X-pand into the Future

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Corporate Actions for Equity Derivatives: Harmonization of Handling

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Content may be most important for:	**Attachment:**
Ü All departments	Updated sections of Contract Specifications for Futures Contracts and Options Contracts at Eurex Deutschland and Eurex Zürich

Summary:

In their meeting on September 20, 2006 the Management Boards of the Eurex Exchanges decided to change the handling of corporate actions for equity derivatives. The changes will affect the following three areas:

- Company takeovers and mergers
- Extraordinary dividends
- Cash settlement in case of execution

All changes will come into effect for all equity options and futures listed at Eurex on **January 1, 2007**.

Corporate Actions for Equity Derivatives: Harmonization of Handling

After intensive consultations with representatives of the circle of Eurex Members and other derivatives exchanges, the Management Boards of the Eurex Exchanges decided in their meeting on September 20, 2006, to carry out a number of essential modifications of the contract specifications regarding handling of corporate actions. For the exact wording, please refer to the updated sections of Contract Specifications for Futures Contracts and Options Contracts at Eurex Deutschland and Eurex Zürich, which can be found attached to this circular.

The following text summarizes the modifications.

1. Company Mergers and Takeovers

As a general rule, there is a distinction between offers consisting of shares only, of a combination of shares and cash payment, or cash payment only.

If a transaction is done by means of a share offer, generally the former underlying is replaced by the offered underlying in the respective conversion ratio. Trading in the option and/or futures contract on the new underlying is continued. In the future, adjustment of the respective contracts will be triggered only by successful conclusion of a transaction. The additional restriction of a minimum acceptance threshold of 95 percent formerly required for takeover offers on German stock corporations will no longer be valid. This procedure also applies for mixed shares/cash offers. At the point in time the offer is made public, however, the share of equities needs to be at least 33 percent of the total value.

In case of a cash offer, contracts are currently settled according to their intrinsic value. Thereby, the point in time of settlement may be well before the original expiry date of the respective options contract. When the amended version of the Contract Specifications will become effective on January 1, 2007, transactions that are taking place in cash will be settled according to the “Fair Value Method“, once the transaction has been concluded successfully. The same procedure applies for mixed shares/cash compensation offers, for which the cash amount is at least 67 percent at the point in time the offer is announced.

Fair value of an option is calculated by means of the options price model used by Eurex (Cox-Ross-Rubinstein binomial model). Calculation of each options series takes place on settlement day allowing for the value of the underlying based on the offer, the risk-free interest rate based on the option’s maturity as well as estimated dividends accumulating up to the original expiry date of the option. Furthermore, volatility will be determined for each strike price. For determination of each volatility, the following applies:

From the settlement prices of the individual series on the ten days before the first public announcement of a takeover, the implicit volatility is calculated. As a second step, an average volatility is determined. Every highest and lowest value shall be excluded from the calculation of the average. For all options that are even more out-of-the-money than the first option that is settled with the minimal tick (e.g., EUR 0.01), the implicit volatility of this option is continued.

In case of equity futures, settlement is done on the basis of the value of the underlying based on the offer and allowing for the risk-free interest rate of the remaining maturity and, if applicable, estimated dividends.

By means of introduction of this so-called Fair Value Method, harmonization is achieved with Euronext.Liffe in handling takeovers as requested by market participants.

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2. Extraordinary dividends

At Eurex, adjustments of contract sizes or strike prices for derivatives on single stocks are only done in case of extraordinary dividends, but not in case of “ordinary” dividends. In several countries, distribution of ordinary dividends is done by means of re-payment of nominal value. In case of options and futures contracts on shares of Swiss companies, the question whether or not adjustment of options and futures contracts will take place is also dependant on how high the dividend of the previous year was. In the future, there will be no further reference to the previous year’s dividend, i.e. re-payment of nominal value that takes place in the context of an ordinary dividend distribution will be treated as such and will not lead to any adjustments of options or futures contracts.
Furthermore, improved communication between European exchanges shall lead to consolidation in a way that distribution of dividend in one share on which derivatives are listed at several exchanges will no longer be handled as ordinary dividend in one market and as extraordinary dividend in another market.

3. Cash settlement upon execution

Another change refers to technical settlement of contracts upon execution of capital-adjusted series. Currently, cash settlement is done either for the fractional part of the contract size (e.g., for a contract size of 103.1456, the amount of 0.1456 is settled in cash) or for the part that exceeds the standard contract size (e.g., for a contract size of 103.1456 the amount of 3.1456 is settled in cash).

