

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-79435; File No. SR-OCC-2016-014)

November 30, 2016

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 1, Related to Compliance with Section 871(m) of the Internal Revenue Code

On October 18, 2016, The Options Clearing Corporation (“OCC”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change SR-OCC-2016-014 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder.<sup>2</sup> On November 1, 2016, the proposed rule change was published for comment in the Federal Register.<sup>3</sup> On November 28, 2016, OCC filed Amendment No. 1 to the proposal.<sup>4</sup> The Commission did not receive any comments on the proposed rule change. The Commission is publishing this notice to solicit comment on Amendment No. 1 from interested persons and is approving the proposed rule change, as modified by Amendment No. 1, on an accelerated basis.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> Securities Exchange Act Release No. 79172 (Oct. 27, 2016), 81 FR 75867 (Nov. 1, 2016) (SR-OCC-2016-014) (“Notice”).

<sup>4</sup> In Amendment No. 1, OCC amended the proposal by adjusting and clarifying the date by which an affected Clearing Member would need to demonstrate compliance with the proposed rule change, to allow additional time for the Internal Revenue Service (“IRS”) to finalize the form necessary to demonstrate such compliance. Whereas the original filing defined the “Section 871(m) Implementation Date” to mean “December 1, 2016, or, if later, the date that is 30 days before the Section 871(m) Effective Date”, Amendment No. 1 defines “Section 871(m) Implementation Date” to mean “such date on or after December 1, 2016 as [OCC] may designate in an Information Memo issued to its Clearing Members.”

## I. Description of the Proposed Rule Change

The following is a description of the proposed rule change as provided by OCC.<sup>5</sup>

All capitalized terms not defined herein have the same meaning as set forth in OCC's By-Laws and Rules.<sup>6</sup>

### A. Background

OCC is proposing to modify its By-Laws and Rules to address the application of I.R.C. Section 871(m) ("Section 871(m)")<sup>7</sup> to listed options transactions commencing on January 1, 2017. The proposed modifications are designed to ensure that OCC will not be liable for U.S. withholding tax with respect to certain options transactions entered into by OCC's Clearing Members that are treated as non-U.S. persons for federal income tax purposes.

Section 871(m), which was enacted in 2010, imposes a 30% withholding tax on "dividend equivalent" payments that are made or deemed to be made to non-U.S. persons with respect to certain derivatives (such as total return swaps) that reference equity of a U.S. issuer. In enacting Section 871(m), Congress was attempting to address the ability of foreign persons to obtain the economics of owning dividend-paying stock through a derivative while avoiding the withholding tax that would apply to dividends paid on the stock if the foreign person owned the stock directly.<sup>8</sup>

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<sup>5</sup> The proposed amendments and OCC's By-Laws and Rules can be found on OCC's public website: <http://optionsclearing.com/about/publications/bylaws.jsp>.

<sup>6</sup> *Id.*

<sup>7</sup> 26 U.S.C. 871(m).

<sup>8</sup> *See* 26 U.S.C. 871(a)(1)(A) (30% tax on dividends paid to non-resident aliens).

In September 2015, the Treasury Department adopted final regulations (the “Final Section 871(m) Regulations”)<sup>9</sup> based on a proposal issued in December 2013 expanding the types of derivatives to which Section 871(m) applies to include certain listed options transactions with an effective date of January 1, 2017. While actual dividends paid to foreign owners of U.S. equities have been subject to withholding tax for over 80 years, transactions by foreign persons in listed options referencing U.S. equities have not previously given rise to withholding tax. The application of Section 871(m) to listed options, as provided in the Final Section 871(m) Regulations, thus introduces new tax obligations and associated risks for OCC and its Clearing Members.

Under the Final Section 871(m) Regulations, any equity option entered into by a non-U.S. person with an initial delta of .8 or above is considered a “Section 871(m) Transaction” and can potentially give rise to a dividend equivalent subject to withholding tax.<sup>10</sup> A dividend equivalent is deemed to arise if a dividend is paid on the underlying stock while such an option is outstanding even though no corresponding payment is made on the option. A complex set of rules and exceptions in the Final Section 871(m) Regulations must be followed in order for the withholding agent (as defined in 26 CFR

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<sup>9</sup> See T.D. 9734, 80 Fed. Reg. 56866 (Sept. 18, 2015).

