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August 19, 2014

Hon. Mary Jo White
Hon. Luis A. Aguilar
Hon. Daniel M. Gallagher
Hon. Michael S. Piwowar
Hon. Kara M. Stein
United States Securities and Exchange Commission
100 F. Street, NE
Washington, D.C. 20549

Re: SR-OCC-2014- 15

Dear Commissioners:

We represent a group of members of the Philadelphia Stock Exchange (including Bedrock Trading LP, Elm Trading LP, First Derivative Traders LP, Keystone Trading Partners and Largo Trading LP) that are market markers in listed securities options and that, from time to time, employ a strategy known generically as "dividend trading." We submit this comment letter on behalf of those clients.

We appreciate the opportunity to submit these comments to you concerning SR-OCC-2014-15. Our clients believe that the proposed rule change, if implemented, would reduce competition among market participants, reduce market transparency, would not address any perceived disadvantage to public customers of broker-dealers and would work to destabilize the market for the subject options. Moreover (and perhaps more importantly at this stage), we believe that The Options Clearing Corporation ("OCC") is seeking to usurp the regulatory authority of other self-regulatory organizations ("SROs" and each an "SRO"), in a bald attempt to improperly disadvantage one group of broker-dealers in favor of another group of broker-dealers. In that regard, the proposed rule change is premised on questionable, if not non-existent, statutory authority.

Ultimately, we request that the Commission take steps to disapprove the proposed rule change.

A. The Proposed Rule Change Is Not Grounded in the Exchange Act.

The starting point for consideration of a proposed rule change filed with the Commission by a Registered Clearing Agency (such as OCC) is the statutory grounding for the proposed rule change. Pursuant to Section 19(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), the Commission must conclude, after notice, comments and due consideration, that the proposed rule change is consistent with not only the purposes of the Exchange Act, but (specifically) with the provisions of the Exchange Act governing the activities and rules of registered clearing agencies.

In turn, Section 17A(a)(2)(A) of the Exchange Act provides these relevant standards:

> **17A(a)(2)(A)** The Commission is directed, therefore, having due regard for the public interest, the protection of investors, the safeguarding of securities and funds, and **maintenance of fair competition among brokers and dealers**, clearing agencies, and transfer agents, to use its authority under this title –
>
> > **17A(a)(2)(A)(i)** to facilitate the establishment of a national system for the prompt and accurate clearance and settlement of transactions in securities (other than exempt securities); and
> >
> > **17A(a)(2)(A)(ii)** to facilitate the establishment of linked or coordinated facilities for clearance and settlement of transactions in securities, securities options, contracts of sale for future delivery and options thereon, and commodity options.
>
> (*emphasis supplied*).

Signally, these standards include the maintenance of fair competition among brokers and dealers. Although couched in language that would suggest that the rule change is intended to simply revise an operating procedure of the OCC [to net long and short positions and orders solely of market makers before processing exercise notices] OCC has advised its Members that its true purpose of the proposed rule change (and presumably a second proposed rule change filing) is to eliminate a specific trading practice (*i.e.*, dividend trades) at the expense of, and detriment to, certain Market Makers. *See,* OCC Notice to "All Clearing Members" #35087, August 11, 2014 (attached hereto as Exhibit "A") "to implement a policy that prohibits the dividend options strategy."

SRO rules respecting trades and trading practices are the province of SROs such as national securities exchanges where the trading takes place. The rules of such SROs are subject to the broader standards of Exchange Act Section 6(b). The OCC is not a national securities exchange (nor a national securities association) and its rulemaking authority is limited to that of a Registered Clearing Agency. The rules of the various options exchanges define "opening" options transactions to be based on the "intention" of the trader to open or increase a long position and a "closing" options transaction to be based on the "intention" of the trader to reduce or eliminate a short position in such options.[1] If approved, OCC's rule would essentially negate these exchange rules without any statutory or regulatory authority for it to do so.

