



NOTICE TO MEMBERS

No. 2007 – 086

July 26, 2007

REQUEST FOR COMMENTS

ADJUSTMENTS IN CONTRACT TERMS : MODIFICATIONS TO THE 10% RULE AND THE ELIMINATION OF ROUNDING STRIKE PRICES

AMENDMENTS TO RULES A-1 AND A-9 OF CDCC

Summary

The Board of Directors of the Canadian Derivatives Clearing Corporation (CDCC) approved amendments to Rules A-1 "Definitions" and A-9 "Adjustments in Contract Terms" similar to the rule modifications filed with and approved by the Securities and Exchange Commission (SEC) by the Options Clearing Corporation (OCC) regarding the elimination of rounding and changes to the cash dividend adjustment policies ("the 10% Rule").

The proposed amendments to CDCC's Rules include the primary objectives of more transparency and less uncertainty for CDCC's clearing members as well as ensuring that arbitrage opportunities between options on inter-listed stocks cleared by CDCC and OCC are eliminated.

You will find enclosed the analysis document of the rule amendments and the proposed regulatory amendments.

Process for Changes to the Rules

CDCC is a recognized self-regulatory organization (SRO) by the Autorité des marchés financiers (the Autorité) and as such, carries on activities as a clearing house and as an SRO in Québec.

The Board of Directors of CDCC has the power to approve the adoption or amendment of Rules of CDCC. The amendments are submitted to the Autorité for approval.

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Comments on the proposed amendments to Rules A-1 and A-9 of CDCC must be submitted within 30 days following the date of publication of the present notice in the bulletin of the Autorité des marchés financiers. Please submit your comments to:

Ms. Joëlle Saint-Arnault
Secretary
Canadian Derivatives Clearing Corporation
Tour de la Bourse
P.O. Box 61, 800 Victoria Square
Montréal, Québec H4Z 1A9
E-mail : legal@m-x.ca

A copy of these comments shall also be forwarded to the Autorité to :

Ms. Anne-Marie Beaudoin
Director – Secretariat of L’Autorité
Autorité des marchés financiers
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**AMENDMENT TO RULES A-1 and A-9:
Adjustments in Contract Terms:
Modifications to the 10% Rule and the
Elimination of Rounding Strike Prices**

A – Rationale

(i) Modification of the 10% Rule:

- The term commonly referred to by the market as the “10% Rule” refers to the practice whereby a cash dividend or distribution in an amount which does not exceed 10% of the market value (as of the close of trading on the trading day prior to the date on which such dividend or distribution is announced) of the Underlying Interest will, as a general rule, be deemed to be "ordinary cash dividends or distributions" within the meaning of paragraph (3) of Section A-902, and therefore would not normally be subject to an adjustment.
- Following the decision by the Options Clearing Corporation (OCC) to seek U.S. Securities and Exchange Commission (SEC) approval for a proposed change to the “10% Rule” and the likely impact to CDCC clearing members on a significant percentage of inter-listed shares, CDCC has revisited its current Rules regarding contract adjustments. OCC has advised the SEC that they will inform them in due course of the date for the implementation of the change to this Rule.
- CDCC’s rationale to revise the 10% Rule are the following:
 - Sizeable open interest, large contract volumes and modern option pricing models that take dividends into account, can make

not adjusting for dividends of less than 10% have a pronounced impact.

- Changes to the tax codes which now tax dividends more favourably have incited companies to pay more frequent “special” dividends.
- Economic disadvantages for call holders forced to exercise to capture dividends if adjustments are not made.
- A fixed dollar threshold as opposed to a percentage calculation allows for more transparency and less uncertainty.
- OCC has received approval from the SEC for this Rule change. CDCC should follow OCC’s lead, due to the large number of inter-listed options and CDCC’s Clearing Members wish that CDCC maintain consistency with OCC policies and / or processes.

