

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-49925; File No. SR-OCC-2004-08]

### Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Relating to the Clearance and Settlement of Variance Futures and Options on Variance Futures

June 28, 2004.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> notice is hereby given that on May 11, 2004, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change described in Items I, II, and III below, which items have been prepared primarily by OCC. The Commission is publishing this notice to solicit comments on the proposed rule change from interested parties.

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

OCC is seeking approval to clear and settle variance futures and to clear and settle options on variance futures.

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

In its filing with the Commission, OCC 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. OCC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of these statements.<sup>2</sup>

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

###### 1. Introduction

The purpose of this proposed rule change is to enable OCC to clear and settle futures contracts on the variance over a set time period of a reference variable selected by the futures market proposing to trade the contracts "variance futures" and to clear and settle options on variance futures. A variance is a statistical measure of the

variability of price returns relative to an average (mean) price return.

CBOE Futures Exchange, LLC ("CFE") has proposed to trade variance futures for which the reference variable would be the S&P 500 Index. The underlying variance will be calculated by CFE (or its agent) using a standard formula that uses continuously compounded daily returns on the reference variable for a specified time period. The calculated variance will then be annualized assuming 252 business days per year. CFE currently proposes futures on the one month variance and three month variance of the S&P 500 Index although CFE may list variance futures on other variance measurement periods for the S&P 500 Index or on other reference variables in the future. The variance measurement period for each series of variance futures traded on CFE will begin on the first business day following the maturity date of the previously maturing series and continue to (and include) the maturity date of the subject series. CFE may open trading in a series of variance futures prior to the beginning of the measurement period for the underlying variance. For example, CFE may open a future contract on the one month variance of the S&P 500 Index four months before its maturity date where the measurement period for the variance underlying that variance future would be the one month prior to the maturity date of the future.

Futures on variance differ from futures on volatility indexes currently traded on CFE and cleared and settled by OCC in that underlying variance is calculated using only historical daily closing values of the reference variable while an underlying volatility index represents the implied volatility component of bid and ask premium quotations for options on a reference variable.

OCC believes that an underlying variance is a "commodity" within the definition of Section 1a(4) of the Commodity Exchange Act ("CEA"), which defines "commodity" to include "all \* \* \* rights, and interests in which contracts for future delivery are presently or in the future dealt in." OCC believes a variance as proposed to be traded by CFE is clearly neither a "security" as defined in Section 3(a)(10) of the Securities Exchange Act of 1934 (the "Act") nor a "narrow-based security index" as defined in Section 3(a)(55)(B) of the Act. Accordingly, OCC believes a futures contract on such a variance would not be a "security future" within the meaning of Section 3(a)(55)(A) of the Act and therefore would be within the exclusive

jurisdiction of the Commodity Futures Trading Commission. OCC therefore proposes to clear this product in its capacity as a "derivatives clearing organization" registered under Section 5b of the CEA.

###### 2. Rule Changes

In order to provide for the clearance of variance futures, OCC proposes to add four new defined terms to Article I of its By-Laws. The more general term "multiplier" would be added to encompass the already defined term "index multiplier" as well as the multiplier that would be applied to a variance future to determine the final settlement price. Adding the multiplier definition would simplify other amendments to the By-Laws and Rules as described below. The term "reference variable" will be defined to mean the price or value of a security, commodity, future, currency, asset, index, or other thing, the variance or other measure of variability of which is used as the underlying interest for a cleared contract. The term would be needed to describe contracts, such as variance futures, that have as their underlying a measure of the variability of the price or level of an index or instrument. "Underlying variance" or "variance" would be defined as the variability of the reference variable over a specified time period as measured by the futures market on which the variance future is traded or that market's designated reporting authority. A "variance future" would be defined as a future on a variance.

