

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-49420; File No. SR-OCC-2003-08)

March 16, 2004

Self-Regulatory Organizations; The Options Clearing Corporation; Order Approving Proposed Rule Change Related to Delivery Settlement of Exercised Stock Options and Matured Stock Futures

I. Introduction

On August 22, 2003, The Options Clearing Corporation (“OCC”) filed with the Securities and Exchange Commission (“Commission”) proposed rule change SR-OCC-2003-08 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”).¹ Notice of the proposal was published in the Federal Register on February 13, 2004.² No comment letters were received. For the reasons discussed below, the Commission is approving the proposed rule change.

II. Description

OCC is Restructuring its rules applicable to delivery settlement of exercised stock options and matured stock futures.

The purpose of the proposed rule change is to:

(1) restructure OCC’s Rules applicable to physical settlement of exercised stock options and matured stock futures to reflect that such settlements are normally effected through the National Securities Clearing Corporation (“NSCC”) (i.e., the correspondent clearing corporation) with broker-to-broker (“BTB”) settlement procedures as a backup;

¹ 15 U.S.C. 78s(b)(1).

² Securities Exchange Act Release No. 49208 (February 9, 2004), 69 FR 7275.

(2) require that BTB settlements be made on a delivery-versus-payment (“DVP”) basis at The Depository Trust Company (“DTC”) unless OCC directs otherwise;

(3) revise OCC’s Rules applicable to delivery settlement effected on a BTB basis in order to reflect the enhanced system capabilities to track such settlements offered by ENCORE Release 4.0, which was installed on September 26, 2003;³

(4) revise OCC’s Rules relating to buy-ins and sell-outs to parallel NSCC’s Rules relating to buy-ins with respect to security balance orders; and

(5) revise OCC’s Rule relating to protect provisions so OCC rules parallel NSCC’s Rules relating to protect provisions with respect to security balance orders.

OCC’s By-Laws define an “underlying security” with respect to physically settled stock options and stock futures to mean the security or other asset that OCC is obligated to sell or to purchase upon exercise or maturity of the contract. Normally, underlying securities are delivered and paid for through the facilities of NSCC, but under certain circumstances settlement must be made on a BTB basis.⁴ If more than one underlying security is deliverable with respect to an exercised or matured contract, ENCORE Release 4.0 will treat the delivery of each underlying security as a separate settlement obligation. Payment of the aggregate purchase price for an underlying security will also be treated as a separate settlement obligation.⁵ As is the

³ ENCORE Release 4.0, which includes updated systems for settlement of physical delivery stock options and stock futures, is a major installation in OCC’s multiyear project to rewrite its clearance and settlement system.

⁴ Such circumstances include cases when NSCC excludes an underlying security from its continuous net settlement system or when OCC suspends a clearing member with pending settlements that have not yet been guaranteed by NSCC.

⁵ If the underlying security includes a cash component (e.g., cash in lieu amounts or the proceeds of a cash merger), the cash is settled through OCC’s cash settlement system.

case today, OCC will allocate a percentage of the exercise price or the final settlement price to each underlying security to be delivered.⁶

OCC will provide clearing members with Delivery Advices indicating whether settlements are to be effected through NSCC or on a BTB basis. Delivery Advices will specify settlement information for the clearing member including each underlying security to be delivered or received, the aggregate purchase price to be received or paid, the delivery date, the exercise price or final settlement price, the percentage of the exercise price allocated to the underlying security, the contra-clearing member to the settlement (for BTB settlements), and in the case of options, the activity (i.e., exercise or assignment) giving rise to the settlement obligation.

OCC will normally require that BTB settlements be made on a DVP basis through the facilities of DTC in order to avoid the need for OCC to margin “Herstatt risk” (i.e., the risk that a party may fail to make delivery or payment, as the case may be, after having itself received payment or delivery). However, the proposed rule change retains provisions for BTB settlements outside of DTC to provide for the rare case where an underlying security may not be DTC-eligible and reflects the enhanced ENCORE Release 4.0 system capabilities to process and monitor BTB settlements. For BTB settlements, the delivering clearing member will enter into ENCORE the number of units of the underlying security delivered (up to the total delivery requirement) and the amount received in respect thereof. The receiving clearing member will enter the number of units of the underlying security received and the amount paid. These entries can occur at different times. Only if the entries match (i.e., the number of units delivered equals

⁶ An adjustment of a contract in response to a corporate action may result in more than one underlying security being deliverable upon exercise or maturity. OCC By-Laws, Article VI, Section 11 and Article XIII, Section 4.

the number received or the amount received equals the amount paid, as the case may be) will the settlement obligation be discharged. In the event that the matched number of units or payment amounts is less than the total settlement obligation, only the deficiency will be treated as unsettled. An entry for which no response has been given by the second business day after its posting will be deemed settled provided that the specified delivery date has passed.

Contradictory entries will be treated as unmatched items and will be deemed unsettled. All unsettled obligations will be margined.⁷ Partial deliveries will be permitted but only in round lots except where an adjustment has resulted in a unit of trading other than a round lot, in which case partial deliveries will also be permitted in the odd lot component or multiples thereof.⁸

Chapter IX of OCC's Rules sets forth the delivery and payment rules for stock options and stock futures. Those Rules are being restructured to reflect that settlement normally occurs through NSCC with BTB settlement as the backup. Consistent with other OCC Rule Chapters, an introductory section has been added to Chapter IX of the Rules. This introductory section sets forth OCC's authority to designate a settlement method with regard to exercised stock options and matured stock futures, OCC's general policy to effect such settlement through NSCC, and OCC's authority to alter a previous designation of a settlement method. Former Rule 913, which concerns settlements through NSCC, has been renumbered as Rule 901. Other conforming changes have been made to the Rule to reflect the general policy that settlement will occur through NSCC.

⁷ The total obligation will continue to be margined until the installation of the margin subsystem.

⁸ For example, where the unit of trading for an adjusted contract is 133 shares, a writer of three assigned calls could deliver in increments of 100 shares, 200 shares, 300 shares, 33 shares, 66 shares, and/or 99 shares separately or in any combination up to a total of 399 shares.

Former Rules 901 through 907, which pertain to BTB settlements, have been renumbered as Rules 902 through 908. These Rules, along with Rule 909, have been modified to reflect the enhanced system for monitoring and tracking BTB settlements described above. Rules 910 and 911, which concern fails to deliver and receive, respectively, and 910A, which concerns protect procedures, have been modified to more closely parallel applicable provisions of NSCC's Rules. Obsolete rule references have been deleted, and conforming changes have been made to other By-Law and rule provisions as necessary.

III. Discussion

Section 17A(b)(3)(F) of the Act requires that the rules of a clearing agency be designed to perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions.⁹ The Commission finds that OCC's proposed rule change is consistent with this requirement because it will promote the prompt and accurate clearance and settlement of securities transactions by clarifying its Rules and enhancing its procedures with respect to the physical settlement of exercised options and matured security futures.

IV. 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.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (File No. SR-OCC-2003-08) be and hereby is approved.

⁹ 15 U.S.C. 78q-1(b)(3)(F).

For the Commission by the Division of Market Regulation, pursuant to delegated authority.¹⁰

Margaret H. McFarland
Deputy Secretary

¹⁰ 17 CFR 200.30-3(a)(12).

