THE OPTIONS CLEARING CORPORATION

#25361

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SUBJECT: CHANGES TO CASH DIVIDEND ADJUSTMENT POLICIES – GUIDELINES – ADDITIONAL INFORMATION - REMINDER

OCC Information Memo 25113 described additional changes to the new policy that will govern adjustments to options in response to cash dividends or distributions. These additional changes concerned the application of the $12.50 per contract threshold that will be used to determine whether contract adjustments will be made. This Information Memo incorporates a discussion of the $12.50 threshold into previously released Information Memo 24624 which describes the new adjustment policy.
(The $12.50 threshold is discussed in the "FAQ's" section of this Memo.)

Previous OCC Information Memos (most recent: 24284) have described changes to OCC By-Laws for adjusting options in response to cash dividends or distributions under what has come to be known as the "10% Rule". These changes will become effective for cash dividends announced on or after February 1, 2009. OCC has been asked questions about how the new adjustment policy will be administered and to provide examples of how the new adjustment approach might be applied to actual or hypothetical situations. The purpose of this Memo is to respond to some of these questions. A review of the new adjustment policy is presented below, followed by a number of "FAQ's".

I. Review of Changes to Cash Dividend Adjustment Policies

The "10% Rule"

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

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

Under the changes to the OCC By-Laws approved by the SEC, **a cash dividend or distribution will be considered ordinary (regardless of size) if it is declared pursuant to a policy or practice of paying such dividends on a quarterly or other regular basis. Dividends paid outside such practice will be considered extraordinary. OCC will normally adjust for extraordinary dividends unless the amount is less than $12.50 per contract.** The determination of whether a given cash dividend is "ordinary" according to this definition will be made by adjustment panels of the OCC Securities Committee. (These adjustment panels are convened for the purpose of determining the appropriate contract adjustment under the OCC By-Laws in response to corporate events. They are composed of two representatives of each exchange that trades the affected option and a representative of OCC who votes only in the event of a tie. The adjustment panels consider each corporate event on a case by case basis.)

Minimum Size Threshold

In the interest of providing some limit on option symbol proliferation arising from adjustments, cash dividends that are determined to be "extraordinary" will also be subject to a size test before a contract adjustment is effected: **the per contract value of the dividend must be at least $12.50.**

The advantage of a fixed dollar threshold is avoiding uncertainty: the per contract value of the dividend can be immediately determined, without the need to do a percentage calculation based on the closing price of the underlying shares on the declaration date, as is currently the case under the "10% Rule". The simple calculation of the value of the dividend on a per contract basis can even be applied to proposed or contingent (not yet declared) dividends, thus eliminating a lot of uncertainty that exists under the current method.

Threshold Consistency Across Relevant Interpretations: Fund Shares

Interpretation .08 to Article VI, Section 11A of the OCC By-Laws provides that cash distributions for fund share capital gains will normally result in contract adjustments. Under Interpretation .08 as currently in effect, there is a zero threshold for fund share capital gains distributions. To provide consistency, when the new rules become effective, the $12.50 per contract size threshold will be applied to all adjustments for cash distributions: **in addition to other criteria, all cash distributions, including fund share capital gains distributions, must yield at least $12.50 per contract value in order to trigger adjustment.**

Effective Date

The new adjustment policy as described above applies to cash dividends or distributions announced on or after **February 1, 2009.**

The "Grandfathering Plan"

The changes to the OCC By-Laws contained an implementation plan to allow all equity option positions that existed at the time the required Options Disclosure Document supplement was published on May 9, 2007 to continue to be subject to the current 10% Rule for cash dividends, thereby permanently "grandfathering" them under the existing 10% Rule. Please see Information Memo 22966 and earlier Memos for a description of the grandfathering plan.

II. Frequently Asked Questions

Disclaimer: The OCC Securities Committee has reviewed the questions and answers presented below and believes they provide useful guidelines for how the new adjustment policy will be applied in practice. However, as indicated several times below, all adjustments are individually determined by an adjustment panel of the Securities Committee on a case by case basis, and adjustment panels may make exceptions to general rules, interpretations, and policies in cases where they determine such exceptions to be appropriate. In no instance are the examples provided below meant to determine in advance the decisions that any adjustment panel will make in the future.

Overview of the New Adjustment Policy

Q. Who decides if an option adjustment shall be made?

A. All adjustments are determined on a case by case basis by an adjustment panel of the OCC Securities Committee. Each adjustment panel is comprised of two representatives from each exchange that trades the option in question, plus an OCC representative. The OCC member only casts a vote to break a tie. The adjustment panel decides whether an adjustment is called for and how it should be done.

Q. What cash dividends call for an adjustment?

A. "Ordinary" cash dividends do not call for adjustments. An "ordinary" cash dividend is defined as one paid "pursuant to a policy or practice of paying such dividend on a quarterly or other regular basis". A cash dividend which is considered to be *outside* this regular policy is non-ordinary, or "special". Assuming a given dividend is "special" according to this definition, a size test is also imposed: the value of the dividend must be at least $12.50 per option contract. Thus, if the dividend is "special" and yields at least $12.50 per option contract, then an adjustment will be made.

