interfaces. The documents can be found at www.optionsclearing.com/symbology and each entity (clearing members and non-OCC clearing members that receive non-proprietary information from OCC) will be responsible for communicating its contents to its own constituents.

OSI is a multi-year effort and is expected to conclude in November 2009. OCC's web site serves as the best resource for market participants—and all interested parties—to keep up-to-date on the initiative. Additionally, the Symbology Committee has set up a mechanism that allows questions and comments regarding OSI to be submitted to www.optionsclearing.com/initiatives/symbology/contact.jsp.

2007 New York Equity Options Conference date announced

Planning for the 2nd Annual Equity Options Conference is underway. OIC and the Futures Industry Association will jointly host this educational event on September 19-20 at the Grand Hyatt in New York. The program will consist of two separate events, one tailored to industry professionals and the other for retail investors.

Please check www.888options.com or www.futuresindustry.org for registration information and schedule details, which will be posted as they become available.

occ welcomes new board members

This spring, OCC welcomed two members to its Board of Directors. They are: Gerard McGraw, President of the Operations & Services Group (OSG) for Fidelity Brokerage Company, and Joseph Elmlinger, Managing Director, Head of Global Equity Derivatives, Citigroup Corporate and Investment Bank. Frank J. Bisignano was elected to the role of Vice Chairman to succeed Dr. Richard R. Lindsey.

Prior to joining Fidelity, Mr. McGraw was Senior Vice President in the Capital Markets Controller's Group and Capital Markets Administration at Smith Barney Inc. From 1987 to 1993, he was Senior Vice President of Financial Reporting for Securities Operations at Shearson Lehman Brothers, Inc. Previously, Mr. McGraw served as a principal financial examiner with the New York Stock Exchange, Inc., a staff auditor at Morgan Guaranty Trust Co. of NY, and senior auditor at Paine Webber Inc.

Mr. Elmlinger has held various positions in equity derivatives during his 14 years with Citigroup. He began his career at Bankers Trust Company in 1985 in the Latin America Merchant Banking Group focusing on sovereign debt for private equity exchanges. In 1990, he joined Amsterdam Pacific Corporation, a private equity firm jointly owned by Bechtel Investments and ABN Amro Bank, where he completed one of the early privatizations in Poland.

From 1991 to 1993, Mr. Elmlinger started up corporate equity derivatives teams at Bankers Trust and Salomon Brothers.

Mr. Bisignano is Chief Administrative Officer for JPMorgan Chase & Co. and a member of the firm's Operating Committee. Previously, he served as Chief Executive Officer for Citigroup's Global Transaction Services business and a member of Citigroup's Management Committee and Operating Committee. Prior to that, Mr. Bisignano was the Chief Administrative Officer of Citigroup's Global Corporate and Investment Banking Group, while also serving as Deputy Head of Operations and Technology for all of Citigroup from 2000 to 2003. Before joining Smith Barney in 1994, Mr. Bisignano was Executive Vice President and Chief Consumer Lending Officer at First Fidelity Bancorporation and was a Senior Vice President at Shearson Lehman Brothers.

"The Board is pleased to welcome our newest members. The combined industry experiences of Gerry and Joe will further enhance our board," said Wayne P. Luthringshausen, OCC Chairman and Chief Executive Officer. "We also bid farewell to Dr. Richard Lindsey, who made significant contributions during his five years serving on our Board and welcome Frank Bisignano as his successor as Member Vice Chairman."

DDS and FIXML conversion complete

April 1 marked the conversion deadline for clearing members to align their systems with OCC's Data Distribution Services (DDS) for ENCORE. The conversion ensures that all members' messaging systems are based in FIXML, Financial Information eXchange Markup Language, thus allowing for better integration and transmission of real-time data messaging.

