

May 2010 Supplement to Characteristics and Risks of Standardized Options

The February 1994 version of the booklet entitled *Characteristics and Risks of Standardized Options* (the "Booklet") is amended as provided below to accommodate the introduction of options on index-linked securities.

1. *The first full paragraph on page 2 of the Booklet, as previously amended in the May 2007 and September 2008 Supplements, is replaced by the following:*

Each options market selects the underlying interests on which options are traded on that market. Options are currently available covering four types of underlying interests: equity securities (which term includes "fund shares" described in Chapter III), indexes (including stock, variability, strategy-based and dividend indexes), debt securities and credit events, and foreign currencies. Options on other types of underlying interests may become available in the future.

2. *The first three paragraphs in Chapter V appearing on page 29 of the Booklet, as amended by the June 2007 Supplement, are replaced by the following four paragraphs:*

Three kinds of debt options have been approved for trading at the date of this booklet. Two of these kinds are sometimes referred to as price-based options. Price-based options are options which give their holders the right either to purchase or sell a specified underlying debt security or to receive a cash settlement payment based on the value of an underlying debt security (depending on whether the options are physical delivery or cash-settled options). Options on securities issued by the U.S. Treasury are one kind of price-based debt options. Options on index-linked securities are a second kind of price-based debt options. An "index-linked security" is a debt security that trades on one or more exchanges similarly to an equity security, and that provides a cash return to its owner based on the

performance of a "reference asset" which may, for example, consist of a securities or commodities index, a futures index, a physical commodity, a foreign currency, another debt security, or some combination of the above. The term "index" in the context of an index-linked security has a broader meaning than that set forth in Chapter IV since, in the context of an index-linked security, the term is a synonym for the term "reference asset" and is not limited to securities indexes.

A third kind of debt options, called yield-based options, are options that are cash-settled based on the difference between the exercise price and the value of an underlying yield. At the date of this booklet, all yield-based options that have been approved for trading are based on the yields of U.S. Treasury securities. The distinctions between price-based and yield-based options are fundamental and should be understood by readers interested in investing in debt options.

A fourth kind of options, called credit default options, are also described in this Chapter. Credit default options are cash-settled options that are related to the creditworthiness of issuers or guarantors of debt securities, and are exercised upon confirmation of a credit event affecting an underlying debt security or securities.

The principal risks of holders and writers of debt options and credit default options are discussed in Chapter X. Readers interested in buying or writing debt options or credit default options should not only read this chapter but should also carefully read Chapter X, particularly the discussions under the headings "Risks of Option Holders," "Risks of Option Writers," "Other Risks," "Special Risks of Debt Options," and "Special Risks of Credit Default Options."

3. The first paragraph on page 31, immediately following the heading "Treasury Securities," is replaced by the following:

The underlying debt securities of one kind of price-based options that have been approved for trading at the date of this booklet, and the debt securities from which the underlying yields of yield-based options are derived, are Treasury securities — e.g., 30-year Treasury bonds, 10-year Treasury notes, 5-year Treasury notes and Treasury bills.

4. *The following section is inserted immediately after the last paragraph on page 34 of the Booklet prior to the paragraphs inserted by the June 2007 Supplement:*

OPTIONS ON CONVENTIONAL INDEX-LINKED SECURITIES

Index-linked securities are debt securities that trade on exchanges similarly to equity securities. Index-linked securities are issued by financial institutions such as banks and may take the form of trust certificates, units or some other interest. An index-linked security provides owners with a cash return based on the performance of a "reference asset" which may, for example, consist of a securities or commodities index, a futures index, a physical commodity, a foreign currency, another debt security, or some combination of the above. References in this booklet to "units" of underlying index-linked securities include these various forms of interests. The term "index" in the context of an index-linked security has a broader meaning than that set forth in Chapter IV because, in the context of an index-linked security, the term is a synonym for the term "reference asset" and is not limited to securities indexes. As of the date of this Supplement, options are approved to be traded on conventional index-linked securities, but not on leveraged or inverse index-linked securities.

As a general rule, a single index-linked security option covers 100 units of the underlying security. However, it is possible that the number of underlying units covered by an index-linked security option would be adjusted after the option is issued if an adjustment panel determines, as described below, that it is appropriate to make such an adjustment.

The exercise prices of options on index-linked securities that are approved for trading at the date of this booklet are stated in U.S. dollars per unit. As with a stock option, the exercise price of an index-linked security option must be multiplied by the number of units underlying the option in order to determine the aggregate exercise price and aggregate premium of the option.

Index-linked securities generally have a term of at least one year but not greater than thirty years. Index-linked securities may be redeemable at certain intervals at the option of the holder through the issuer at a price related to the applicable underlying reference asset,

subject to a minimum redemption increment and other conditions. Redemption of index-linked securities may affect the market for the securities by reducing the quantity of securities available for trading. Index-linked securities may return less than the principal originally invested, regardless of the solvency of the issuer of the securities.