It is beyond the regulatory jurisdiction of a Registered Clearing Agency to neutralize trading and a trading strategy effected on a National Securities Exchange by Members of that National Securities Exchange, where that Exchange and the Commission have permitted that trading and strategy for decades simply because some clearing broker may make an operational error. It is the province of the Commission and each National Securities Exchange to regulate the conduct of broker-dealers; including compliance with the net capital rule *(i.e.,* Exchange Act Rule 15c3-1). This rule proposal has nothing to do with the risks of clearing members and nothing to do with risk management at OCC.

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1 *See, e.g.,* Rule 1000 (b) (24), (25), (26) and (27) of NASDAQ OMX PHLX:

24. Opening Purchase Transaction—The term "opening purchase transaction" means an Exchange options transaction in which the purchaser's intention is to create or increase a long position in the series of options involved in such transaction.

25. Opening Writing Transaction—The term "opening writing transaction" means an Exchange options transaction in which the seller's (writer's) intention is to create or increase a short position in the series of options involved in such transaction.

26. Closing Sale Transaction—The term "closing sale transaction" means an Exchange options transaction in which the seller's intention is to reduce or eliminate a long position in the series of options involved in such transaction.

27. Closing Purchase Transaction—The term "closing purchase transaction" means an Exchange options transaction in which the purchaser's intention is to reduce or eliminate a short position in the series of options involved in such transaction.

Moreover, the OCC fails to tell the Commission or the public in its rule filing that its own existing rules provide that Clearing Members may correct errors in the submission and filing of Exercise Notices, after the normal deadlines - - assuming a minimal measure of oversight and management on the part of the Clearing Firm and/or the relevant trader(s). *See,* OCC Rule 801 (d). Thus, even if an operational error were to occur in processing the exercise of an options position pursuant to a dividend trade, the clearing firm at issue could correct the error under the OCC's existing rule.

The OCC's stated attempt to eliminate dividend trades by market makers is not grounded in any authority under the Exchange Act and should be denied for that reason alone. However, closer review of the proposed rule change demonstrates that, even if it were properly grounded in statutory authority, the proposed rule change is inconsistent with the substantive requirements of the Exchange Act.

B. The Proposed Rule Is *Per Se* Anticompetitive and, By Design, Favors One Group of Broker-Dealers over Another Group of Broker- Dealers.

As discussed above, Section 17A of the Exchange Act requires that rule changes and rules of and by a Registered Clearing Agency be consistent with the "maintenance of fair competition among brokers and dealers." Here, the stated purpose of the proposed rule change is the elimination of competition among brokers and dealers - - by disadvantaging market makers in options to the nominal benefit of large clearing brokers and dealers, who may internalize order flow in in-the-money options. If dividend trading is eliminated, these broker-dealers will have additional incentive to internalize that order flow, since those firms will receive the economic benefit of unexercised in-the-money call options which they sold to their customers.

As an initial matter, the proposed rule change would affect the trading and accounts of market makers only. All other investors and traders could continue to effect dividend trades. This is *per se* anticompetitive.

The proposed rule change here at issue clearly does not fit within the prescribed standards. By revising its rules so that it will now refuse to accept exercise notices on new long options positions on an intra-day basis, solely for the accounts of market makers, the OCC is effectively nullifying an existing rule (*i.e.*, OCC Rule 801(c)) that has been in effect for over thirty-five (35) years - - and has been employed by market participants on a regular and ongoing basis for over forty (40) years.

OCC Rule 801(c) states:

> (c) Option contracts may be exercised only in a unit of trading or an integral multiple thereof. **Exercise notices may be filed in respect of opening purchase transactions which have not yet been accepted by the Corporation, and shall be assigned by the Corporation at the same time and in the same manner as exercise notices filed on the same business day in respect of issued option contracts, provided that any such exercise notice shall be deemed to be null and void and of no force or effect if the opening purchase transaction in respect of which it was filed is not accepted by the Corporation on the business day immediately following the date on which such exercise notice was filed.** (*emphasis supplied.*)

Longstanding OCC Rule (801(c)) clearly permits the submission of exercise notices by its members on an intra-day basis - - and without regard to the status of the relevant member as being "net long." How this change fosters competition is baffling. In similar fashion, we feel compelled to ask what possible regulatory interest of the OCC would be served by the rule change?