Article VI, Section 10(d) of the By-Laws currently provides that the index multiplier for an index future is set by a market at the time a series is opened and may be adjusted under Article XII, Sections 3 and 4. The rule change would make Section 10(d) applicable to variance futures by replacing the term "index multiplier" with the new term "multiplier" and by specifically referring to variance futures as well as index futures. Likewise, Article XII, Sections 3 and 4 (relating to adjustments) and Section 5, "Unavailability or Inaccuracy of Final Settlement Price," are made applicable to variance futures and options on such futures. In order to determine the variance of a variance future that has a stock index as its reference variable, the level of the stock index must be accurate and available. Therefore, OCC would require similar authority to adjust variance futures for changes in the index that is the reference variable or the unavailability of such index, as OCC has in the case of indexes underlying index futures. Additionally, a new

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

<sup>2</sup> The Commission has modified the text of the summaries prepared by OCC.

Section 4(d) would be added to Article XII to account for the fact that variance futures may also need to be adjusted for changes in the calculation of the underlying variance itself.

Variance futures are non-equity futures and as such would be margined under Chapter VI, Rule 602.<sup>3</sup> Rule 602(a)–(e) describes OCC's current automated margining system, TIMS. However, TIMS is not currently configured to calculate appropriate margin levels for variance futures. Thus, the appropriate risk margin levels for variance futures cannot be determined through the application of Rule 602(a)–(e). It will be necessary to add variance futures to those instruments that are exempted from the provisions of 602(a)–(e) by Rule 602(f). New Rule 602(f)(6) would direct that risk margin for variance futures be calculated using such measures of risk as OCC deems appropriate. Because the margin requirements for variance futures will not be set through TIMS, those margin requirements will not appear on the Daily Margin Report provided for in Rule 605, which is a report of the TIMS calculations applied to a Clearing Member's positions. OCC will add an interpretation and policy to Rule 605 advising Clearing Members that risk margin with respect to variance futures will not be included in the Daily Margin Report, and that notifications to Clearing Members of their risk margin requirement in respect of variance futures will be given before 9 a.m. Central Time, which is the same deadline that applies to delivery of the Daily Margin Report. Clearing Members will be required to make settlement of variance futures risk margin as if it were included in the Daily Margin Report.

The "Introduction" to Chapter XIII will be amended to include variance futures among those futures contracts that OCC is approved to clear and settle. Rule 1301(a) will be, like Article VI, Section 10(d), made applicable to variance futures by simply replacing "index multiplier" with "multiplier" and by adding references to variance futures where index futures are referenced.

### 3. Amendment to Clearing Agreement

OCC and CFC will be entering into First Amendment to Agreement for Clearing and Settling Security Futures and Futures and Futures Options on Broad-Based Indexes. The Amendment will make several changes to the Clearing Agreement in anticipation of the clearance of variance futures. Only

certain of those changes will be substantive. Section 3(b) of the Clearing Agreement currently identifies the permissible underlying interests for futures contracts that CFE may clear through OCC. Section 5 of the Amendment will amend Section 3(b) to permit the parties to agree on additional underlying interests by completion and execution of a schedule in the form that will be attached to the Amendment as Schedule C. The parties have also agreed upon and will include with the Amendment a Schedule C–1 for variance futures. Section 10 of the Amendment will amend Section 3(e) to extend the established procedure for selecting underlying interests to an underlying interest listed on a Schedule C.

Section 3(c)(i) of the Clearing Agreement currently states that broad-based index futures are the only acceptable underlying interest for options to be cleared under the Clearing Agreement. Section 6 of the Amendment would change this language so that any future other than a security future may be an underlying interest for such an option.

The Clearing Agreement currently requires CFE to indemnify OCC in certain circumstances. Section 11 of the Amendment would add a provision clarifying, among other things, the applicability of the indemnification provisions to certain currently pending litigation against CBOE and CFE and to similar litigation or claims that may be brought in the future. Section 11 of the Amendment would also make CBOE a party to the Clearing Agreement for the purpose of assuming joint and several liability with OCC in the event that OCC is entitled to indemnification with respect to such litigation or claims.

\* \* \* \* \*

The proposed changes to OCC's By-Laws and Rules and the Amendment to the Clearing Agreement are consistent with the purposes and requirements of Section 17A of the Act<sup>4</sup> because they are designed to promote the prompt and accurate clearance and settlement, to foster cooperation and coordination with persons engaged in clearance and settlement, to remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement, and, in general, to protect investors and the public interest.

