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**DATE:** **JANUARY 3, 2012**

**SUBJECT:** **CHANGES TO CASH DIVIDEND ADJUSTMENT POLICIES – GUIDELINES – ADDITIONAL INFORMATION**
*****REPOST OF MEMO #27648*****

OCC Information Memo **27649** described additional changes to the policy that will govern adjustments to options in response to cash dividends or distributions. These additional changes will become effective on February 1, 2012 and concern the authority of the Securities Committee to stop adjusting for certain cash dividends which had previously occasioned adjustments. This Information Memo incorporates a discussion of this recent policy change. (See the "FAQ" section of this Memo.)

OCC has been asked questions about how the adjustment policy for cash dividends or distributions 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 adjustment policy is presented below, followed by a number of "FAQ's".

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

Under the changes to the OCC By-Laws which became effective in February 2009, **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 non-ordinary. OCC will normally adjust for non-ordinary 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.)

## 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. Assuming a given dividend is non-ordinary 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 non-ordinary 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. Non-ordinary dividends declared outside the normal policy of the company cannot be anticipated and integrated into pricing with the same degree of assurance. Thus, when such 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 such 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 non-ordinary dividend?
A. No. Although such 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 non-ordinary.

**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 non-ordinary, 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 shares) 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 that, in general, the $12.50 threshold is applied at the ***option contract*** level – **not** per share.[1]

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 "non-ordinary"?

[1] A threshold of .125 **per share** is used in determining contract adjustments for capital gains and other distributions for fund shares, as described Interpretation .08 to Article VI, Section 11A of the OCC By-Laws

> A. The adjustment panels of the OCC Securities Committee will make this determination. In doing so, adjustment panels may consider the company's characterization of the dividend but the company's characterization is not binding on adjustment panels. Adjustment panels may take into account other factors deemed appropriate including, but not limited to, the company's stated dividend policy and payment history, prior option adjustments, and factors bearing on the maintenance of a fair and orderly market.

Q. What if a company that previously paid no dividends initiates a regular dividend program – would the initial dividend be considered "non-ordinary" 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 "non-ordinary" 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 "non-ordinary", 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.

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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 "non-ordinary", 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.

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 $.125 threshold test will be applied: the portion of the distribution attributable to the component security's special dividend must yield $.125 value per share before an adjustment is done.

Q. What if a company declares a non-ordinary 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 Diamond Offshore (DO) special dividends present an interesting case. DO has paid a series of special dividends on a quarterly basis, alongside their regular quarterly dividend. Some investors feel these special dividends have demonstrated such consistency over time that they should be deemed ordinary and should no longer occasion adjustments. How will the Securities Committee approach such a situation?

A. Even though the adjustment panels may have previously adjusted for a series of non-ordinary dividends, they have the authority to stop adjusting for such dividends if the panels believe the issuer has a policy or practice of paying such dividends or distributions on a quarterly or other regular basis, or the issuer has paid such dividends or distributions for four or more consecutive months or quarters or two or more years after the initial payment. The panels could make this determination whether or not the amounts paid were the same from period to period. The adjustment panels would announce decisions to no longer adjust for each affected option. Such determinations would be made on a case by case basis. **Note – this policy will be effective February 1, 2012.**

Q. How and when will the Securities Committee provide notification of decisions to cease adjusting for recurring non-ordinary dividends on existing options?

A. Notification will be provided in an OCC Information Memo. In most cases, it is anticipated that notification from the Securities Committee will be given when an option's final adjustment for recurring non-ordinary dividends is made and will generally be included in the final adjustment information memo. For example, if XYZ Stock has announced its $4^{th}$ recurring non-ordinary quarterly dividend, an information memo will be published indicating an adjustment will occur for the $4^{th}$ dividend. In addition, this memo will also include the Securities Committee's decision that subsequent non-ordinary quarterly dividends will not be adjusted for. **Note – this policy will be effective February 1, 2012.**

Q. What if the underlying security on a newly listed option has a history of recurring non-ordinary dividends? Will options be adjusted for subsequent non-ordinary dividends since there have been no previous adjustments?

A. No, generally not. In a case involving a newly listed option for which no prior dividend adjustments have occurred, adjustments will generally not be made for recurring non-ordinary dividends because a consistent pattern of non-ordinary dividends exists for the underlying security. In such a situation, recurring non-ordinary dividends typically will not result in an adjustment for the newly listed option, even though no prior notification has been given that no adjustment would be made. **Note – this policy will be effective February 1, 2012.**

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.

## <u>Operational Matters</u>

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 non-ordinary dividend, investors will immediately know an adjustment will occur if the dividend is actually declared.

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 exact dividend amount in known is advance of the ex-date. 2) If the exact dividend amount is not known or if strike reduction would result in a strike of zero or less, 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.**