In the rule change filing, the OCC refers to a submission that it received from SIFMA, expressing concerns …"that an operational error in processing dividend trades could result in a clearing member being liable for a settlement amount that could place the clearing member in financial peril and potentially exceed the collateral deposited by the clearing member with OCC." (SR-OCC-2014-15, at page 5). This is the only substantive risk or exposure that OCC cites to in justifying its proposal.

Yet, in the very next paragraph of its filing, the OCC concedes that such potential risk is at most *de minimis*: "OCC noted that these transactions represent only a small number of OCC cleared options, and that most of the dividend play trading is cleared through two large clearing members that are large and well-capitalized and have robust risk management processes. OCC therefore concluded that dividend plays did not materially increase OCC's risk." As discussed above in the context of OCC Rule 800 (d), even in the event of such an error, the draconian losses feared by SIFMA and represented by the OCC can easily be avoided.

In effect, the OCC affirmatively states that its claimed "Statutory Basis" for the proposed rule change (*e.g.*, "to minimize sources of operational risk to clearing members") is a straw man. What is left is the bald statement that the OCC seeks, without stated statutory basis, rationale or pointed explanation, to limit or eliminate dividend trading by market makers.

C. The Proposed Rule Is *Per Se* Anticompetitive and, By Design, Favors Certain National Securities Exchanges over Others.

Although not found anywhere within the four corners of SR-OCC-2014-15, our clients are convinced that the ultimate purpose and intent of the proposed rule change is to reduce the trade volume reported by NASDAQ OMX PHLX (formerly the Philadelphia Stock Exchange) where the vast majority of dividend trades are effected, so as to artificially increase the relative market share reported on other exchanges; particularly the International Stock Exchange ("ISE") – which we understand has fomented the proposed rule change. See, Reuters Article, May 23, 2013, attached hereto as Exhibit B. While not a part of the formal record of SR-OCC-2014-15, this article is among a plethora of articles, speeches and presentations made by the ISE, particularly by its President, Gary Katz. The Commission should take notice of these numerous statements.

We are also constrained to note, at this point, that the majority of the Members of the OCC Board of Directors represent competing national securities exchanges and large broker-dealers; all of whom have economic self-interest in reducing or eliminating dividend trading and the related volume reported at a competitor, NASDAQ OMX PHLX. Our clients are all Members of that exchange – the target of OCC's unsupported policy.

In the absence of any legitimate statutory basis for the proposed rule change coupled with its per se anticompetitive purpose, the Commission should reject - - not approve - - the proposed rule change.

D. The Proposed Rule Change, if Enacted, Would Artificially Reduce Market Efficiency, Decrease Liquidity and Increase Volatility.

If enacted, the revised OCC rule will result in a shallower, more volatile market for the relevant options for a number of reasons:

1. All market participants reasonably expect, and are entitled to reasonably expect, that deep in-the-money call options will be exercised on or before the "ex-dividend date" and assigned against persons holding short call options. This is a fundamental part of the tenor of a call option and has been how options are priced and traded since the onset of listed securities options trading in 1973. Different market participants may employ differing reasons, methodologies and strategies in connection with their options trading, which explains why, on occasion, an in-the-money call position will not be exercised by its holder before an ex-dividend date. (In some cases, for example, the transactional costs associated with options exercise may negate the economic benefit of the anticipated dividend. For others, the cost of carrying the underlying long stock on margin at retail rates might make such an exercise uneconomical. Still

other options holders may not wish to or may not have the economic ability to incur the costs of purchasing the stock upon the exercise.) However, the fact that some options traders may exercise a particular in-the-money long call position while some others may not does not necessarily imply that one group or the other is trading or acting in an untoward or inappropriate manner.

Suggesting that this fact, of itself, is indicative of some unfair or untoward practice or device is nothing more than another straw man; nonsense masquerading as consumer protection.