(ii) Elimination of the 1/8 rounding:

CDCC’s rationale behind the elimination of rounding are the following:

- The inequities resulting from the rounding are considered significant as options trading volume and open interest have increased over the years.
- Larger positions and sophisticated trading techniques (spread strategies) can magnify the small single-contract rounding inequities into sizeable amounts.
- The fact that OCC has received approval from the SEC for this Rule change obliges CDCC to follow OCC’s lead, due to the large number of inter-listed options in the US.
- OCC will be implementing this approved Rule change on September 4, 2007

(iii) Amendments to Rule A-102

The definitions of "Ordinary Dividend or Distribution" or "Special Dividend or Distribution" were abrogated since they will no longer be applied because of the amendments to Rule A-9.

B -- Proposed Rule Changes

The proposed Rule changes can be summarized as follows:

Cash dividends or distributions:

- To define "ordinary" cash dividends as those dividends paid on a regular basis pursuant to such a dividend policy. Dividends (excluding those paid initially, or those increased dividends) paid outside of such a policy would be considered "special" and could trigger adjustment.
- Those dividends deemed "special" would qualify for adjustment if they exceed the fixed size threshold of \$15.00 per option contract.
- The same \$15.00 per option contract would apply to all cash distributions.

Elimination of Rounding Strike Prices:

The need for rounding strike prices can be avoided by using a different adjustment methodology which consists of adjusting the deliverable but not the strike price.

The basic elements of all adjustments under the new methodology are the following:

- Strike prices remain unchanged;
- The additional shares are added to the contract deliverable;
- The adjusted option continues to use 100 as the multiplier to extend premium and strike amounts;
- The number of contracts remains the same.

CDCC's proposed amendments include applying the new methodology to stock splits as well as stock distributions with the exception of 2 for 1 and 4 for 1 stock splits that do not require rounding of strike prices.

The inequities due to rounding would not be considered if option strike prices could be denominated in decimals. CDCC and MX systems can currently accommodate decimal strike prices but the participants cannot. The new methodology is an interim solution until the industry can accommodate decimal strike prices for equity options.

In addition, various clarifications of the applications of the current Rules have been included following comments from members. In particular, a specification of the treatment of a spin-off is included.

C -- The Issue

CDCC's current rules are out of line with what was proposed by OCC and approved by the SEC. As approximately one-third of MX options are inter-listed in the US, a situation where an adjustment would occur at OCC but not at CDCC must be avoided.

It should also be noted that CDCC's Membership has consistently requested that CDCC's rules be harmonized with that of OCC to ensure that there is no confusion for clients.

D – Objective and Public Interest

The objective of the amendments is to improve transparency in terms of decisions made by the Adjustments Committee. In addition, in this instance CDCC must align itself with OCC to ensure equivalent treatment of inter-listed options in the US and Canada.

On March 23, 2006, the Notice to Members No. 2006-039 was issued, requesting comments concerning the proposed Rule amendments. Very few comments were received; only one comment was received in respect of the “10% Rule”. This comment was favorable.

adjustments. This document includes the SEC’s approval.

E -- Process

The management of CDCC recommends the CDCC Board of Directors approval of the amended CDCC Rule A-9.

These Rule changes have been presented to the Risk Management Advisory Committee of CDCC.

F – References:

- Amendments to CDCC Rules A-1 and A-9, and its Interpretations and Policies
- CDCC Notice to Members of March 23, 2006
- OCC Rules, Section 11A
- OCC Notice 22966 dated May 11, 2007 concerning changes to the “10 percent” rule with regards to contract adjustments. This notice outlines the implementation strategy.
- OCC Notice 23016 dated May 24, 2007 concerning changes concerning rounding with regards to contract adjustments. This notice announces the implementation date of September 4, 2007.
- SEC document dated March 2, 2006 concerning OCC’s proposal to change practices surrounding contract adjustments.
- SEC document dated November 14, 2006 concerning OCC’s proposal to change practices surrounding contract adjustments.
- SEC document dated February 8, 2007 concerning OCC’s proposal to change practices surrounding contract

CANADIAN DERIVATIVES CLEARING CORPORATION

PART A - GENERAL

RULE A-1 DEFINITIONS

Section A-102 Definitions

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"Firm Account" - the account or accounts required to be established for ~~Exchange~~ Transactions of the Clearing Members pursuant to Sections B-102, B-103, C-102, C-103, D-102 and D-103.