In the future, cash settlement upon execution of capital-adjusted series will only take place for the fractional part of the contract size, i.e., as a general rule, the part of the contract size that refers to the integral part of the contract size needs to be settled upon execution.

All modifications mentioned above will become effective as of January 1, 2007. For transactions announced in the time span before this date, the current version of the contract specifications shall apply, even though their entry will take place after January 1, 2007.

Frankfurt, October 9, 2006

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[….]

1.6 Subpart: Contract Specifications for Futures Contracts on Shares

The following subpart contains the contract form for Futures Contracts on Shares ("Shares-Futures Contracts").

[….]

1.6.7 ~~Amendments~~ Alterations to the Contract Sizes~~,~~ ~~Exercise Prices~~ and Expiration Days of ~~Shares~~ Futures contracts on Shares

(1) Should dividends ~~or payments similar to dividends~~ incur, an adjustment of the Futures Contracts does not take place.

Dividends are also capital reductions through reductions of the nominal amount of the shares - in case a company pays the amount of the reduction of the nominal amount instead of a dividend or if such amount is part of the regular dividend - as well as guaranteed cash compensations of subscription rights and other similar assets which are offered instead of a dividend.

(2) Extraordinarily ~~or disproportionately~~ high dividends, bonuses or other cash distributions as well as dividends which are not distributed within the scope of the regular dividend policy or which the company declares as non-regular dividends (e.g. special dividends, anniversary bonus) are not regarded as dividends within the meaning of paragraph 1. In case such distributions incur, ~~the price of the Future Contract is reduced by an amount which makes allowance for the value of the distribution after measure of a formula determined by the Eurex Exchanges. The number of shares underlying the contract will be increased accordingly~~ the futures contract shall be adjusted by multiplying the original contract size by the R-factor. The R-factor is described in the Eurex User Manual System Overview and Information Manual. At the same time, the settlement prices shall be adjusted accordingly, so that the original contract value remains unchanged.

(3) If subscription rights are granted, ~~the settlement price of Shares-Futures contracts concluded on the previous day is reduced by an amount which makes allowance for the value of the distribution after measure of a formula determined by the Eurex Exchanges; the number of shares underlying the Shares-Futues contract will be increased accordingly~~ the futures contract shall be adjusted by multiplying the original contract size by the R-factor; at the same time, the settlement prices shall be adjusted accordingly, so that the original contract value remains unchanged.

(4) With capital increases ~~from the resources~~out of company reserves ~~of the company issuing shares which underlie the Futures Contract~~, the number of shares underlying the Shares-Futures contract increases

according to the ratio of their portion of the former registered share capital of the company issuing such shares. ~~The final settlement price of the Shares-Futures contract is reduced by a value corresponding said ratio.~~ At the same time, the settlement prices shall be adjusted accordingly, so that the original contract value remains unchanged.

With capital reductions ~~of the company issuing shares which underlie the Futures Contract~~, the ~~price as well as the~~ contract size as well as the settlement prices of the futures contracts remain unchanged if the capital reduction is carried out by means of reduction of the nominal value of the shares. With capital reductions by way of redeeming shares or by consolidation, the number of shares underlying the futures contract will be reduced according to the reduction ratio. At the same time, ~~the final settlement price of the futures increases by a value correspondent to aforementioned ratio.~~ the settlement prices shall be adjusted accordingly, so that the original contract value remains unchanged.~~Non-intregral shares are cleared in cash.~~

(5) The ~~final settlement price of the futures contract~~contract size in case of share splits of shares underlying the futures contract ~~is reduced~~increases correspondent to the ratio of the share split. At the same time, the settlement prices shall be adjusted accordingly, so that the original contract value remains unchanged.~~The contract size and/or the number of contracts changes according to the ratio of the share split.~~

(~~5~~6) In case of changes in capital (paragraph 3 and 4) and adjustments pursuant to paragraph 2, all orders and quotes in the order book in the respective futures contracts will be deleted by the Eurex exchanges. The Eurex exchanges inform all exchange participants of an imminent cancellation.

(~~6~~7) If shareholders are offered a conversion of ~~old~~ shares ~~into new shares or shares of another stock corporation~~ in ~~cases~~the course ~~regulated by law (e.g.~~of mergers, ~~consolidation, conversion of share forms by change of Articles of Association),~~or acquisitions, the futures contracts ~~concerned whose expiration day is after the discontinuation of trading of the old shares at a stock exchange ("cutoff date")~~ will be adjusted, provided that the transaction has been effectively executed ~~as follows:~~. A transaction is deemed executed effectively as soon as it is entered in the respective register (in case of merger) or in case the irrevocable result of an offer is announced by the acquiring company. The futures contracts shall be adjusted with effect from the day on which the compensation specified in the conversion offer is available to the shareholders.

