

Regulatory Circular RG 96-96

Date: November 6, 1996

To: Exchange Membership
ATTENTION: SROPs, CROPs, ROPs and Operations Managers

From: Regulatory Services Division

Re: Exercise of American-Style Options

Regulatory Circular RG 96-11 was issued pursuant to Rule 11.1(a) for the purpose of clarifying the application of the present rules and procedures of The Options Clearing Corporation (“OCC”) to the exercise of American-style options. This revised circular incorporates changes in Exchange requirements which result from the adoption of Rule 24.18, effective November 18, 1996. Rule 24.18 limits the exercise of American-style index options to the “net long position” open in any options series at the time of exercise. A full explanation of Rule 24.18 can be found in RG96-94. Rule 24.18 does not effect OCC procedures for processing exercises in index options.

OCC Rule 801(d) permits the filing of exercise notices in respect of opening purchase transactions on the day that those transactions occur. OCC’s sequencing procedures for processing daily activity on every day other than the final trading day¹ provide that opening purchase transactions, opening sales transactions and closing purchase transactions effected on that day are processed before exercises, and that exercises are processed before that day’s closing sales transactions. As a result, OCC’s sequencing procedures make it operationally possible for an investor (whether a market-maker, a member firm or a customer) to exercise an option series on any day other than the final trading day to the full extent of the sum of:

(1) all the long positions in his account at the opening of that day

PLUS

(2)(a) *in the case of a firm or customer*, all positions resulting from the investor’s opening purchase transactions on that day without deduction for that day’s closing sales transactions, or
(b) *in the case of a market-maker*, all positions resulting from the market-maker’s purchase transactions that day² without deduction for the market-maker’s sales transactions effected that

¹ For the purposes of this circular, the final trading day is the expiration date of options that trade on their expiration date or the last trading day prior to the expiration date for all other options.

² Market-makers are not required to mark their transactions as opening or closing transactions.

day.

These procedures permit the holder of an American-style option to exercise the option at any time up to the exercise cut-off time on any trading day other than the final trading day, even if the holder has sold the option in a closing sale transaction during that trading day. Due to rather complex operational requirements OCC's sequencing procedures must remain unchanged. However, CBOE Rule 24.18 now prohibits certain index option exercises where closing transactions have been effected prior to exercise. This is illustrated by the following examples:

Example 1: Investor X is long 15 call option contracts of a series at the opening of a trading day other than the final trading day. During that day, X purchases 20 contracts of that series in opening purchase transactions and sells 10 contracts in closing sales transactions. X will be able under OCC's rules to exercise 35 contracts of that series that day. However, in the case of American-style index options only (i.e., OEX options), CBOE Rule 24.18 would prohibit a member who knows or has reason to know of the closing sale transactions from exercising on X's behalf more than the net long position of 25 contracts at any time at or after the closing sale of 10 contracts.

Example 2: Investor Y is short 20 call option contracts of a series at the opening of such a trading day. During the day, Y purchases 20 contracts of that series in opening purchase transactions. Y will be able to exercise 20 contracts of that series that day, and will remain short the 20 contracts. However, in the case of OEX option contracts, if Y's transactions had been effected in a market-maker's account, the purchase would have been deemed to have been a closing transaction for the purposes of CBOE Rule 24.18 and would have been offset by Y's short position, resulting in no net long position to exercise.

Example 3: Market-maker Z is short 100 call options contracts at the opening of that trading day. During the day, Z purchases 100 contracts and sells 100 contracts of that series. Z will be able to exercise 100 contracts of that series that day under OCC's rules. However, in the case of OEX option contracts, CBOE Rule 24.18 would prohibit Z from exercising any contracts without regard to the sale transactions, since the purchase transactions would be deemed to be closing transactions, and would be netted against his beginning short position, resulting

in no net long position to exercise.

Closing sales transactions are processed each day by OCC after exercises and before assignments. As a result, if the number of contracts sold by an investor in closing sales transactions exceeds the number of long positions remaining in the account after exercises are processed, the excess will be treated by OCC as having been sold in opening sales transactions and will be subject to being assigned exercises. As an illustration, if Investor X in the above example had exercised all 35 contracts, then (assuming there were no other open long positions or opening purchase transactions of that series in the Clearing Member's account at OCC) the closing sales transactions for the 10 contracts would have been processed by OCC as opening sales transactions and would have been subject to assignments of exercises.³

The foregoing describes the right of investors to exercise American-style options on trading days other than the final trading day as a result of the application of OCC's sequencing procedures. It should be noted, however, that a brokerage firm or Clearing Member could have procedures which would prevent an investor from effecting an exercise that would result in changing a closing sales transaction into an opening sales transaction. Among the reasons for such procedures would be to assure compliance with applicable position limits, suitability requirements, margin requirements, and the firm's procedures for permitting uncovered short options transactions.

OCC's sequencing procedures for processing activity on the final trading day provide for the processing of all purchases and sales transactions before exercises and assignments are processed. As a result, on the final trading day an investor may not exercise more than the investor's long positions remaining after netting any short position the investor may have at the opening that day and all options contracts the investor sells that day. Thus, on the final trading day Investor X in Example 1 above would have been able to exercise only 25 contracts, and Investor Y and Market-maker Z in Examples 2 and 3 would not have been able to exercise any contracts.

Questions concerning these exercise procedures can be directed to Patricia Cerny at (312) 786-7722, or to Karen Charleston at (312) 786-7724, in the Department of Market Regulation.

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If a transaction that is effected in a Clearing Member's customers' or firm account as a closing sales transaction is processed as an opening sales transaction as a result of an exercise, the Clearing Member may need to take steps to assure that OCC's records correctly reflect the open positions in the account.

(RG96-11, revised)