~~"Ordinary Dividend or Distribution — a cash or stock dividend or distribution declared pursuant to a policy or practice of paying such dividends or distributions on a quarterly basis or other regular basis."~~

~~"Special Dividend or Distribution — a cash or stock dividend or distribution declared outside a regular policy or practice of paying such dividends or distributions."~~

"Underlying Interest" - Asset which underlies and determines the value of a Derivative Instrument. The Underlying Interest may be a commodity or a financial instrument such as a stock, a trust unit, a bond, a currency, a stock or economic index or any other asset.

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Amended 9/87, 12/89, 5/90, 4/91, 6/91, 1/92, 9/92, 9/93, 6/94, 9/96, 10/97; 5/98; 9/98; 3/99; 03/02, 04/03, 02/06, 00/07

RULE A-9 ADJUSTMENTS IN CONTRACT TERMS

SECTION A-901 APPLICATION

This Rule A-9 is applicable to Transactions where the Underlying Interest is an equity related product.

New 03/02; amended 04/03, 02/06

Section A-902 Adjustments in Terms

- (1) Whenever there is a dividend, stock dividend, stock distribution, stock split, trust unit split, reverse stock split, reverse trust unit split, rights offering, distribution, reorganization, recapitalization, reclassification or similar event in respect of any Underlying Interest, or a merger, consolidation, dissolution or liquidation of the issuer of any Underlying Interest, the number of Derivative Instruments, the Unit of Trading, the Exercise Price, and the Underlying Interest, or any of them, with respect to all outstanding Derivative Instruments open for trading in that Underlying Interest may be adjusted in accordance with this Section A-902.
- (2) Subject to paragraph ~~4210~~ of this Section A-902, all adjustments made pursuant to this Section A-902 shall be made by a committee (“Adjustments Committee”). The Adjustments Committee shall determine whether to make adjustments to reflect particular events in respect of an Underlying Interest, and the nature and extent of any such adjustment, based on its judgment as to what is appropriate for the protection of investors and the public interest, taking into account such factors as fairness to Clearing Members and the Corporation, the maintenance of a fair and orderly market in Derivative Instruments on the Underlying Interest, consistency of interpretation and practice, efficiency of exercise settlement procedures, and the coordination with other clearing agencies of the clearance and settlement of transactions in the Underlying Interest. The Adjustments Committee may, in addition to determining adjustments on a case-by-case basis, adopt statements of policy or interpretation having general application to specified types of events. Any such statements of policy or interpretation shall be disseminated to all Clearing Members, exchanges and securities regulatory authorities having jurisdiction over the Corporation. Every determination by the Adjustments Committee pursuant to this Section A-902 shall be within the sole discretion of the Adjustments Committee and shall be conclusive and binding on all Clearing Members and not subject to review, other than review by securities and regulatory authorities having jurisdiction over the Corporation pursuant to applicable provisions of the respective statutes.
- (3) It shall be the general rule that there will be no adjustments to reflect (i) ordinary cash dividends or distributions, or ordinary stock dividends or distributions, or ordinary trust unit dividends or distributions paid by the issuer of the Underlying Interest, or (ii) any cash dividend or distribution paid by the issuer of the Underlying Interest if such dividend or distribution is less than \$0.15 per share.

(4) (i) It shall be the general rule that in the case of a stock dividend, stock distribution, stock split, trust unit dividend, trust unit distribution, trust unit split or similar event whereby either one or three more whole numbers of additional whole shares of the Underlying Interest are issued with respect to each outstanding share, (eg. a 2 for 1 or a 4 for 1 stock split), each Derivatives Instrument covering that Underlying Interest shall be increased by the same number of additional contracts as the number of additional shares issued with respect to each share of the Underlying Interest. In the case of Options and similar instruments, the Exercise Price per share in effect immediately prior to such event shall be proportionately reduced, and the Unit of Trading shall remain the same.