Q. What's the rationale for this approach?

A. In general, dividends declared pursuant to a policy or practice of a company can be anticipated and priced into option premiums according to standard models. (For example, Pfizer has announced it will pay $.24 quarterly dividends as part of an established dividend program.) "Special" dividends declared outside the normal policy of the company cannot be anticipated and integrated into pricing with the same degree of assurance.. Thus, when special dividends are announced, if no adjustment is made, the only way a call holder can capture the dividend is through exercise prior to the ex-dividend date. When this happens, significant option time value can be lost and financial losses due to operational error in submitting exercises may occur. The intention is to allow "special" dividends to accrue to the benefit of call holders without requiring them to exercise their options.

Q. So any dividend that can't be *anticipated* will be deemed a special dividend?

A. No. Although special dividends may be unanticipated, the important criterion is whether a dividend is paid pursuant to a program or policy of paying dividends on a quarterly or other regular basis. In some cases, the dividends of a company paid according to such a policy may be highly variable and subject to increases or decreases that some may consider “unanticipated”. Nevertheless, these dividends would not normally be deemed “special”.

Examples: What if…?

Q. Can you give an example of how the $12.50 adjustment threshold will work in practice?

A. In order for an option to be adjusted, the value of the dividend must be at least $12.50 per option contract. **However, if the security on which the dividend is paid underlies option contracts with more than one contract size – e.g., as a result of adjustments for previous splits – then the nonstandard contracts would be adjusted only if the value of the dividend on the nonstandard contract is at least $12.50 *and* the standard-size contract (normally 100 shares) would also be adjusted.**

For example, suppose an option covers 100 shares of stock and a $0.10 special cash dividend is declared. This dividend, although “special”, would yield only $10.00 in value for this option contract. Therefore, no adjustment would be made.

A second example: Suppose an option covers 100 shares of stock and another option covers 150 shares of the same stock (as the result of a previous adjustment for a 3 for 2 split). A $0.10 special dividend is declared. The dividend would yield $10.00 in value for the 100 share option and $15.00 for the other. However, in this case, since the standard-size (100 share) contract would not be adjusted (the $12.50 threshold not being met), the 150 share option would also ***not*** be adjusted.

A third: Suppose an option covers 100 shares of stock and another option covers 50 shares of the same stock (as a result of a previous adjustment for a 1 for 2 reverse split). A $0.15 special dividend is declared. The dividend would yield $15.00 in value for the 100 share option and $7.50 for the 50 share option. In this case, the standard-size (100 share) option would be adjusted, but the 50 share option would ***not*** be adjusted because the value of the dividend per contract would be only $7.50, and a nonstandard option is not adjusted if the value of the dividend per contract is less than $12.50 even if the standard-size option is adjusted.

These examples also illustrate the $12.50 threshold is applied at the ***option contract*** level - **not** per share.

Occasionally only nonstandard options exist. In these cases, since there is no standard-size option to refer back to, the application of the $12.50 per contract threshold will determine whether an adjustment is made.

Q. Who determines if a cash dividend is “special”?

A. The adjustment panels of the OCC Securities Committee will make this determination. In most cases, we anticipate being able to rely on the description of the company itself in describing its dividend. In our experience, dividends that are called “special” or “extraordinary” (or similar terms) by the company in fact describe the non-ordinary dividend events that we want to capture by adjustment. <u>However, the company’s characterization of a dividend is not binding on adjustment panels.</u>

Q. What if a company that previously paid no dividends initiates a regular dividend program – would the initial dividend be considered "special" and therefore adjustable?

A. No. The initial dividend would be paid pursuant to a policy under which the company intends to pay dividends on a regular basis. Therefore, it would not be deemed "special" and adjustable.

Q. What if a company announced a dramatic increase in a regular dividend? For example, what if a company's last quarterly dividend was $.20 and the current quarterly dividend was bumped to $1.00 – wouldn't that be a "special", one-time event that would call for an adjustment?

A. No – most likely not. As mentioned earlier, we would start with the company's description of its dividend. If the company has a quarterly dividend program and the company says this quarter's dividend is $1.00, then we anticipate the adjustment panel would deem the dividend to be ordinary and not adjustable. However, as mentioned, the decisions of the adjustment panels are always made on a case by case basis, in light of the circumstances and facts as understood at the time.

Q. What about REITs, natural resource trusts, and similar companies that pay very irregular dividends? Such companies could pay no dividends for many months and then suddenly pay a dividend. Would that be considered a "special", adjustable dividend?

A. No – most likely not. The kinds of companies mentioned in the question often have very regular dividend *policies* but will *actually* pay dividends only when certain conditions are met, or in response to market conditions. REITs, for example, are generally required to pay out profits to shareholders when and if profits are realized. They may determine dividends monthly, although the cash amount available for distribution may actually be zero in any given month. Thus, although the dividend payouts of such companies may be irregular, insofar as they occur *pursuant to the policy of the company,* they would be considered ordinary and not adjustable. The adjustment panels would look to the company's characterization of the dividend and its dividend policy.

