

March 2005 Supplement to Characteristics and Risks of Standardized Options

To accommodate options on any index intended to measure the predicted volatility of the daily returns of a stock index, the Booklet is amended as follows:

1. *The first two paragraphs on page 23, under the caption "About Indexes," are replaced with the following three paragraphs and new caption:*

As referred to in this booklet, an index is a measure of the prices or other attributes of a group of securities* or other interests. Although indexes have been developed to cover a variety of interests, such as stocks and other equity securities, debt securities and foreign currencies, and even to measure the cost of living, the following discussion relates only to indexes on equity securities (which are called stock indexes in this booklet) and indexes that are intended to measure the predicted volatility of specified stock indexes (which are called volatility indexes in this booklet) and options on such indexes.

Stock indexes are compiled and published by various sources, including securities markets. A stock index may be designed to be representative of the stock market of a particular nation as a whole, of securities traded in a particular market, of a broad market sector (e.g., industrials), or of a particular industry (e.g., electronics). A stock index may be based on securities traded primarily in U.S. markets, securities traded primarily in a foreign market, or a combination of securities whose primary markets are in various countries. A stock index may be based on the prices of all, or only a sample, of the securities whose prices it is intended to represent. Like stock indexes, volatility indexes are securities indexes. However, the component securities of a volatility index are put and call options series on a specified stock index. Options on volatility indexes are referred to generically as "volatility options."

Information relating specifically to stock indexes appears below under the caption "Stock Indexes." Information relating specifically to volatility indexes appears below under the caption "Volatility Indexes." Information appearing below under the caption "Stock Indexes and Volatility Indexes" is relevant to both stock indexes and volatility indexes.

* *Some indexes reflect values of companies, rather than securities, by taking into account both the prices of constituent securities and the number of those securities outstanding.*

STOCK INDEXES

2. *The first sentence in the second full paragraph on page 25 is replaced with the following sentence:*

Investors should keep in mind that a stock index can respond only to reported price movements in its constituent securities.

3. *The paragraph that was inserted following the third full paragraph on p. 26 in the December 1997 Supplement to this booklet is relocated so that it follows the second full paragraph on page 25 (since that paragraph relates to stock indexes and not to volatility indexes).*

4. *The following paragraphs and captions are added on page 25 following the relocated paragraph referred to in point 3 immediately above:*

VOLATILITY INDEXES

Volatility indexes, and investment strategies involving the use of volatility options, are inherently complex. You should be certain that you understand the method of calculation and significance of any volatility index and the uses for which volatility options based on that index are suited before buying or selling the options.

A volatility index is designed to measure the predicted volatility of a specified “reference” stock index. A volatility index represents a prediction of the volatility of the reference index over a specified future time period—for example, 30 calendar days. In statistical terms, a volatility index measures the predicted standard deviation of the daily returns of the reference index measured over the specified future time period.

Economic, political, social and other events affecting the *level* of the reference index may also affect the *volatility* of the reference index. Volatility indexes have historically tended to move inversely to their reference indexes, since volatility tends to be associated with turmoil in the stock markets and turmoil tends to be associated with downward moves in the stock market. But this relationship does not always hold true and, indeed, a volatility index may be rising at a time when its reference index is also rising. It bears emphasizing that a volatility index on which options are traded reflects only *predictions* about the future volatility of the reference index as those predictions are *implied* by reported current premium values for options on the reference index. The actual volatility of the reference index may not conform to those predictions.

As with other index options, a call volatility option will be in the money at exercise if the exercise settlement value of the underlying index is above the exercise price of the option, and a put volatility option will be in the money at exercise if the exercise settlement value of the underlying index is below the exercise price of the option. Whether the volatility option is in the money is determined in relation only to the value of the underlying volatility index, and not in relation to the reference index. Volatility index values will be affected by any factor that affects the component options series of the index, including, among other things, applicable laws, regulations and trading rules, the market-making and order processing systems of the markets on which the options are traded, and the liquidity and efficiency of those markets.

There are various methods of estimating predicted volatility, and different methods may provide different estimates. Under the method that is used for volatility options that are proposed to be traded at the date of this Supplement, volatility index values are calculated using premium values of out-of-the-money series of options on the reference index in expiration months that are selected and weighted to yield a measure of the volatility of the reference index over a specified future time period. For example, a volatility index that is calculated using this method and that is designed to provide a prediction of volatility over 30 calendar days is based on premium values of out-of-the-money options series on the reference index expiring in the two nearest months with at least 8 calendar days left to expiration.

Volatility options that are described in this Supplement are European-style (that is, are exercisable only on their respective expiration dates) and “A.M.-settled” (that is, are settled using exercise settlement values that are derived from opening values of the component put and call options). An exercise settlement value for these volatility options is calculated from *actual opening premium prices* of the relevant series of options on the reference index unless there is no trade in a series at the opening, in which case the *mid-point of the bid and offer premium quotations* for that series as determined at the opening of trading is used. All other index values for each of these volatility indexes are calculated using the *mid-points of the bid and offer premium quotations* of the options series that comprise the volatility index. (Since these index values are based on quotations they are sometimes referred to as “indicative values.”)