~~The adjustment takes place on the Exchange day following the cutoff date. The old shares will be replaced by the new shares issued in the course of the merger or by other shares offered by the stock corporation in the same quantity. In all other cases in which the conversion rate is other than 1:1 or the existing shareholders are additionally offered a cash compensation, the price and contract size of the futures contracts will also be adjusted accordingly.~~The adjustment of futures contracts of the target company requires tradability of the derivatives on this underlying as well as possibility of trading of the offered shares or other rights on one of the Exchanges determined by the Eurex Exchanges.

~~If shareholders, in case of a conversion of old shares into new shares regulated by law, are offered a cash compensation, securities other than shares or other rights (altogether hereinafter referred to as "Other Rights"), the term of the Future contracts ends as soon as the old shares are no longer admitted~~

~~for trading at a Stock Exchange ("Cutoff Date"). The same applies if derivatives on the Other Rights offered cannot be traded at the Eurex Exchanges as a matter of law.~~If shareholders are exclusively offered a compensation consisting of shares or shares plus a cash interest, where the distribution of the cash part does not exceed 67% of the whole compensation, the adjustment is carried out through the R-factor method. The shares underlying the contract shall be replaced with the shares offered in the conversion offer under consideration of the relevant conversion ratio.

~~Furthermore, for Futures Contracts on shares of German stock corporations, the following applies: if a shareholder, after having given a takeover bid pursuant to the German Securities Acquisition and Takeover Act ("WpÜG"), has acquired shares of a stock corporation ("Target Company") of at least 95 % of the basic capital ("Principal Shareholder"), the Futures contracts whose expiration dates exceed the cutoff date – as is the case with a conversion of old shares into new shares or shares of another stock corporation – will be adjusted pursuant to the German Stock Corporation Law or German Law Regulating Transformation of Companies (see above) on the Exchange day after the Principal Shareholder has supplied the consideration owed for the acquisition of the shares and as soon as the shares of the Target Company are at his disposal ("Cutoff Date"). Whether the shareholder has actually acquired 95 % of the Target Company's shares, is to be verified pursuant to § 30 WpÜG.~~ If shareholders are exclusively offered a cash compensation, the term of the futures contract ends with effective date described in 1.6.7 paragraph 7 clause 3. Futures contracts whose expiry date is after the close of trading shall be settled by their theoretical value. The same applies if the compensation consists of shares and a cash interest, and if the cash interest amounts to a value of more than 67 % at the point of announcement of the offer and if the prerequisites according to 1.6.7 paragraph 7 clause 4 are not given.

The determination of the theoretical value is carried out by using the riskless interest rate and under consideration of future dividends.

((~~78~~))~~If shareholders are offered a conversion of old shares into new shares, shares of another company, securities other than shares, other rights or a cash compensation and if such capital market transaction is not regulated by the provisions pursuant to paragraph 6,~~ If a corporate action, which is carried out within the meaning of aforementioned conditions, is not regulated or covered by such conditions, the Management Boards of the Eurex Exchanges shall adjust the relevant futures contracts for purposes of maintaining the original contracts value, to guarantee well-regulated market conditions and to ensure clearing and settlement of the contracts. Also in case a capital transaction not regulated by the conditions of number 1.6.7 is carried out, the Eurex Exchanges shall issue a regulation similar to such conditions. The Eurex Exchanges shall notify the Exchange participants of the intended actions.

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2.6 Subpart: Contract Specifications for Options Contracts and Low Exercise Price Options on Stocks

[....]

2.6.10.1 Alterations of Conract Sizes, Exercise Prices und Expiration Days of Stock Options

(1) Exercise prices shall not be adjusted upon the payment of any dividends.

Dividends are also ~~capital reductions by nominal value reduction with shares of Swiss stock corporations respectively~~ capital reductions by reduction of the nominal value of the shares - if the company pays the amount of the reduction of the nominal value ~~reduction~~ instead of a dividend ~~and if this amount does not exceed the dividend of the previous year~~ or if the dividends are part of the regular dividends – as well as guaranteed cash compensations of subscription rights and other comparable rights offered instead of a dividend.

(2) Extraordinarily high dividends, bonuses or other cash distributions, as well as dividends which are not distributed within the scope of the regular dividend policy or which are declared as non-regular dividend by the company (e.g. special dividends, anniversary bonus) shall not be deemed to be dividends within the meaning of paragraph (1), Clause 1 and 2. In the event of such distributions, the exercise price for stock options written prior to the day of such distribution shall be reduced by an amount that reflects the value of the distribution, as determined in accordance with a formula established by the Eurex Exchanges; correspondingly, the number of shares underlying the contract shall be increased in such a manner that the original value of the contract is maintained.