<sup>10</sup> Under the regulations, “delta” refers to the ratio of the change in the fair market value of an option to a small change in the fair market value of the number of shares of the underlying security referenced by the option. See 26 CFR 1.871-15(g)(1). Individual options entered into “in connection with each other” must generally be combined and tested against the .8 delta threshold on a combined basis (the “Combination Rule”). See 26 CFR 1.871-15(n). For example, if a non-U.S. person buys a call option and writes a put option on the same stock, and the options are entered into in connection with each other, the delta of the call and the delta of the put are added together. If the sum is .8 or higher, the two transactions are treated as Section 871(m) Transactions.

1.1441-7) to determine if the withholding tax in fact applies, and, if so, the amount of the dividend equivalent subject to withholding tax.

Two separate but overlapping U.S. withholding tax regimes will apply to dividend equivalents on listed options that are Section 871(m) Transactions. The first regime, sometimes referred to as “Chapter 3 Withholding,” is the basic U.S. income tax withholding regime under Chapter 3 subtitle A of the Internal Revenue Code (“Chapter 3”), which has existed for many years.<sup>11</sup> The second regime, known as “FATCA,”<sup>12</sup> was enacted in 2010 and, subject to transition rules, first applied to withholdable payments (such as dividends and interest) made after June 30, 2014. The Treasury Department has issued extensive regulations under FATCA (the “FATCA Regulations”).<sup>13</sup>

The two withholding tax regimes serve very different purposes. Chapter 3 Withholding requires a withholding agent to withhold 30% of a withholdable payment and remit it to the Internal Revenue Service (“IRS”).<sup>14</sup> The withholding tax is the mechanism by which the non-U.S. person receiving the payment satisfies its tax liability to the United States.

FATCA, on the other hand, was enacted with the purpose of curbing tax evasion by U.S. citizens and residents through the use of offshore bank accounts. FATCA

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<sup>11</sup> See 26 U.S.C. 1441-1446.

<sup>12</sup> See 26 U.S.C. 1471-1474. FATCA stands for the Foreign Account Tax Compliance Act, which is found in Chapter 4 of subtitle A of Title 26. References in this filing to “Chapter 4” are references to FATCA, and vice versa.

<sup>13</sup> See 26 CFR 1.1471-0 through 1.1474-1.1474-7.

<sup>14</sup> Withholdable payments include U.S. source dividends, as defined in 26 U.S.C. 1441(b), and dividend equivalents are treated as U.S. source dividends for this purpose. 26 U.S.C. 871(m)(1).

imposes a 30% withholding tax (“FATCA Withholding”) on U.S.-source dividends and other withholdable payments (including dividend equivalents)<sup>15</sup> made by a U.S. withholding agent to a foreign financial institution (“FFI”), such as a bank or brokerage firm, unless the financial institution agrees to provide information to the IRS about its U.S. account holders. The purpose of FATCA Withholding is thus to force FFIs to provide the required information about U.S. account holders to the IRS. FFIs that enter into the required agreement with the IRS are referred to as “Participating FFIs,” and those that do not are referred to as “Nonparticipating FFIs.” The 30% FATCA Withholding applies to withholdable payments made to a Nonparticipating FFI whether the Nonparticipating FFI is the beneficial owner of the payment or acting as a broker, custodian or other intermediary with respect to the payment. To the extent that withholdable payments are made to a Nonparticipating FFI in any capacity, a U.S. withholding agent, such as OCC or its U.S. Clearing Members, transmitting these payments to the Nonparticipating FFI will be liable to the IRS for any amounts of FATCA Withholding that the U.S. withholding agent should, but does not, withhold and remit to the IRS.