Because different values are used in calculating the indicative values and exercise settlement values for volatility options that are described in this Supplement,

there is a risk that there may be a divergence between the exercise settlement value and an indicative value calculated at the opening on the date on which the exercise settlement value is being determined. This risk is described further in Chapter X of this booklet, in paragraph 12 under the heading “Special Risks of Index Options.” Additional information regarding the method used to calculate the values of a particular volatility index is available from the market on which options on that index are traded.

Like other indexes on which options are traded, the values of volatility indexes are ordinarily updated throughout the trading day, and current values for a volatility index are generally available from brokers and from the markets on which options on that index are traded. Daily closing values and exercise settlement values for volatility indexes may be published in newspapers.

Investors should keep in mind that indicative values of a volatility index can reflect changes in the predicted volatility of the reference index only to the extent that quotations of the constituent options of the volatility index are current. Indicative values for a volatility index may be disseminated, and volatility options may be traded, during times when one or more constituent securities in the reference index are not trading, or when the quotations for one or more of the options series comprising the volatility index are not current. An exercise settlement value for a volatility index may be calculated even if one or more constituent securities in the reference index are not trading. In any of these cases, an indicative value or exercise settlement value will be based on non-current information. The quality of the information reflected in the values of a volatility index should be evaluated in light of the depth and liquidity of the markets for the securities in the reference index and the options that are the components of the index.

The information set forth on pages 26 through 28 under the caption “Features of Index Options” is generally applicable to volatility options. However, the method of determining the exercise settlement value for volatility options may differ from those for other index options. (As described above, an exercise settlement value for volatility options that are described in this Supplement may use a combination of actual opening premium prices for some of the constituent options series and averaged bid and ask premium quotations for others of the constituent options series on the day of exercise.) Other means for determining the exercise settlement values of volatility options may be established. Volatility options may also have expiration

dates that are different from those of other index options. You should be sure that you understand the method of calculation of the exercise settlement value and know the expiration date for each volatility option you wish to buy or write.

STOCK INDEXES AND VOLATILITY INDEXES

5. *The following paragraph is inserted on page 73 immediately following the caption “Special Risks of Index Options:”*

The risks described in paragraphs 1. through 10. on pages 73 through 78 of this booklet relate primarily to options on stock indexes. Risks involved in buying or writing options on volatility indexes are described in paragraphs 11. through 14.

6. *The following paragraphs are inserted on page 78 immediately following paragraph number 10:*

11. Strategies involving the purchase and sale of options on a volatility index are inherently complex and require a thorough understanding of the concept of predicted volatility that is measured by the index. The component securities of a volatility index are put and call options (not stocks, which are the component securities of stock indexes). You must have a thorough understanding of the method used to calculate the volatility index in order to understand how conditions in the market for its component options series may affect the values of the index. You may fail to realize your investment objective even if you have correctly predicted certain events if you do not understand how those events may or may not affect the level of the index. There is no assurance that predicted volatility as measured by a particular volatility index will correspond to the actual volatility of the reference index or to measures of predicted volatility calculated using other methods.

12. Because different values are used in calculating indicative values and exercise settlement values of volatility indexes underlying volatility options that are described in this Supplement, there is a risk that there may be a divergence between the exercise settlement value and an indicative value calculated at the opening on the date on which the exercise settlement value is being determined. (Please refer to the discussion in Chapter IV under the heading “Volatility Indexes” for the definition of the term “indicative value” and a description of the method that is used to calculate an “exercise settlement value” for volatility options that are proposed to be traded at the date of this Supplement.) It is to be expected that there

will be at least some divergence between the exercise settlement value for expiring volatility options and an indicative value calculated at the opening on the same date, because the opening price for each of the options series that is used to calculate the exercise settlement value will typically be at either the bid or the ask quotation, depending on the forces of supply and demand for that series, and not at the mid-point between the bid and ask quotations. This divergence may represent a significant percentage of the indicative value for the volatility index if the forces of supply and demand cause all or most of the series to open on the same side of the market.

13. Persons who exercise volatility options or are assigned exercises based on an erroneous index level will ordinarily be required to make settlement based on the exercise settlement value as initially reported by the designated reporting authority for the index, even if a corrected value is subsequently announced. In extraordinary circumstances (e.g., where an exercise settlement value as initially reported is obviously wrong, and a corrected value is promptly announced), OCC has discretion to direct that exercise settlements be based on a corrected exercise settlement value. Ordinarily, however, the exercise settlement value as initially reported by the designated reporting authority for the underlying volatility index will be conclusive for exercise settlement purposes. As described in paragraph 8. on page 77 with respect to other indexes, reported levels of a volatility index may be based on non-current information. This may occur as a result of delays or interruptions in either the market for the securities in the reference index or in the markets for options on the reference index.

14. As in the case of writers of other index options, writers of volatility options cannot provide in advance for their potential settlement obligations by acquiring the underlying interest. Offsetting the risk of writing a volatility option may be even more difficult than offsetting the risk of writing other index options. Similarly, there are timing risks and other risks analogous to those discussed in paragraphs 3. and 4. on pages 74 and 75 of this booklet whenever an investor attempts to employ strategies involving transactions in volatility options and transactions in stocks or in options, futures contracts or other investments related to stocks.