When an option is exercised, the Eurex Exchanges will provide cash settlement for ~~any shares in excess of the contract size.~~the fractional part of the new contract size.

The amount of such cash settlement shall be determined on the basis of the difference between the reduced exercise price of the option and the reference price (Chapter II, number 3.6.4 of the Clearing Conditions of Eurex Clearing AG).

(~~2~~3) If subscription rights are granted,the exercise prices of stock options for those options series written prior to the first ~~Exchange~~ trading day of such subscription rights shall be reduced by an amount that reflects the value of the subscription right, as determined in accordance with a formula established by the Eurex Exchanges; correspondingly, the number of shares underlying the contract shall be increased such that the original value of the contract is maintained.

When an option is exercised, the Eurex Exchanges will provide cash settlement for ~~any shares in excess of the standard contract size.~~the fractional part of the new contract size.

Paragraph (2) shall apply to for any cash settlement mutatis mutandis.

(~~3~~4) In the event of capital increases out of the company reserves~~'s equity~~ *(Gesellschaftsmitteln)*, the number of shares underlying a contract will be increased proportionally to maintain the proportion of the share capital represented by these shares. The exercise price shall be reduced by a value such that the original value of the contract remains unchanged. When an option is exercised, the Eurex Exchanges shall provide cash settlement for any fractional shares the new contract size may cover~~, provided that the new shares are vested with the same rights as the old shares. In the case of divergent terms, there shall be a cash settlement for the portion exceeding the standard contract size~~; in all other respects, shares and other fractional interests, if any, shall be delivered based on the new contract size. This shall also apply with respect to stock dividends and similar events.

Paragraph (2) shall apply to such cash settlements mutatis mutandis.

~~(45)~~ (~~45~~)In case of capital reductions, the exercise prices and the standard contract size of the options shall ren

If a reduction of capital is realized by a reduction of the nominal value of the shares in order to pay back the nominal capital to the shareholders, the number of shares underlying the contract increases according to the ratio of reduction, if such reduction is accomplished independent of the payment of ~~or in addition to~~ the dividend. At the same time, the exercise price reduces by an amount which does not change the original contract value~~. In case the reduction of capital is not applied in addition to but instead of a dividend, the exercise prices as well as the contract sizes of the options will only be adjusted by the value exceeding the dividend of the previous year.~~

If a reduction of capital is realized by redeeming or consolidating shares, the number of shares covered by a contract shall be reduced proportionally to the proportion of the reduction of the share capital. The exercise price shall be simultaneously increased to a value such that the original value of the contract remains unchanged.

(~~5~~6) In the event of stock splits, the exercise prices of stock options shall be reduced in proportion to the split rate. The contract size and / or the position size shall be modified in a ratio such that the option holder's original position remains unchanged.

(~~6~~7) If shareholders are offered a conversion of shares in case of mergers or acquisitions, the options contracts will be adjusted, provided that the transaction has been effectively executed. A transaction is deemed executed effectively as soon as it is entered in the respective register (in case of merger) or in case the irrevocable result of an offer is announced by the acquiring company. The options contracts shall be adjusted with effect from the day on which the compensation specified in the conversion offer

is available to the shareholders. ~~If, in the cases required by law (e.g. merger, consolidation, conversion of classes of shares by means of an amendment to the articles of association, collectively a "Merger" (Umwandlung)), shareholders receive an offer to exchange their old shares for new shares or shares of another stock corporation, any options concerned which are due to expire after the discontinuation of trading in the old shares on a stock exchange (the "Reference Date") shall be adjusted as follows:~~

~~The options shall be adjusted on the Exchange day immediately following the Reference Date. The old shares shall be replaced by the same number of new shares issued due to the Merger, or of the other shares offered by the stock corporation. In all other cases in which the exchange ratio is not 1:1 or the holders of old shares are also offered a cash compensation, the exercise prices and contract sizes shall also be adjusted in such a manner that the original contract value is maintained. The new underlying shall be delivered at the earliest from the day on which the stock corporation exchanged the old shares for new shares or shares of another stock corporation.~~ The options contracts of the target company can be adjusted provided that the compensation of the acquiring company specified in the conversion offer can be delivered via the central custodians or delivery locations recognised by Eurex Clearing AG, that derivatives can be traded on this underlying and that trading of the offered shares or of other rights on an Exchange determined by the Eurex Exchanges is possible.