DDS was developed in December 2004 and since then, OCC has been assisting clearing members, exchanges and other ENCORE subscribers in converting to the new system. DDS replaces the previous Data Service machine readable files and is a key component of ENCORE, which uses FIXML to provide a more effective method of data messaging. This is achieved by FIXML's standardized use of elements and attributes rather than traditional proprietary record layouts.

On April 2, as a result of the DDS conversion, OCC ceased transmission and production of several legacy system files for both options and futures. Files for options trading include adjusted positions, data service, flex prices, open interest, prices data, series information and special settlements. Files for futures trading include adjusted positions, data service, prices data service, series information and special settlements.

The DDS transition also mandated that all inbound post-trade files must be FIXML-based as of March 30, 2007, replacing the fixed length inbound post-trade records. Clearing members and service bureaus were notified of this extended deadline last December, which provided additional time to complete the required testing prior to converting to the new system.

business continuity efforts forge ahead

OCC continues to hold active leadership roles in two industry organizations dedicated to protecting the financial sector in the event of a natural or man-made disaster: The Financial Services Sector Coordinating Council for Critical Infrastructure Protection and Homeland Security (FSSCC) and ChicagoFIRST. Recent activities of both groups are highlighted below:

- On March 1, FSSCC released its 2006 Annual Report. Highlighted within the Annual Report is the Sector Specific Plan (SSP) for Banking and Finance, which joins 16 other SSPs in the National Infrastructure Protection Plan identified in Homeland Security Presidential Directive 7. The Banking and Finance SSP outlines a strategy for working collaboratively with public and private sector partners to identify, prioritize and coordinate the protection of critical infrastructure. The FSSCC 2006 Annual Report is available at www.fsscc.org.
- FSSCC recently participated in a National Infrastructure Advisory Council (NIAC) Working Group that prioritized key resource and critical infrastructure needs for vaccination allocation in the event of a pandemic. The NIAC Working Group produced a report of their findings and recommendations, "Prioritization of Critical Infrastructure for a Pandemic Outbreak in the United States," which is available at http://www.dhs.gov/xlibrary/assets/niac/niac-pandemic_wg_v8-011707.pdf.
- FSSCC is currently working with the National Communications System (NCS) on a study that simulates Internet activity and availability during a pandemic. NCS, a government group of telecommunications companies, built a computer lab model using data supplied by FSSCC. FSSCC surveyed its member organizations to determine the bandwidth needs and location of their employees who would be working from home during a pandemic. This data helps the model determine when and where the Internet becomes unstable or unusable due to lack of capacity. NCS will submit their findings and recommendations to the Department of Homeland Security (DHS) Council in June.
- ChicagoFIRST and the U.S. Department of Treasury held the first annual meeting for the Regional Partnership Coalition (RPC) in Washington, D.C. on April 20. *RPCfirst* is the collective group of public/private partnerships that have formed in cities across the U.S. following the ChicagoFIRST model. The meeting provided a forum through which *RPCfirst* members could learn more about the Department of Treasury and DHS goals and assistance for regional partnerships; DHS' national level credentialing system; the national public/private partnership structure; and available information sharing and communications tools. Participants included representatives from DHS, U.S. Department of Treasury, Board of Governors of the Federal Reserve Board, FSSCC, and the Telecommunications and Electricity sectors.

customer portfolio margining ruling takes effect

The much anticipated rule change allowing broker-dealers to use a risk-based portfolio approach for the margining of customer accounts took effect on April 2. This risk-based approach is based on OCC's TIMS margin methodology, which determines the maximum loss associated with a portfolio given a percentage move in an underlying asset.

Those wishing to learn more about the new customer portfolio margining rules can find useful tools and literature

available at:

- <http://cpm.theocc.com>
- www.cboe.com/margin
- "Clearing the Deck: A Historic Change in the Leveraging of Securities Purchasing: The Advent of Portfolio Margining," written by Michael Jamroz of Deloitte & Touche. Originally published in the January/February 2007 issue of *Futures Industry*, the article is available at www.futuresindustry.org/fi-magazine-home.asp.

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