Standardized Options – Who's Your Daddy?

September 7, 2011 by Keith Paul Bishop

A securities call option is a derivative security representing the right, but not the obligation, to acquire an underlying security. When the person selling an option is also the issuer of the underlying security, then there is no question that that person is also the issuer of the option. *See* Section 2(a)(4) of the Securities Act of 1933 and California Corporations Code Section 25010.

The Options Clearing Corporation

Exchange traded options involve a different dynamic. The SEC first permitted national securities exchanges to trade standardized options in the early 1970s. Because the option holder (*i.e.,* the person holding the right to acquire the underlying security) must look to the option writer (*i.e.,* the person obligated to perform), clearing agencies, such as The Options Clearing Corporation, were created so that the option holders could look to the systems created by a clearing agency's rules, rather than the individual option writers for performance. Founded in 1973, the OCC claims to be the world's largest equity derivatives clearing organization. The SEC determined that the OCC should be deemed the issuer of standardized options. *See* Release No. 33-6411 (June 24, 1982) [47 FR 28688]. Initially, all transactions in standardized options were registered under the Securities Act on Form S-1. This must have been an exceedingly cumbersome process. It wasn't until 2003 that the SEC exempted standardized options from all provisions of the Securities Act (other than the anti-fraud provisions of Section 17) provided that the options are *issued* by a registered clearing agency and traded on a national securities exchange registered under Section 6(a) of the Securities Exchange Act of 1934 or on a national securities association registered under Section 15A(a) of the Exchange Act. SEC Rule 238 and Release Nos. 33-8171; 34-47082.

California's Limited Exemption For Exchange Traded Options

In 1985, the Commissioner adopted Rule 260.105.35 exempting from the qualification requirements of Sections 25110 (issuer transactions) and 25130 (nonissuer transactions) the offer and sale of exchange traded options on stock indices or guarantees thereof, provided, among other things, those options are offered and sold by the OCC on an exchange approved by the Commissioner. Notably, this exemption is limited to options on stock indices (*i.e.,* measures of the prices of groups of stocks) and guarantees and does not refer to options on individual equity securities. In contrast, Section 201(6) of the Uniform Securities Act (2002) is much broader - exempting, among other things, "an option or similar derivative security on a security or index of securities . . . issued by a clearing

agency registered under the Securities Exchange Act of 1934 and listed or designated for trading on a national securities exchange, a facility of a national securities exchange, or a facility of a national securities assocation registered under the Securities Exchange Act of 1934 . . .".

Section 18 of the Securities Act

From a state securities law perspective, what is the status of these standardized options? If the options are listed or approved for listing on any exchange named in Section 18(b)(1)(A) or SEC Rule 146, then they are "covered securities" and state qualification or registration requirements are preempted pursuant to Section 18 of the Securities Act. The question becomes more interesting when the options are not themselves listed on an exchange named in either the statute or rule. For a chart listing the national securities exchanges registered under Section 6(a) of the Exchange Act and indicating whether they are named in the statute or rule, see my earlier post, "California and the Certification of Stock Exchanges". As noted above, the Commissioner by rule has exempted only exchange-traded options on stock indices and guarantees thereof that are approved on certain exchanges.

The C2 Options Exchange Petition

Recently, the C2 Options Exchange, Incorporated submitted a this rulemaking petition asking that the SEC amend Rule 146(b) to include the C2 exchange. (As I noted in "New U.S. Exchange – 'It's Better Than A Magic Latern Show'", the BATS exchange recently submitted a similar petition.) The C2 exchange is an all electronic exchange owned by CBOE Holdings, Inc., which is the holding company for the Chicago Board Options Exchange, Incorporated.

The C2 exchange argues in its petition that OCC issued options that are not listed on an exchange named in Section 18(b)(1)(A) or Rule 146 are nevertheless covered securities. For this conclusion, C2 points out that pursuant to Section 18(b)(1)(C) a "covered security" includes a security of the same issuer that is equal in seniority to a security that listed on a named exchange. C2 asserts that every exhange traded option is issued by the same issuer – the OCC. C2 also claims that most standardized options are listed on markets named in the statute or rule and that all options issued by the OCC are "equal in seniority". This is why it is important to know who the issuer is. If the issuer is considered the company that issued the underlying security, then the requirement that the security be of the same issuer would not be met.

A Paradise of Anomaly?

This state of affairs seems anomalous. Unless the options are themselves are covered securities, options issued by an issuer will be subject to California's qualification requirements regardless of whether the underlying security is a covered security. (For an explanation of why this is so, see this post.) According to the C2 exchange, however, a standardized option is not subject to qualification under state blue sky laws if it issued by a third party, such as the OCC, that issues at least one option that is a covered security.