2. The market price for any listed securities option is determined by considering a multitude of factors, one of which is announced and/or anticipated dividends. If certain participants, i.e. short call holders in dividend paying stocks, have incentive to remain short, the market value for such options will be adversely affected. This will cause an immediate loss to long holders of such options. Consequently, options pricing will become less stable and predictive, there will be fewer closing options trades, and the inevitable result will be less liquidity and depth in the market. Volatility will also increase and, rather than have a stabilizing impact on the market, the rule change, if made effective, will have a destabilizing impact. Customers will lose liquidity when they need it most.

3. The proposed "net long" requirement has no underlying statutory basis, and market efficiency is not advanced by its imposition. The requirement in the securities laws that one must have a "net long" position in order to take certain action with regard to a securities position (such as in connection with tendering securities pursuant to an exchange or tender offer) is grounded in concerns of fraudulent and/or manipulative conduct. That is demonstrated easily by considering massive short tendering in which far more shares are tendered in response to an exchange offer or tender offer than are actually outstanding, with the resulting potential for market disruption, forced buy-ins and potential harm to holders of the relevant security who tendered what they owned, but had their share of the offer's benefits reduced because more shares were tendered than ever existed.

Such concerns are not at issue in the case of so called dividend trading - - submitting an exercise notice on a long call options position being acquired on an opening purchase on an intra-day basis. The dividend will be paid by the issuer on 100%, but never more than 100%, of the outstanding shares - - and will be paid to all holders of record as of the dividend date. Every shareholder on the ex-dividend date will be entitled to receive the dividend; there is no untoward consequence of dividend trading and no harm to public investors. In fact, the impact of the rule change, if implemented, could be to disadvantage public customers who give their broker a sell order at any time prior to the ex-dividend date.

4. At present, dividend trades serve a public purpose. Public customers are alerted to the ex-dividend date by the activity and it acts as a beacon highlighting the need for public customers to consider whether it is in their interests to adjust their positions.

Ultimately, the proposed rule change is not in the public interest nor consistent with the standards articulated in the Exchange Act, and should not be approved by the Commission. For the reasons articulated above, we strongly urge that the Commission not approve SR-OCC-2014-15.

Respectfully submitted,

James D. Van De Graaff RPB
Katten Muchin Rosenman LLP

Robert P. Bramnik
Duane Morris, LLP

Cc: Stephen Luparello, Director, Division of Trading and Markets
Peter Curley, Associate Director, Division of Trading and Markets

RPB/ral

EXHIBIT A

OCC

#35087

TO: **ALL CLEARING MEMBERS**

FROM: **MEMBER SERVICES**

DATE: **AUGUST 11, 2014**

SUBJECT: **NET LONG EXERCISE POLICY - UPDATE**

As previously stated in Information Memos #32743, #34259, #34855 and #35021, the OCC Board of Directors has directed OCC management to research and develop an approach to implement a policy that prohibits the dividend options strategy.

With this direction, OCC is making a change to its position processing sequence to "Net" all accounts that are held "Net" (currently market-maker accounts) prior to applying exercise instructions. This change is targeted for a November 14, 2014 implementation, subject to prior regulatory approval.

In July, the OCC Board of Directors directed staff to adopt a rule prohibiting clearing members from clearing the dividend options strategy. This change will be in addition to and come after the market-maker processing change currently scheduled for November, 2014. OCC is in the process of developing rule language, monitoring processes and rule enforcement mechanisms to support the Board's directive, all of which is subject to regulatory approval. Additional information will be provided as it becomes available.

If you have any questions regarding this memo, please contact Member Services Help Desk at the following numbers: 800-544-6091 or 800-621-6072. Within Canada, please call 800-424-7320. Clearing members may also e-mail us at memberservices@theocc.com.

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Saphir, Ann. "U.S. Options Clearer Moves to End Trade Type Dominated by Nasdaq." *Reuters*. Thomson Reuters, 23 May 2013. Web. 20 Aug. 2014. Available at http://www.reuters.com/article/2013/05/24/us-exchanges-nasdaq-options-idUSBRE94N00220130524