(ii) It shall be the general rule with respect to any stock dividend, stock distribution, stock split, trust unit dividend, trust unit distribution or trust unit split whereby other than either one or three additional whole number of shares are issued, that each Derivative Instrument covering the affected Underlying Interest shall be adjusted, solely for purposes of determining the property deliverable upon settlement of the Derivatives Instrument, by increasing the Unit of Trading so as to include the number of shares or amount of property distributed (or decreasing the Unit of Trading to reflect the number of shares or amount of property eliminated, in the case of a reverse stock split or reverse trust unit split, combination of shares or trust units, or similar event).

~~(5)(i) For Options and similar instruments it shall be the general rule that in the case of a stock dividend, stock distribution, stock split or similar event whereby other than a whole number of shares of the Underlying Interest is issued in respect of each outstanding share, the Exercise Price in effect immediately prior to such event shall be proportionately reduced, and conversely, in the case of a reverse stock split, consolidation or combination of shares, or similar event, the Exercise Price in effect immediately prior to such event shall be proportionately increased. Whenever the Exercise Price with respect to an Option or similar instrument has been reduced or increased in accordance with this paragraph (5), the Unit of Trading shall be proportionately increased or reduced, as the case may be.~~

(iii) For all Transactions other than Options and similar instruments it shall be the general rule that in the case of a stock dividend, stock distribution, stock split, trust unit dividend, trust unit distribution, trust unit split or similar event whereby either one or more whole number of additional shares of the Underlying Interest are issued with respect to each outstanding share, each Derivative Instrument covering that Underlying Interest shall be increased by the same number of additional contracts as the number of additional shares issued with respect to each share of the Underlying Interest. ~~other than a whole number of shares of the Underlying Interest is issued in respect of each outstanding share, the Unit of Trading shall be proportionately increased and, conversely, in the case of a reverse stock split, consolidation or combination of shares or similar event, the Unit of Trading shall be proportionately reduced.~~

~~(5)~~ (6) It shall be the general rule that in the case of any distribution made with respect to shares of an Underlying Interest, other than ~~cash~~ ordinary dividends or distributions subject to paragraph (3) of this Section A-902 and other than dividends or distributions for which adjustments are provided in paragraphs (4) ~~or (5)~~ of this Section A-902, if an adjustment is determined by the Adjustments Committee to be appropriate,

for Options and similar instruments:

- (i) the Exercise Price in effect immediately prior to such event shall be reduced by the value per share of the distributed property, in which event the Unit of Trading shall not be adjusted, or
- (ii) the Unit of Trading in effect immediately prior to such event shall be adjusted so as to include the amount of property distributed with respect to the number of shares of the Underlying Interest represented by the Unit of Trading in effect prior to such adjustment, in which event the Exercise Price shall not be adjusted;

for all other Transactions for which an Exercise Price is not available:

- (+) the Unit of Trading in effect immediately prior to such event shall be adjusted so as to include the amount of property distributed with respect to the number of shares of the Underlying Interest represented by the Unit of Trading in effect prior to such adjustment.

The Adjustments Committee shall, with respect to adjustments under this paragraph or any other paragraph of this Section A-902, have the authority to determine the value of distributed property.

- (67) In the case of any event for which adjustments are not provided in any of the foregoing paragraphs of this Section A-902, the Adjustments Committee may make such adjustments, if any, with respect to the Derivative Instrument affected by such event as the Adjustments Committee determines.

- (78) Adjustments pursuant to this Section A-902 as a general rule shall become effective in respect of Transactions outstanding on the "ex-dividend date" established by the exchange or exchanges on which the Underlying Interest is traded. In the event that the "ex-dividend date" for an Underlying Interest traded on exchanges differs from one exchange to another, the Corporation shall deem the earliest date to be the "ex-dividend date" for the purposes of this Section A-902. "Ex-dividend dates" established by any other exchange or exchanges on which an Underlying Interest may be traded shall be disregarded.