The Treasury Department has provided alternative means of complying with FATCA for FFIs that are resident in foreign jurisdictions that enter into an intergovernmental agreement (“IGA”) with the United States (each such foreign jurisdiction being referred to as a “FATCA Partner”). An FFI resident in a FATCA

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<sup>15</sup> The types of payments subject to FATCA Withholding are generally the same as those subject to Chapter 3 Withholding, although FATCA Withholding also applies to gross proceeds from the sale or other disposition of any instrument that gives rise to such payments. *See* 26 U.S.C. 1473(1). Gross proceeds withholding under FATCA is scheduled to become effective in 2019.

Partner jurisdiction must either transmit the information required by FATCA to its local tax authority, which in turn would transmit the information to the IRS pursuant to a tax treaty or information exchange agreement (referred to as a “Model 1 IGA”), or the FFI must be authorized or required by FATCA Partner law to enter into an FFI agreement and to transmit FATCA reporting directly to the IRS (referred to as a “Model 2 IGA”).

Under both IGA models, payments to such FFIs would not be subject to FATCA Withholding so long as the FFI complies with the FATCA Partner’s laws as mandated in the IGA. OCC currently has eight non-U.S. Clearing Members, all of which are Canadian firms. Canada entered into a Model 1 IGA with the United States on February 5, 2014, as a result of which OCC’s Canadian Clearing Members that comply with the Canadian laws mandated in such Model 1 IGA are “Reporting Model 1 FFIs” and are exempt from FATCA Withholding.

Because OCC does not make payments of U.S.-source interest and dividends to its Clearing Members, OCC’s transactions with its Clearing Members have not to date given rise to payments subject to Chapter 3 Withholding or to FATCA Withholding. Both Chapter 3 Withholding and FATCA Withholding will become applicable to OCC and its Clearing Members, however, once Section 871(m) applies to listed options commencing January 1, 2017.

#### 1. Impact on OCC and its Clearing Members

The application of Section 871(m) to listed options transactions that are Section 871(m) Transactions in combination with Chapter 3 Withholding and FATCA Withholding will have significant implications for OCC and its Clearing Members. These implications differ depending upon whether the Clearing Member involved in the

transaction is a U.S. firm or a non-U.S. firm. When a U.S. Clearing Member is involved, Section 871(m) is relevant if the Clearing Member is acting (directly or indirectly) on behalf of a non-U.S. customer.<sup>16</sup> When a U.S. Clearing Member is acting for a foreign customer, the U.S. Clearing Member will need to determine whether the transaction is a Section 871(m) Transaction, and, if so, the amount of any dividend equivalents subject to withholding. Under Chapter 3 and Chapter 4, withholding tax will need to be collected by the U.S. Clearing Member on any such dividend equivalent and remitted to the IRS.<sup>17</sup> Reporting by the U.S. Clearing Member with respect to such amounts on IRS Forms 1042 and 1042-S would also be required.<sup>18</sup>

OCC will not be obligated to withhold on any dividend equivalents associated with listed options that are Section 871(m) Transactions when the Clearing Member involved is a U.S. firm. Under the applicable Treasury Regulations, because OCC is treated as making such payments to a U.S. financial institution, OCC is not required to withhold. Rather, the withholding obligation falls on the U.S. Clearing Member if the member is acting directly for a non-U.S. person, or potentially on another broker or custodian with a closer connection to the non-U.S. person. Similarly, OCC will not have any tax reporting obligations. Those obligations will typically fall on the broker that has the obligation to withhold. In general terms, OCC is relieved of the obligation to

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<sup>16</sup> Section 871(m) is not relevant if the U.S. Clearing Member is acting on behalf of a U.S. customer or for its own account.

<sup>17</sup> The obligation to withhold arises under both Chapter 3 and Chapter 4 (*i.e.*, FATCA), but duplicate withholding is not required. Under Section 1474(d) and 26 CFR 1.1474-6T(b)(1), amounts withheld under FATCA are credited against amounts required to be withheld under chapter 3.