If the compensation exclusively consists of shares or shares plus a cash interest, the adjustment is carried out via the R-factor method. The shares underlying the contract shall be replaced by the shares offered in the conversion offer under consideration of the relevant conversion ratio.

If the compensation is exclusively carried out in cash, the term of the option contract ends with effect from the date described in 2.6.10 paragraph 7 clause 3. Options contracts whose expiry date is after the close of trading shall be settled by their theoretically fair value. The same applies if the compensation consists of shares and cash compensation and if the cash interest exceeds a value of 67 % at the point of announcement of the offer; and if the prerequisites according to 2.6.10 paragraph 7 clause 4 are not given.

The theoretically fair value shall be determined in using the Cox-Ross Options model. The volatility which is defined for determination of the fair value, is the average value of the implied volatilities of the daily settlement prices on the ten trading days prior to announcement of the takeover bid. As an alternative, the Eurex Exchanges consult a group of at least five Exchange participants and determine the average implied vola on basis of the information obtained from these Exchange participants. Further information regarding calculation of the fair value is available in the Eurex User Manual System Overview and Information Manual.

~~If, in the case of an exchange of shares as required by law, shareholders are offered a cash compensation, securities other than shares or other rights (collectively the "Other Rights") instead of new shares, the term of the options shall expire as soon as the old shares are no longer admitted to trading on a securities exchange (the "Reference Date"). The same shall apply if the Other Rights offered cannot be delivered through the central depositories or other depositories *(Lieferstelle)* recognized by Eurex Clearing AG, or if derivatives on the Other Rights offered cannot be traded on the Eurex Exchanges as a matter of law.~~

~~If an option concerned is exercised on the Reference Date, the shares underlying the contract shall be replaced by the Other Rights. The Other Rights shall be delivered on the day on which they are transferred by the offering company. If this day is not an Exchange day, delivery shall be effected on the Exchange day immediately following the Reference Date. If the Other Rights offered cannot be delivered through the central depositories or other depositories *(Lieferstelle)* recognized by Eurex Clearing AG, or if derivatives on the Other Rights offered cannot be traded on the Eurex Exchanges as a matter of law, the Eurex Exchanges shall provide a proportional cash compensation.~~

~~In case of Options contracts on stocks of German stock corporations that the following shall, in addition, apply: to the extent that a shareholder, having submitted a takeover bid in accordance with the German Securities Acquisition and Takeover Act (Wertpapiererwerbs- und Übernahmegesetz, "WpÜG"), has acquired at least ninety-five per cent of the registered share capital of a stock corporation ("Target Company") – such shareholder being referred to as the "Principal Shareholder" –, any options concerned which are due to expire after the Principal Shareholder has paid the consideration owed for the acquisition of such shares and may therefore dispose of the shares of the Target Company ("Reference Date"), shall be adjusted on the Exchange day following the Reference Date in the same way as described with regard to the exchange of shares in accordance with the German Stock Corporation Law (Aktiengesetz) or the German Law Regulating Transformation of Companies (Umwandlungsgesetz) (see above). Whether or not a shareholder has acquired ninety-five per cent of the shares of the Target Company shall be determined in accordance with § 30 WpÜG.~~

(~~7~~8) If a corporate action within the meaning of the aforementioned provisions is exercised but not regulated or covered by the provisions, the Management Boards of the Eurex Exchanges will adjust the respective options in order to maintain the original contract value, to guarantee orderly market conditions and to ensure the clearing and settlement of the contracts. In case a corporate action is exercised which is not regulated by the provisions of Number 2.6.10.1 the Eurex Exchanges will also adopt a regulation which aligns to such provision. The Eurex Exchanges shall inform the Exchange Participants of the intended measures.

(~~8~~9) With exercise of stock options whose contract sizes have been adjusted in the course of a corporate action, the Eurex Exchanges make a cash compensation. With exercise ~~of Swiss stock options~~, the cash compensation is always provided for the fractional part of the new contract size. ~~With exercise of options denominated in EUR, the cash compensation is provided for the non-fractional part or for the part deviating from the standard contract size.~~ The cash compensation is determined by the difference between the reduced exercise price of the option and the reference price (Chapter II, number 3.6.4 of the Clearing Conditions of Eurex Clearing AG).

(~~9~~10)Amendments to the contract sizes and exercise prices pursuant to paragraph 1 to 7 result in an introduction of new series according to Numbers 2.6.8 and 2.6.9.

With corporate actions (paragraph 1 to 7) all orders and quotes listed in the order book in the respective options series will be deleted by the Eurex Exchanges. The Eurex Exchange inform all Exchange participants about an imminent cancellation.

[….]