OCC

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By Electronic Mail

Kevin M. O'Neill
Deputy Secretary
U.S. Securities and Exchange Commission
100 F. Street, N.E.
Washington, DC 20549
rule-comments@sec.gov

Re: *Proposed Rule Change by The Options Clearing Corporation to Implement a Policy Curtailing "Dividend Plays;" Release No. 34-72677; File No. SR-OCC-2014-15*

Dear Mr. O'Neill:

On July 25, 2014, The Options Clearing Corporation ("OCC")[1] filed a proposed rule change[2] (the "Proposal") with the U.S. Securities and Exchange Commission (the "SEC" or "Commission") to add an interpretation and policy to Rules 801 and 805 stating that OCC will process all sales of options in a market-maker's account prior to the exercise of any long call options in the account to ensure that only net long positions in a particular series may be exercised. The proposed change, coupled with related system modifications, would have the effect of implementing a policy approved by the OCC Board of Directors intended to curtail the use of a trading strategy known as "dividend plays" in the options industry. OCC appreciates the opportunity to respond to comments questioning the Proposal's regulatory sufficiency.[3] For the reasons set forth below, we believe these comments are misplaced.

The Securities Exchange Act of 1934, as amended ("Exchange Act") and the regulations thereunder obligate a systemically important clearing agency like OCC to have rules that are

1 OCC is a registered clearing agency with the SEC and a registered derivatives clearing organization ("DCO") with the Commodity Futures Trading Commission ("CFTC"). The Financial Stability Oversight Council ("FSOC") has also designated OCC as a systemically important financial market utility ("SIFMU").

2 *See* Exchange Act Release No. 72677 (July 25, 2014), 79 FR 44480 (July 31, 2014) (SR-OCC-2014-15).

3 *See* Letter from James D. Van De Graaff, Katten Muchin Rosenman LLP, and Robert P. Bramnik, Duane Morris LLP (March 26, 2014), on behalf of options market maker firms Bedrock Trading LP, Elm Trading LP, First Derivative Traders LP, Keystone Trading Partners and Largo Trading LP (the "DM Letter").

designed to promote the prompt and accurate clearance and settlement of securities transactions and, in general, protect investors and the public interest,[4] provide for a well-founded, transparent and enforceable legal framework for each aspect of its activities,[5] identify sources of operational risk and minimize the identified risks through the development of appropriate systems, controls and procedures.[6]

I. COMMENTS ON THE PROPOSAL

To date, the SEC has received four comments on the Proposal, including two brief comments from private individuals, the DM Letter referred to in footnote 3 and a letter submitted on behalf of the Securities Industry and Financial Markets Association ("SIFMA").[7] The SIFMA Letter, submitted on behalf of hundreds of members in the securities industry, strongly agreed with the Proposal and urged OCC to expand its policy to prevent and eliminate dividend plays. The DM Letter, submitted on behalf of certain options market maker firms that engage in dividend plays, made comments critical of the Proposal that OCC feels are misplaced. OCC appreciates the opportunity to respond to the comments set forth in the DM Letter.

II. RESPONSES TO COMMENTS

A. The Proposal is Grounded in the Exchange Act.

The DM Letter asserted that the Proposal is not grounded in the Exchange Act because, in its view, OCC is seeking to make rules respecting trading practices that are the province of a national securities exchange. The DM Letter essentially asserts that the rules of various options exchanges permit dividend plays and the Proposal would effectively negate those rules. Specifically, the DM Letter asserts that "it is beyond the regulatory jurisdiction of a Registered Clearing Agency to neutralize trading and a trading strategy effected on a 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."[8]

The DM Letter asserts that the relevant standards against which the proposal should be evaluated are contained in Section 17A(a)(2)(A) of the Exchange Act. Section 17A(a)(2)(A) relates to the national market system in general. While not irrelevant, it does not set forth the standards specifically applicable to rule changes of a registered clearing agency; these are contained in Section 17A(b) of the Exchange Act. As stated in the Proposal, OCC's statutory basis for the Proposal is Section 17A(b)(3)(F), which provides that:

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4 15 U.S.C. 78q-1(b)(3)(F).

5 17 C.F.R. 240.17Ad-22(d)(1).

6 17 C.F.R. 240.17Ad-22(d)(4).

7 *See* Letter from Ellen Greene, Vice President, Financial Services Operations, SIFMA, (August 21, 2014) (the "SIFMA Letter").