Q. What if a company is reorganizing itself into a REIT and is required to pay out accumulated profits in a large dividend as it commences a dividend program. You said before that *initial* dividends would not normally call for adjustment. Would you adjust in this case?

A. In our experience, companies reorganizing themselves into REITS or income trusts often designate this initial required pay-out as a "special" dividend. Precedent exists for adjusting for such dividends under OCC's existing adjustment rules, and it is likely that they will be adjusted for under the new rules. Even if the company did not specifically characterize such a dividend as "special", the adjustment panels could decide to deem them special and adjust.

Q. Fund share or ETF options have previously been adjusted in response to special dividends declared with respect to component securities of the fund. The most notable instance was the Microsoft $3.00 special dividend in 2004. How will these kinds of distributions be handled?

A. If a fund (ETF, HOLDR, etc.) is making a cash distribution which is identified (in whole or part) by the fund as attributable to a special dividend on a component security, then the appropriate amount of the cash distribution will also be considered a special, adjustable distribution. For example, if an ETF is making a $1.00 quarterly cash distribution, $.25 of which is attributable to a special dividend on a component security, the adjustment panel will normally consider $0.25 of the aggregate distribution as a special dividend and adjust for $25.00 per option contract (assuming a 100 share option).

Note: The $12.50 size test will also be applied: the portion of the distribution attributable to the component security's special dividend must yield $12.50 value per option contract before an adjustment is done.

Q. What if a company declares a special dividend which is ex-distribution on the same date that a regular dividend is "ex"? Would these be considered one event or two separate events?

A. Two separate events.

Q. The Phelps Dodge (PD) special dividends present an interesting case. PD announced they intended to pay a certain aggregate cash amount in a series of special dividends and/or effect stock buy-backs over the upcoming year. Would these dividends be considered "special"; or would they be considered "ordinary" because they were paid pursuant to an announced program?

A. In the case of PD, each dividend was characterized *by the company* as "special" and although paid pursuant to a "program", PD gave no indications it would be permanent. The "program" allowed special cash dividends to be paid in lieu of stock buy-backs. PD also continued to pay quarterly dividends which were separate from the special dividends. Thus, it is likely the adjustment panels would consider each dividend paid by PD pursuant to this program to be "special" and call for an adjustment. As mentioned earlier, the adjustment panels address each dividend on a case by case basis.

Q. What if a company's regular quarterly dividend is a "return of capital"? Would that make it a special, adjustable dividend?

A. No. Insofar as the dividend is still a regular quarterly dividend, it would not call for an adjustment. Ordinarily, the source of cash to be paid will not be determinative of the adjustment decision. In the past, however, adjustment panels have determined to adjust for any dividends paid pursuant to a plan of liquidation – even regular dividends of the company included in the plan. They may follow this precedent in the future as well for companies undergoing liquidation.

Operational Matters

Q. Will we have to wait until the official declaration date of a dividend before a decision is made about option adjustment?

A. Not necessarily. The adjustment panels will be motivated to make their adjustment decisions as soon as practicable. The panels may decide it is appropriate to base a decision on the company's press release or similar announcement, in advance of the formal declaration date. Of course, if this is done, the adjustment decision would be appropriately conditional. For example, "if declared and paid as described in the press release, then…."

For example, suppose a company announces its intention in a press release to pay a special dividend, but this dividend is contingent on shareholder approval or other conditions. Until the conditions are met, it will not be officially declared. Under the new policy, it will be easy to see if the dividend meets the size criterion: would it yield $12.50 per contract? If "yes", then if the adjustment panel determines it is a "special" dividend, investors will immediately know an adjustment will occur if the dividend is actually declared.

Q. Won't this new adjustment policy result in option symbol proliferation?

A. Yes, to some extent. Contract adjustments under the new policy will be more frequent and in many cases a new symbol will be required. However, OCC and the exchanges feel the benefits of the new policy outweigh the operational costs.

One should note that when equity option strike prices can be denominated in decimals and the need for "ticker codes" for each strike is eliminated, adjustments will be possible *without* the need to change option symbols (as the strike prices can be reduced by the exact amount of the dividend). When that happens, symbol proliferation will not occur. The option industry is looking forward to this capability in 2010.

Q. If an adjustment is called for, *how* will it be done?

A. There will be no changes to the *methods* of adjustment. There are two methods of adjustment: 1) simply reduce the strike prices by the amount of the dividend. This is the preferred method and will normally be used if the strike prices can be reduced *without rounding.* 2) If strike prices can't be reduced without rounding, then the amount of the dividend will be added as a cash component to the option deliverable. When this is done, an option symbol change normally occurs.

Adjustments will continue to be made on the ex-date for the cash dividend as determined by the appropriate market.

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