~~(9) It shall be the general rule that~~

- ~~(i) all adjustments of the Exercise Price of an outstanding Option or similar instrument shall be rounded to the nearest 1/8 of a dollar, and all adjustments of the Unit of Trading shall be rounded down to eliminate any fraction, and~~

- ~~(ii) if the Unit of Trading is rounded down to eliminate a fraction, the adjusted Exercise Price shall be further adjusted, to the nearest 1/8 of a dollar, to reflect any diminution in the value of the Option or similar instrument resulting from the elimination of the fraction.~~

- (108) Notwithstanding the general rules set forth in paragraphs (3) through (79) of this Section A-902 or which may be set forth as interpretations and policies under this Section A-902, the Adjustments Committee shall have the power to make exceptions in those cases or groups of cases in which, in applying the standards set forth in paragraph (2) thereof the Adjustments Committee shall determine such exceptions to be appropriate. However, the general rules shall be applied unless the Adjustments Committee affirmatively determines to make an exception in a particular case or group of cases.

- (191) The Adjustments Committee shall consist of two designated representatives of each exchange that lists the Derivative Instrument that the adjustments apply to, and one representative of the Corporation. The quorum for transacting business at any meeting of the Adjustments Committee shall be one from each exchange that lists the Derivative Instrument that the adjustments apply to and one from the Corporation. The vote of a majority of the members of the Adjustments Committee in attendance at any meeting shall constitute the determination of the Adjustments Committee. The Adjustments Committee may transact its business by means of a telephonic, electronic or other communication facility that permits all participants to communicate appropriately with each other during the meeting. Notwithstanding the foregoing provisions of this paragraph, any representative of the Corporation or of an exchange may designate any other representative of the Corporation or of the exchange, respectively, to serve in his place at any meeting of the Adjustments Committee. In the event of such designation, the designee, for the purposes of such meeting, shall have all of the powers and duties under this Section A-902 of the person designating him. Neither the Corporation nor any exchange shall designate to serve on the Adjustment Committee, any person, who, to the knowledge of the self-regulatory organization designating such person, is the beneficial holder of a long or short position in the Derivative Instrument as to which the Adjustments Committee is to make a determination. As stipulated in the By-laws of the Corporation, a majority of the members of the Adjustments Committee shall be resident Canadians.
- (102) In the event that the Adjustments Committee is unable to determine whether to make adjustments in any particular case, the matter shall be referred to the Board for a determination.

INTERPRETATIONS AND POLICIES

(93)(i) Cash dividends or distributions (regardless of size) paid by the issuer of the Underlying Interest which the Corporation considers to have been declared pursuant to a policy or practice of paying such dividends or distributions on a quarterly basis or other regular basis, as well as resumption of dividends or distributions will, as a general rule, be deemed to be "ordinary cash dividends or distributions" within the meaning of paragraph (3) of this Section A-902. Cash dividends or distributions paid by the issuer of the Underlying Interest which are paid outside of a policy or practice of paying such dividends or distributions on a quarterly basis or other regular basis will be deemed to be "special cash dividends or distributions" if they exceed the threshold of \$15.00 per Option contract.

(ii) Stock dividends or distributions, or trust unit dividends or distributions paid by the issuer of the Underlying Interest in an aggregate amount that per dividend or distribution does not exceed 10% of the number of shares of the Underlying Interest outstanding as of the close of trading on the declaration date, and which the Corporation considers to have been declared pursuant to a policy or practice of paying such dividends or distributions on a quarterly basis or other regular basis. A cash dividend or distribution in an amount which does not exceed 10% of the market value (as of the close of trading on the trading day prior to the date on which such dividend or distribution is announced) of the Underlying Interest will, as a general rule, be deemed to be "ordinary stock cash dividends or distributions" or "ordinary trust unit dividends or distributions" within the meaning of paragraph (3) of this Section A-902. The Adjustments Committee will determine on a case by case basis whether other cash dividends or distributions are "ordinary cash dividends or distributions" or whether they are dividends or distributions for which adjustments should be made.

(iii) Cash dividends or distributions paid by the issuer of the Underlying Interest which the Corporation considers to have been paid outside of a regular policy or practice of paying such dividends or distributions and that exceeds \$0.15 per share will be deemed to be "special cash dividends or distributions".

(iv) Stock dividends or distributions, or trust unit dividends or distributions paid by the issuer of the Underlying Interest which the Corporation considers to have been declared outside of a regular policy and that exceeds 10% of the number of shares of the Underlying Interest will be deemed to be "special stock dividends or distributions" or "special trust unit dividends or distributions".