8 DM Letter at 4.

> The rules of the clearing agency are designed to *promote the prompt and accurate clearance and settlement of securities transactions* and, to the extent applicable, derivative agreements, contracts, and transactions, to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible, to foster cooperation and coordination with persons engaged in the clearance and settlement of securities transactions, to remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions, *and, in general, to protect investors and the public interest*; and are not designed to permit unfair discrimination in the admission of participants or among participants in the use of the clearing agency, or to regulate by virtue of any authority conferred by this chapter matters not related to the purposes of this section or the administration of the clearing agency. (*emphasis added*)

Furthermore, Exchange Act Rule 17Ad-22(d)(4), one of the bases of the Proposal, requires registered clearing agencies to identify sources of operational risk and minimize them through the development of appropriate systems, controls and procedures.[9] Notwithstanding the DM Letter's assertion to the contrary, implementing a policy approved by OCC's Board of Directors to curtail dividend plays falls squarely within OCC's rulemaking authority under Section 17A(b)(3)(F) and Exchange Act Rule 17Ad-22(d)(4).

OCC does not seek to police registered national securities exchanges or broker-dealers trading options on such exchanges. Significantly, OCC did not independently choose to address dividend plays, but instead began its investigation of the risks presented by dividend plays to OCC and market participants following a well-publicized trading error in September 2012 that was related to dividend plays and involved a back office operational error resulting in a loss reported to approach $10 million.[10] Furthermore, OCC was also requested to do so by market participants through SIFMA, which noted that dividend plays are perceived negatively in the marketplace and have been criticized as unfair to retail investors and as distorting options transactions volume.[11] Dividend plays are possible primarily because OCC processes sales after exercises. This historical decision by OCC was made to address the potential miscoding of opening and closing transactions — a risk not applicable to market maker accounts — and without the anticipation that certain option market maker firms would exploit this sequence to execute net neutral transactions with limited market risk that would result in a reallocation of unassigned short positions from retail investors to the traders executing dividend plays. In order to execute a dividend play, a market maker will prearrange with another market maker a transaction under which each firm buys from the other firm a large number of call options of the same series on a stock on the day prior to the stock's ex-dividend date and then sells to the other firm an offsetting number of call options of the same series on the same stock at the same price.

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9 17 C.F.R. 240.17Ad-22(d)(4).

10 *See* Jacob Bunge, *BofA Unit Said to Lose Millions on Options Error*, Wall St. J., Sept. 21, 2012, available at: http://online.wsj.com/news/articles/SB10000872396390444620104578011112447236182.

11 *See* Letter from Ellen Greene, Vice President of SIFMA, to Wayne P. Luthringshausen, Chairman and Chief Executive Officer of OCC (December 3, 2012) ("SIFMA Request Letter").

Because the two transactions are exactly offsetting and executed at the same price, on a net basis each firm's position in the call options is neutral and has limited market risk. At the end of the day, a dividend play trader exercises 100% its long call options, increasing the overall percentage of open interest that is exercised. A certain percentage of open interest in in-the-money call options goes unexercised on the day prior to the ex-dividend date, and accordingly OCC's standard assignment process will close out a large portion of the dividend traders' short positions established that day, but will also close out a large portion of other, pre-existing, market participants' short positions. The larger the position taken by a trader executing a dividend play compared to the pre-existing open interest, the higher the proportion of pre-existing open interest that will be closed out, thereby transferring a larger share of unassigned short positions to the dividend play trader.

Dividend plays became and remained an unofficial practice executed by specialist firms that became tolerated by markets and market participants through the passage of time and the lack, prior to the SIFMA Request Letter, of coordinated complaint by market participants. OCC is not aware of any exchange rules that specifically address dividend plays. The DM Letter cites to rules that simply define "opening" and "closing" transactions, which are relevant for many purposes other than exercises. Accordingly, the proposal does not, as asserted in the DM Letter, "negate" these rules.

As expressly stated in the Proposal, "OCC determined that while it should not take action to eliminate or restrict dividend plays based on [negative perception and abuse of retail investors], nor should it facilitate these transactions."[12] The Proposal does no more than to change OCC's own processing sequence, which was never intended to be exploited for dividend trades, for market maker accounts. In any event, upon urging of market participants and after a comprehensive review of dividend plays, that OCC has adopted a policy of not facilitating dividend plays, which are perceived negatively, criticized as unfair to retail investors and made possible primarily by OCC's own processing sequence is undoubtedly within its authority under Section 17A(b)(3)(F) to perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions, and, in general, to protect investors and the public interest.