An adjustment may be made to certain of the standardized terms of outstanding options on index-linked securities if a particular event occurs that is determined by an adjustment panel to warrant the adjustment. As in the case of stock options, an adjustment panel for options on index-linked securities would be composed of representatives of one or more U.S. options markets and a representative of OCC, as described above in Chapter II.

As a general rule, if the issuer of a particular index-linked security calls the entire issue of the security, the event will be treated like an event in which an underlying equity security is converted into the right to receive a fixed amount of cash. If an event is treated in this manner, when the issue of index-linked securities is called, outstanding options on that issue will be adjusted to require the delivery upon exercise of a fixed amount of cash, and trading in the options will ordinarily cease. As a result, after such an adjustment is made all options on that security that are not in the money will become worthless and all that are in the money will have no time value. The expiration date of the options will ordinarily be accelerated to fall on or shortly after the date on which the underlying security is called. Holders of an in-the-money option whose expiration date is accelerated must be prepared to exercise that option prior to the accelerated exercise cut-off time in order to prevent the option from expiring unexercised. See the discussion in Chapter VIII under "How to Exercise." Writers of options whose expiration date is subject to being accelerated bear the risk that, in the event of such an acceleration, they may be assigned an exercise notice and be required to perform their obligations as writers prior to the original expiration date. When the expiration date of an option is accelerated, no adjustment will be made to compensate for the accelerated expiration date. As with a stock option whose underlying security is converted into a right to receive a fixed amount of cash,

there is no assurance that the exercise settlement date for an accelerated index-linked security option will coincide with the date on which the cash payment to the holders of the underlying security becomes available from the issuer. Covered writers of an accelerated option may therefore be required to pay the cash amount in respect of the option before they receive the cash payment on the underlying security.

In contrast to a situation in which the issuer calls an entire issue of index-linked securities, as a general rule no adjustment will be made to the terms of options on index-linked securities in the event of a call of less than an entire issue of the securities. In addition, as a general rule, no adjustment will be made to the terms of options on index-linked securities for any interest payment on the securities.

As is the case with equity options, an adjustment panel with respect to options on index-linked securities has discretion to make exceptions to the general rules described above.

5. *The following paragraph is inserted near the top of page 58 of the Booklet, after the paragraph inserted by the June 2008 Supplement and immediately before the caption "Risks of Option Holders":*

The value of an option is affected by the value of the underlying interest. It is beyond the scope of this booklet to discuss the characteristics or risks of underlying interests. If a description or risk factor is mentioned in this booklet with respect to a particular class of underlying interest, you should not assume that the same statements will be made with respect to all underlying interests discussed herein to which they may be applicable. You should look to disclosures made by issuers of underlying securities or information provided by publishers of underlying indexes and to information available from your broker or other sources to determine the nature and risks of the interests underlying the options that you trade. Some underlying interests may themselves involve a high degree of risk. Where the value of an underlying security is based in whole or in part on the performance of an index, information provided by the publisher of the referenced index, as well as financial and other disclosures made by the issuer of the underlying security regarding the issuer's ability to perform its obligations, may be relevant.

6. *The following paragraph is inserted on page 78 of the Booklet, immediately following the caption "Special Risks of Debt Options":*

The risks described in paragraphs 1 through 9 of this section relate to debt options other than options on index-linked securities. The risks described in paragraphs 10 and 11 relate exclusively to options on index-linked securities.

7. *The following new paragraphs are inserted on page 82 of the Booklet immediately before the section in Chapter X titled "Special Risks of Foreign Currency Options":*

10. In the event of a shortage of index-linked securities that are deliverable on exercise of a physical delivery option, OCC may impose special exercise settlement procedures similar to those applicable to stock options, including the fixing of a cash settlement price payable by writers who would otherwise be unable to meet their delivery obligations (see the discussion in Chapter VIII under "Settlement"), and/or prohibit the exercise of puts by holders who would be unable to meet the resulting settlement obligations (see paragraph 5 under "Risks of Option Holders" above).

11. In the event that an issuer of an index-linked security calls the entire issue of the security, outstanding options on that issue will be adjusted to require delivery upon exercise of a fixed amount of cash. After such an adjustment, all options on that security that are not in the money will become worthless, and all that are in the money will have no time value. Holders must be prepared to exercise the option to prevent the option from expiring unexercised, and writers must be prepared to perform their obligations prior to the accelerated exercise cut-off date. There is no assurance that the exercise settlement date for an index-linked security option will coincide with the date on which the cash payment to the holders of the underlying security becomes available from the issuer, and covered writers of an accelerated option therefore may be required to pay the cash amount in respect of the option before they receive cash payment on the underlying security.