Nevertheless, the Adjustments Committee will determine, on its sole discretion, on a case-by-case basis whether other dividends or distributions are "ordinary dividends or distributions" or whether they are dividends or distributions for which adjustments should be made, regardless of the threshold of \$0.15 per share applied to "special dividends or distributions".

~~Where the Adjustments Committee determines to adjust for a cash dividend or distribution, the adjustments shall be made in accordance with paragraph (6) of this Section A-902.~~

(96) (i)—Adjustments will not ordinarily be made to reflect the issuance of so-called "poison pill" rights that are not immediately exercisable, trade as a unit or automatically with the Underlying Interest, and may be redeemed by the issuer. In the event such rights become exercisable, begin to trade separately from the Underlying Interest, or are redeemed, the Adjustments Committee will determine whether adjustments are appropriate.

(ii) Adjustments will not be made to reflect a take-over bid or issuer bid made for the Underlying Interest, whether such offer is for cash, Securities or other property. This policy will apply without regard to whether the price of the Underlying Interest may be favourably or adversely affected by the offer or whether the offer may be deemed to be "coercive". Outstanding Transactions ordinarily will be adjusted to reflect a merger, amalgamation, arrangement or similar event that becomes effective following the completion of a take-over bid.

(iii) Adjustments will not be made to reflect changes in the capital structure of an issuer where all of the Underlying Interest in the hands of the public (other than dissenters' shares) are not changed into another Security, cash or other property. For example, adjustments will not be made merely to reflect the issuance (except as a distribution on an Underlying Interest) of new or additional debt, stock, trust units, or options, warrants or other securities convertible into or exercisable for the Underlying Interest, the refinancing of the issuer's outstanding debt, the repurchase by the issuer of less than all of the Underlying Interest outstanding or the sale by the issuer of significant capital assets.

(iv) When an Underlying Interest is converted into a right to receive a fixed amount of cash, such as in a merger, amalgamation, arrangement or similar event, outstanding Options or similar instruments will be adjusted to require the delivery upon exercise of cash in an amount per share equal to the conversion price. As a result of such adjustments, the value of all outstanding In-the-money Options or similar instruments will become fixed, and all At-the-money and Out-of-the-money Options or similar instruments will become worthless.

(v) In the case of a spin off or similar event by the issuer of an Underlying Interest which results in a property distribution, Derivatives Instruments will be adjusted to reflect such distribution. The value of the property distributed shall be reflected in the shares deliverable.

(vi) In the case of a corporate reorganization or similar occurrence by the issuer of an Underlying Interest which results in an automatic share-for-share exchange of the Underlying Interest for shares of another class in the capital of the issuer or in the resulting company, the Transactions on the Underlying Interest will ordinarily be adjusted to require delivery upon exercise of a like number of units of the shares of such other class or of the resulting company. Because the Securities are generally exchanged only on the books of the issuer and/or the resulting company, as the case may be, and are generally not exchanged physically, deliverable shares will ordinarily include certificates that are denominated on their face as shares in the original class of shares of the original issuer, but which, as a result of the corporate transaction, represent shares in the other class or in the resulting company, as the case may be.

(vii) When an Underlying Interest is converted in whole or in part into a debt security and/or a preferred stock, as in a merger, and interest or dividends on such debt security or preferred stock are payable in the form of additional units thereof, outstanding option contracts that have been adjusted to call for delivery of such debt security or preferred stock shall be further adjusted, effective as of the ex-date for each payment of interest or dividends thereon, to call for delivery of the securities distributed as interest or dividends thereon.

(viii) Notwithstanding Interpretation and Policy (03) of this Section A-902, a distribution of short-term and long-term capital gains in respect of index participation units by the issuer thereof, if such distribution equals or exceeds \$ 0.15 per unit shall not, as a general rule, be deemed to be "ordinary dividends or distributions" within the meaning of paragraph (3) of this Section A-902, and adjustments of the terms of Options on such units for any such distributions shall be made in accordance with paragraph (6) of this Section A-902 unless the Adjustments Committee determines, on a case-by-case basis, not to adjust for such a distribution.

Amended 7/88, 1/89, 6/96, 4/98, 03/02, 04/03, 02/06, 00/07