The DM Letter asserts that OCC lacks a valid statutory basis for the Proposal. However, the DM Letter itself acknowledges that one of OCC's claimed statutory basis, *i.e.*, to minimize sources of operational risk to clearing members, is a valid statutory basis[13] and that SIFMA urged OCC to review dividend plays due to the operational risk to clearing members that SIFMA believed dividend plays presented. This risk was explained in both the Proposal and the SIFMA Request Letter cited in the Proposal. The DM Letter notes that after its review of dividend plays, OCC concluded that divided plays did not currently materially increase *OCC's risk* because such transactions represented a small portion of overall cleared transactions and that most dividend play activity was being cleared through two large, well-capitalized clearing members with robust risk management practices. The DM Letter then concludes that OCC's claimed statutory basis is a "straw man" because OCC's risk is not currently materially increased. The DM Letter's

12 *See* Proposal at 10.

13 DM Letter at 5.

challenge to the statutory basis for the Proposal fails on several grounds. First, nowhere in Section 17A(b) of the Exchange Act or Exchange Act Rule 17Ad-22 is OCC limited to addressing risks posed to itself. The risk raised in the SIFMA Request Letter and the Proposal was a risk *to clearing members* posed by dividend plays. Nowhere in the Proposal does OCC state that dividend plays do not pose a risk to any given clearing member clearing dividend plays. OCC is fully within its statutory authority to address risks to clearing members that, although may not pose a material risk to OCC, may pose a risk to an individual clearing member that could have adverse effects on other clearing members, such as a sudden shift in a clearing member's market practices. Second, while it is true that dividend plays do not currently pose a material risk to OCC because most dividend play activities are cleared through two large, well-capitalized clearing members with robust risk management practices, this may not always be the case. OCC's By-Laws or Rules do not limit clearing dividend play activity to such firms. Exchange Act Rule 17Ad-22(d)(4), one of the bases of the Proposal, requires OCC to identify sources of operational risk and minimize them, which is what the Proposal intends to accomplish. Finally, the DM Letter contends that OCC Rule 801(d) provides clearing firms with the ability to correct errors related to dividend plays, which mitigates any operational risk to clearing members from clearing dividend plays. However, Rule 801(d) is in place to allow for the correction of exercise errors generally and is not tailored to dividend play errors. Because of the large positions taken by dividend play traders when compared to the pre-existing open interest in the relevant series of options subject to a dividend play, any operational error could be extremely large and unlikely to be sufficiently mitigated through the use of Rule 801(d). In addition, in order to file a late exercise notice to correct a bona fide error on the part of a clearing member or customer, clearing members must request OCC's permission no later than 6:30 a.m. Central Time. It has been OCC's experience that, in general, most clearing members are unable to meet the 6:30 a.m. deadline, and this was the case with the September 2012 trading error related to dividend plays. Moreover, the large operational errors likely to be associated with dividend plays would be very costly to the relevant clearing member given that Rule 801(d)(2) requires a $75,000 late filing fee per line item listed on the late exercise notice.

B. The Proposal is not Anticompetitive and is not Designed to Favor One Group of Broker-Dealers Over Another Group of Broker-Dealers.

The DM Letter asserts that the "stated purpose" of the Proposal is to eliminate competition among broker-dealers, by disadvantaging options market makers in favor of large clearing broker-dealers. There is of course no such statement in the Proposal, and the Proposal is not intended to address competitive issues. Nor does the Proposal have the effect of eliminating or even reducing competition. All market makers holding options positions established on national securities exchanges will be subject to the same processing sequence.

The DM Letter asserts that because the Proposal would affect market makers only, the Proposal is *per se* anti-competitive. However, the DM Letter itself notes that OCC reserves the right to submit a rule change proposal prohibiting all clearing members from clearing dividend plays and has indicated as much to clearing members.[14] As noted in the Proposal, the vast majority of dividend play activity occurs in market maker accounts. OCC believes that the most

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14 DM Letter at 2.

prudent course of action is to first curtail dividend play activities in the accounts in which the activity is occurring through automated processes where the impact on operations is confined to OCC. As noted in the Proposal, OCC's Operations Roundtable, which consists of a cross-section of OCC's clearing members and operations staff of the options exchanges, evaluated the Proposal prior to submission to the Commission. The Operations Roundtable will continue to evaluate the implementation of the Proposal. OCC believes that obtaining this input represents sound and prudent risk management that falls well within its rulemaking authority. Furthermore, market makers can still participate in the capturing of a dividend, just like any other market participant that seeks to exercise a long in-the-money call option on the day prior to the relevant ex-dividend date. The Proposal will have no effect on the ability of market participants to exercise options so long as the participant's long positions are not fully offset with short positions at the end of the trading day. Instead, the change in processing sequence is limited to preventing market makers from executing extremely large dividend play transactions while maintaining a position in the relevant options that is neutral on a net basis. The majority of these trades are executed at the end of a trading day using a broker on the exchange floor and not an electronic system in order to ensure that the two dividend play traders can buy and sell with each other the same number of options at the same price. The change in processing sequence will curtail this activity, which is intended to provide the party executing the dividend play with limited or no market risk, without limiting any market participant's ability to exercise options in any other situation.