<sup>18</sup> *See* 26 CFR 1.1461-1(c)(2)(i)(L).

withhold and to report dividend equivalents in this situation because the U.S. Clearing Member, and not OCC, is the last U.S. person with custody or control over the relevant payment or funds before they leave the United States. Without regard to the proposed rule change described herein, therefore, Section 871(m) will require OCC's U.S. Clearing Members with foreign customers to develop and maintain systems (i) to identify options transactions that are Section 871(m) Transactions (including under the Combination Rule),<sup>19</sup> (ii) to determine the amount of any dividend equivalents, and (iii) to effectuate withholding. Developing these systems will be challenging and costly.

The situation is very different when the Clearing Member involved is a non-U.S. firm. (As noted above, OCC currently has eight non-U.S. clearing members, all of which are Canadian firms.) Under the Final Section 871(m) Regulations, OCC itself is a withholding agent when a non-U.S. Clearing Member enters into a transaction on behalf of a customer or for its own account.<sup>20</sup> In this situation, OCC is the last U.S. person treated as having custody or control over the payment or funds before they leave the United States. Unless the non-U.S. Clearing Members enter into certain agreements with the IRS (described below), under which they assume primary responsibility for Chapter 3 Withholding tax and are FATCA Compliant, OCC would be required to withhold on dividend equivalents with respect to transactions that are Section 871(m) Transactions.<sup>21</sup>

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<sup>19</sup> See *supra* note 9.

<sup>20</sup> See 26 CFR 1.1441-7(a)(3)(Example 7).

<sup>21</sup> As proposed, the term "FACTA [sic] Compliant" would mean that a FFI Clearing Member has qualified under such procedures promulgated by the IRS as are in effect from time to time to establish an exemption from withholding under FATCA such that OCC will not be required to withhold any amount with respect to any payment or deemed payment to such FFI Clearing Member under FATCA.

In order to carry out these responsibilities, OCC would need to develop and maintain systems (i) to identify transactions that are Section 871(m) Transactions, (ii) to determine the amount of any dividend equivalents, (iii) to effectuate withholding, and (iv) to remit the withheld tax to the IRS. The non-U.S. Clearing Members in this situation generally would not be required to withhold or to report because they already would have been subject to withholding by OCC. Without the proposed rule change, therefore, Section 871(m) by default would impose on the U.S. Clearing Members and OCC—but not on the non-U.S. Clearing Members—the responsibility for withholding and reporting on dividend equivalents. The proposed rule change would transfer OCC’s obligations with respect to the non-U.S. Clearing Members to those members, so that they would be treated in a manner analogous to the U.S. Clearing Members, who themselves will be required to withhold and report on dividend equivalents when Section 871(m) becomes effective with respect to listed options.

To address OCC’s potential Chapter 3 Withholding and reporting obligations, the agreements that non-U.S. Clearing Members can enter into with the IRS to relieve OCC of these obligations are as follows:

- (1) With respect to transactions that the Clearing Member enters into on behalf of customers (that is, as an intermediary), the Clearing Member can enter into a “qualified intermediary agreement” with the IRS under which the Clearing Member assumes primary withholding responsibility. If a Clearing Member has such an agreement in place (such member being a “Qualified Intermediary Assuming Primary Withholding Responsibility”), OCC is relieved of its

obligation to withhold under Chapter 3 with respect to the Clearing Member's customer transactions.

- (2) With respect to transactions the Clearing Member enters into for its own account (that is, as a principal), the Clearing Member will be able to enter into a qualified intermediary agreement with the IRS (as described above) in which it further agrees, *inter alia*, to assume primary withholding responsibility with respect to all dividends and dividend equivalents it receives and makes.<sup>22</sup> Entities entering into such agreements are referred to as "Qualified Derivatives Dealers."