Variance futures are commodity futures within the exclusive jurisdiction of the CFTC, and OCC will therefore clear variance futures in its capacity as a registered derivatives clearing

organization under the CFTC's regulatory jurisdiction. Accordingly, although this rule change represents a change in OCC's existing service of clearing commodity futures contracts, that service is not otherwise within the jurisdiction of the Commission. This rule change will not affect the safeguarding of funds or securities in OCC's possession because OCC will apply procedures and safeguards to the clearing of these contracts that are similar to those it applies to the clearing of securities options and security futures over which the Commission has direct regulatory authority. The respective rights and obligations of OCC and its clearing members with respect to matters within the Commission's jurisdiction will be unaffected.

### (B) Self-Regulatory Organization's Statement on Burden on Competition

OCC does not believe that the proposed rule change would impose any burden on competition.

### (C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

Written comments were not and are not intended to be solicited with respect to the proposed rule change, and none have been received.

### III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The foregoing rule change has become effective upon filing pursuant to Section 19(b)(3)(A)(iii) of the Act<sup>5</sup> and Rule 19b–4(f)(4)<sup>6</sup> thereunder because the proposed rule effects a change in an existing service of OCC that does not adversely affect the safeguarding of securities or funds in the custody or control of OCC or for which OCC is responsible and does not significantly affect the respective rights or obligations of OCC or persons using the service. At any time within sixty days of the filing of such rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule

<sup>3</sup> "Non-equity future" is defined in OCC By-Laws Article I as a future other than a stock future.

<sup>4</sup> 15 U.S.C. 78q–1.

<sup>5</sup> 15 U.S.C. 78s(b)(3)(A)(iii).

<sup>6</sup> 17 CFR 240.19b–4(f)(4).

change is consistent with the Act. Comments may be submitted by any of the following methods:

*Electronic Comments*

- Use the Commission's on-line comment form (<http://www.sec.gov/rules/sro.shtml>) or
- Send an e-mail message to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File No. SR-OCC-2004-08 on the subject line.

*Paper Comments*

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609.

All submissions should refer to File No. SR-OCC-2004-08. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's internet web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW., Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of OCC and on OCC's web site at <http://www.optionsclearing.com>. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File No. SR-OCC-2004-08 and should be submitted on or before July 23, 2004.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>7</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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**SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-49929; File No. SR-OCC-2004-04]

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

June 28, 2004.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup>, notice is hereby given that on March 19, 2004, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change described in Items I, II, and III below, which items have been prepared primarily by OCC. The Commission is publishing this notice to solicit comments on the proposed rule change from interested parties.

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

OCC is seeking to amend its rules to reduce the threshold amounts applied to equity options for purposes of exercise by exception processing on expiration.

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

In its filing with the Commission, OCC 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. OCC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of these statements.<sup>2</sup>

*(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change*

The purpose of the proposed rule change is to amend OCC's Rule 805, "Expiration Date Exercise Procedure," which describes its expiration date exercise procedures including exercise by exception processing. Specifically, OCC proposes to reduce the threshold amounts used to determine equity options that are in the money for

purposes of exercise by exception processing.

**Background**

OCC has for years maintained an "exercise by exception" procedure. Under that procedure, options that are in the money at expiration by more than a specified threshold amount are exercised automatically unless the clearing member carrying the position instructs otherwise. Equity options are determined to be in the money or not based on the difference between the exercise price and the closing price of the underlying equity interest on the last trading day before expiration. The current threshold for equity options is \$.75 in a clearing member's customers' account and \$.25 in any other account (*i.e.*, firm and market makers' accounts).

**Discussion**

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

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

OCC also surveyed all clearing members to obtain their views and comments on the proposed change. Survey results demonstrated strong support across the membership for the change. Of 116 clearing members, 105 responded to the survey with 96 clearing members in favor of the threshold change.<sup>4</sup> Clearing members supporting the change confirmed the Roundtable's view that it would significantly reduce the number of instructions they are required to input

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

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

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

<sup>2</sup> The Commission has modified the text of the summaries prepared by OCC.

<sup>7</sup> 17 CFR 200.30-3(a)(12).