The DM Letter further claims that the proposal effectively nullifies OCC Rule 801(c), which permits the submission of intra-day exercise notices, but this is not correct. Clearing Members may continue to submit intra-day exercise notices. The Proposal simply changes OCC's processing sequence such that only net long positions in a particular series may be exercised. So long as an account is net long, the intra-day exercise notice will be honored.

C. <u>The Proposal is not Anticompetitive and is not Designed to Favor Certain National Securities Exchanges over Others.</u>

The DM Letter makes the unsupported assertion that the intent of the Proposal is to reduce the trade volume reported by one exchange so as to artificially increase the relative market sale reported on other exchanges. In making this assertion the market makers in question ignore the composition of OCC's Board of Directors, which approved the rule change and is made up of two management directors, three public directors, nine clearing member directors and five exchange directors. The composition of the Board makes it impossible that a limited number of exchanges, let alone a single exchange, could have caused the Proposal to be approved for an improper purpose. Moreover, as noted above, OCC did not initiate the Proposal, but instead was encouraged to do so pursuant to an unsolicited request by market participants through SIFMA to review dividend play activities.

D. <u>The Proposal Would Not Artificially Reduce Market Efficiency, Decrease Liquidity and Increase Volatility.</u>

The DM Letter asserts that the Proposal would reduce market efficiency and liquidity and increase volatility through four separate assertions, each discussed below.

1. The DM Letter points out that market participants may have numerous reasons for not executing in-the-money call options and that the fact that a trader executes or fails to execute an in-the-money call option does not imply any "untoward or inappropriate" practice. OCC agrees. However, the Proposal is not targeting market participants who do or do not exercise call options. Rather it will have the effect of curtailing a specific practice under which certain market makers execute extremely large net neutral transactions only on the day prior to the relevant ex-dividend date and that rely on other market participants' failure to exercise in-the-money calls and on OCC's processing sequence.

2. The DM Letter asserts that if OCC curtails dividend plays, options pricing will become less stable and the market will have less liquidity. This speculation is unlikely to match the actual outcome if the Proposal is approved. As detailed in the Proposal, dividend plays involve large numbers of offsetting purchases and sales of the same series of options on the day prior to the relevant ex-dividend date between two dividend play traders. The larger the position taken by the dividend trader, the higher the proportion of pre-existing short positions of other market participants that will be closed out, and the larger the share of unassigned short positions that will be allocated away from these other market participants to the dividend play traders. As discussed above, the majority of these trades are prearranged between market makers and executed at the end of a trading day using a floor broker instead of an electronic system open to all market participants. The floor broker knows both sides of the dividend play trade, which results in the open interest in the relevant series of options being inflated, often up to two and one-half times the last two weeks average daily volume. The trading volume in the relevant options returns to normal volumes the day after dividend date. To argue that these transactions add liquidity and provides for a more stable market for deep in-the-money options is questionable at best. If these transactions were to be sent to the open market they would be unlikely to be executed. Accordingly, these trades are not providing liquidity to the general market participants.

3. The DM Letter asserts that the "net long" requirement has no underlying statutory basis and uses an analogy to short tendering of securities to show that similar concerns are not present with dividend plays. This argument is a red herring. OCC is not relying on the narrow statutory basis that a market participant must be "net long" to take certain actions in order to avoid manipulative or deceptive conduct. Rather, as explained above, OCC has ample statutory basis for the Proposal under Section 17A(b)(3)(F) of the Exchange Act. Moreover, the DM Letter's assertion that there is "no harm to public investors" cannot be true. Dividend plays are only profitable to the dividend play trader because the strategy results in a larger share of unassigned short positions being allocated away from other market participants, including public investors, to the dividend play traders.

4. The DM Letter asserts that dividend trades serve a public purpose because the strategy alerts public customers to the ex-dividend date. However, as discussed above, the vast majority of dividend play transactions are done at the end of the trading day through a floor broker that knows both sides of the trades. This timing and manner of executing dividend plays cannot properly alert public customers to the ex-dividend date, nor is it necessary to alert the public to the ex-dividend date. Public customers and other market participants have ample

means of learning the ex-dividend date, including calendars of ex-dividend dates published by national stock exchanges.[15]

III. CONCLUSION

For the reasons set forth above, the Proposal is entirely consistent with the Exchange Act and the rules and regulations thereunder applicable to OCC as well as with the public interest and protection of investors. It should therefore be approved by the Commission.

Sincerely,

James E. Brown

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[15] *See e.g.*, http://www.nasdaq.com/dividend-stocks/dividend-calendar.aspx.