The Treasury Regulations regarding Qualified Derivatives Dealers are currently in temporary form and are subject to change. Treasury and the IRS recently issued Notice 2016-42, which has proposed changes to the "qualified intermediary agreement" necessary to expand the Qualified Derivatives Dealer exception to include all transactions in which a Qualified Derivatives Dealer acts as a principal for its own account, regardless of whether it does so in its dealer capacity.<sup>23</sup> If these changes are incorporated into the final qualified intermediary agreement, and if the Clearing Members timely enter into such agreements, OCC does not believe, based on IRS Notice 2016-42, that OCC will be obligated to withhold under Chapter 3 on any transactions entered into by the Clearing Member for its own account.

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<sup>22</sup> See 26 CFR 1.1441-1T(e)(6); Notice 2016-42, 2016-29 I.R.B. (July 1, 2016).

<sup>23</sup> The concept of dealer in the tax context is different than in the securities regulatory context, where dealer activity would include both principal trading to facilitate customer activity as well as principal trading solely on behalf of the firm.

With respect to FATCA Withholding, OCC would not be required to withhold if the non-U.S. Clearing Member has entered into an agreement with the IRS to provide information about its U.S. account holders or if the Clearing Member is a resident of a country that has entered into an IGA and the member complies with its reporting responsibilities under the local legislation implementing the IGA.

Even if OCC's non-U.S. Clearing Members enter into the agreements with the IRS described above (or with respect to FATCA are resident in a country with an IGA), OCC would still be required to report to the IRS the amounts of dividend equivalents it is treated as paying to those Clearing Members.<sup>24</sup>

2. Preparing for Implementation of Section 871(m) as Applied to Listed Options

Beginning on January 1, 2017, the Final Section 871(m) Regulations would treat OCC as paying dividend equivalents subject to both Chapter 3 Withholding and FATCA Withholding -- even though no actual payments are made -- when a non-U.S. Clearing Member enters into a listed equity option with an initial delta of .8 or higher. OCC has evaluated its existing systems and services to determine whether and how it may comply with such withholding obligations. As a result of this evaluation, OCC has determined that its existing systems are not capable of effectuating withholding with regard to the transactions processed by OCC. OCC does not have access to the necessary transaction-specific information to determine whether a particular transaction triggers withholding, nor the systems to obtain such information. For example, OCC cannot associate options transactions in a Clearing Member's customer account with any particular customer.

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<sup>24</sup> See 26 CFR 1.1461-1(c)(2)(i)(L).

Similarly, when an option contract in a Clearing Member's customer account is closed out, OCC cannot determine the specific contract that is closed out when there are multiple identical contracts in the Clearing Member's customer account.<sup>25</sup>

Even if OCC had access to all necessary information, the daily net settlement process in which OCC engages would not permit OCC to effectuate withholding without introducing significant settlement and liquidity risk, particularly since dividend equivalents on listed options do not involve an actual cash payment to the Clearing Member from which amounts could be withheld. OCC nets credits and debits per Clearing Member for daily settlement. Given OCC's netting, effectuating withholding could require OCC in certain circumstances to apply its own funds in order to remit withholding taxes to the IRS whenever the net credit owed to a non-U.S. Clearing Member is less than the withholding tax. In addition, if a non-U.S. Clearing Member has dividend equivalent payments aggregating \$50 million, but the member is in a net debit settlement position for that day because of OCC's daily net crediting and debiting, there would be no payment to this Clearing Member from which OCC could withhold. In this example, OCC would likely need to fund the \$15 million withholding tax (30% of \$50 million) until such time as the Clearing Member could reimburse OCC. Furthermore, the cost of implementing a withholding system for the small number of Clearing Members that are non-U.S. firms (currently eight out of 115 Clearing Members) would be

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<sup>25</sup> Contracts with identical terms but entered into on different days or at different times will have different initial deltas. As a result, some (those with initial deltas above .8) may be Section 871(m) Transactions, while others may not be. It is thus critical to know which specific contract is closed out for purposes of determining if dividend equivalents arise with respect to a particular contract that is a Section 871(m) Transaction.

substantial and disproportionate to the related benefit. Since the cost of developing and maintaining a complex withholding system would be passed on to OCC's Clearing Members at large, it would burden both U.S. Clearing Members and non-U.S. Clearing Members that have entered into the requisite agreements with the IRS and are FATCA Compliant.

Section 871(m) requires OCC's U.S. Clearing Members with foreign customers to build and maintain systems in order to carry out their withholding responsibilities under Chapter 3 and Chapter 4 for dividend equivalents in connection with transactions with their foreign customers. Absent the proposed rule change, OCC's non-U.S. Clearing Members could decide not to develop similarly appropriate systems. Such a decision would force OCC to be in a position to comply with withholding obligations on Section 871(m) Transactions under Chapter 3 and Chapter 4 with regard to its non-U.S. Clearing Members, which, as noted above, OCC cannot do based on the way its settlement process and systems work. If such a situation were to theoretically occur, the resulting compliance costs would be shifted from the non-U.S. Clearing Members to OCC, and would cause such costs to be borne indirectly by OCC's U.S. Clearing Members, which already would be bearing their own compliance costs with regard to Section 871(m) Transactions. Moreover, as noted, the non-U.S. Clearing Members are in a better position than OCC to comply with Chapter 3 and Chapter 4 reporting and withholding requirements for Section 871(m) Transactions because they have customer information that OCC lacks. Under the proposed rule change, the costs associated with developing and maintaining the required systems would be moved back to the non-U.S. Clearing

Members, who would essentially be placed in the same position as U.S. Clearing Members in terms of having to incur their own U.S. tax compliance costs.

For the reasons explained above, OCC is proposing amendments to its Rules, as described below, to implement prudent, preventive measures that would require all of OCC's non-U.S. Clearing Members to enter into agreements with the IRS under which they assume primary withholding responsibility, to become Qualified Derivatives Dealers, and to be FATCA Compliant, so as to permit OCC to make payments (and deemed payments of dividend equivalents) to such Clearing Members free from U.S. withholding tax. In preparation for the proposed rule change and the implementation of Section 871(m) as applied to listed options, OCC has asked its non-U.S. Clearing Members to provide OCC with tax documentation certifying their tax status for purposes of both FATCA and Chapter 3 Withholding. All of these Clearing Members are Canadian firms and, in response to OCC's request, each of them has provided documentation certifying that it is a Reporting Model 1 FFI under the IGA with Canada, and therefore FATCA Compliant. Each has also certified that for Chapter 3 Withholding purposes, it is a Qualified Intermediary Assuming Primary Withholding Responsibility. None of these Clearing Members are currently Qualified Derivatives Dealers because the IRS has not yet finalized the relevant regulations and the associated agreement that must be entered into with the IRS. The IRS is expected to finalize the regulations and provide the agreement language before January 1, 2017. If the IRS does not take any further action before January 1, 2017, then the regulations will go into effect, as they are currently written, on January 1, 2017. In that case, FFI Clearing Members would become subject to withholding by OCC with respect to Section 871(m) Transactions in which the

FFI Clearing Members are acting as a principal (*i.e.*, transactions for the member's own account). Because of the practical difficulty OCC would encounter in attempting to distinguish dealer transactions in which the FFI Clearing Member is acting as an intermediary versus those in which it is acting as a principal, OCC will not allow the FFI Clearing Members to clear any dealer trades in the absence of final guidance or the ability of OCC's FFI Clearing Members to distinguish intermediary versus principal transactions in a manner that would allow OCC to process intermediary transactions free of any withholding obligations under Section 871(m). As discussed above, however, OCC expects the IRS to finalize the regulations and to provide the relevant agreement language before January 1, 2017.

B. Proposed Amendments to OCC's By-Laws and Rules

For the reasons discussed above, OCC is proposing a number of amendments to its By-Laws and Rules designed to require that, as a general requirement for membership, all existing and future Clearing Members that are treated as non-U.S. entities for U.S. federal income tax purposes must enter into appropriate agreements with the IRS and be FATCA Compliant, such that OCC will not be responsible for withholding on dividend equivalents under Section 871(m). Specifically, OCC proposes to amend Article I of its By-Laws to include the following defined terms. The term "FFI Clearing Member" would mean any Clearing Member that is treated as a non-U.S. entity for U.S. federal income tax purposes. The term "Dividend Equivalent" would be defined as having the meaning provided in Section 871(m) of the I.R.C. and related Treasury Regulations and other official interpretations thereof. The term "FATCA" would be defined as meaning: (i) the provisions of Sections 1471 through 1474 of the Internal Revenue Code of 1986,

as amended, which were enacted as part of The Foreign Account Tax Compliance Act (or any amendment thereto or successor sections thereof), and related Treasury Regulations and other official interpretations thereof, as in effect from time to time, and (ii) the provisions of any intergovernmental agreement to implement The Foreign Account Tax Compliance Act as in effect from time to time between the United States and the jurisdiction of the FFI Clearing Member's residency. The term "FATCA Compliant" would mean, with respect to an FFI Clearing Member, that such FFI Clearing Member has qualified under such procedures promulgated by the IRS as are in effect from time to time to establish exemption from withholding under FATCA such that OCC will not be required to withhold any amount with respect to any payment or deemed payment to such FFI Clearing Member under FATCA. The term "Qualified Intermediary Assuming Primary Withholding Responsibility" would mean an FFI Clearing Member that has entered into an agreement with the IRS to be a qualified intermediary and to assume primary responsibility for reporting and for collecting and remitting withholding tax under Chapter 3 and Chapter 4 of subtitle A, and Chapter 61 and Section 3406, of the I.R.C. with respect to any income (including Dividend Equivalents) arising from transactions entered into by the Clearing Member with OCC as an intermediary, including transactions entered into on behalf of such Clearing Member's customers. The term "Qualified Derivatives Dealer" would be defined as an FFI Clearing Member that has entered into an agreement with IRS that permits OCC to make Dividend Equivalent payments to such clearing member free from U.S. withholding tax under Chapter 3 and Chapter 4 of subtitle A, and Chapter 61 and Section 3406, of the I.R.C. with respect to transactions entered into by such clearing member with OCC as a principal for such

Clearing Member's own account. "Section 871(m) Effective Date" would be defined as meaning January 1, 2017, or, if later, the date on which Section 871(m) and related Treasury Regulations and other official interpretations thereof, first apply to listed options transactions. Finally, "Section 871(m) Implementation Date" would mean December 1, 2016, or, if later, the date that is 30 days before the Section 871(m) Effective Date.<sup>26</sup>

The proposed rule change also would add Section 1(e) to Article V of OCC's By-Laws, which would require any applicant, that if admitted to membership would be an FFI Clearing Member, to be a Qualified Intermediary Assuming Primary Withholding Responsibility and to be FATCA Compliant beginning on the Section 871(m) Implementation Date. In addition, if the applicant intends to trade for its own account, the applicant would be required to be a Qualified Derivatives Dealer.

Furthermore, the proposed rule change would impose additional requirements on FFI Clearing Members. Specifically, proposed Rule 310(d)(1) would prohibit FFI Clearing Members from conducting any transaction or activity through OCC unless the Clearing Member is a Qualified Intermediary Assuming Primary Withholding Responsibility and FATCA Compliant, beginning on the Section 871(m) Effective Date. In addition, FFI Clearing Members would not be permitted to enter into a transaction for their own accounts unless such Clearing Member is a Qualified Derivatives Dealer and

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<sup>26</sup> Although withholding with regard to Dividend Equivalent payments to non-U.S. clearing members is scheduled take effect beginning January 1, 2017, the proposed amendments to the By-Laws and Rules would require existing non-U.S. clearing members to provide documentation certifying their compliance with the requirements of Rule 310(d) 30 days prior to January 1, 2017, in order for OCC to review the certification materials and to address in a timely manner any potential non-compliance, in accordance with its Rules.

such transaction is within the scope of the exemption from withholding tax for Dividend Equivalents paid to Qualified Derivatives Dealers.

Proposed Rule 310(d)(2) would require each FFI Clearing Member to certify annually to OCC, beginning on the Section 871(m) Implementation Date, that it satisfies the above requirements and also to update its certification to OCC (*viz.*, a completed Form W-8IMY electing primary withholding responsibility and Qualified Derivatives Dealer status) if required by applicable law or administrative guidance or if its certification is no longer accurate. Proposed Rule 310(d)(3) also would require each FFI Clearing Member to provide OCC with the information it needs relating to Dividend Equivalents, in sufficient detail and in a sufficiently timely manner, for OCC to comply with its obligation under Chapters 3 and 4 to make required reports to the IRS regarding Dividend Equivalents and the transactions giving rise to same between OCC and the FFI Clearing Member.

Additionally, proposed Rule 310(d)(4) would require each FFI Clearing Member to inform OCC promptly if it is not, or has reason to know that it will not be, in compliance with Rule 310(d) within 2 days of knowledge thereof. This rule ensures that OCC will be notified in a timely manner in the event that an FFI Clearing Member no longer maintains the appropriate arrangements described above to ensure that all withholding and reporting obligations with respect to Dividend Equivalents under Section 871(m) and Chapter 3 and 4 are being fulfilled.

Finally, proposed Rule 310(d)(5) would require each FFI Clearing Member to indemnify OCC for any loss, liability, or expense sustained by OCC resulting from such member's failure to comply with proposed Rule 310(d). As discussed above, a Dividend

Equivalent is deemed to arise if a dividend is paid on the underlying stock while an option is outstanding, even though no corresponding payment is made on the option. Due to the nature of OCC's settlement process, there may be no actual payments to the FFI Clearing Member from which OCC could withhold in order to address a liability or expense incurred by OCC arising from a member's failure to comply with the proposed rules. As a result, if OCC were required to satisfy any liability or expense caused by such member's failure to comply out of OCC's own funds, OCC would look to the FFI Clearing Member to indemnify OCC for such losses.

## II. Discussion and Commission Findings

Section 19(b)(2)(C) of the Act<sup>27</sup> directs the Commission to approve a proposed rule change of a self-regulatory organization if it finds that the rule change, as proposed, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to such organization. The Commission finds that the proposed rule change is consistent with Section 17A(b)(3)(F) of the Act,<sup>28</sup> which requires, among other things, that the rules of a clearing agency: (i) promote the prompt and accurate clearance and settlement of securities transactions and, to the extent applicable, derivative agreements, contracts, and transactions; (ii) assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible; and (iii) are not designed to permit unfair discrimination among participants in the use of the clearing agency.

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<sup>27</sup> 15 U.S.C. 78s(b)(2)(C).

<sup>28</sup> 15 U.S.C. 78q-1(b)(3)(F).

According to OCC, the proposed rule change is needed to eliminate the uncertainty in funds settlement that otherwise would arise if OCC were subject to withholding obligations with respect to Dividend Equivalents under Section 871(m). As noted above in Section I.A.2, given OCC's daily net settlement process, OCC may be required to apply its own funds if it were obligated to effectuate withholdings to the IRS pursuant to Section 871(m). The assumption of withholding responsibilities by OCC would introduce uncertainty and risks around the settlement of funds at OCC. The proposed rule change would transfer the obligation for any such withholding (and any resulting liability) to FFI Clearing Members by requiring FFI Clearing Members to enter into certain agreements with the IRS under which the FFI Clearing Member assumes primary withholding responsibilities with respect to transactions that it enters into on behalf of customers (i.e., as an intermediary) or for its own account (i.e., as a principal) and to be FATCA Compliant. The proposed rule change therefore would eliminate the potential uncertainty and risks in the daily settlement of funds at OCC that otherwise would be imposed by Section 871(m)'s new mandate. Thus, the Commission finds that the proposed rule change is designed to promote the prompt and accurate clearance and settlement of securities and derivatives transactions, and the safeguarding of securities and funds at OCC. While the proposed rule change would impose additional requirements and/or restrictions on FFI Clearing Members, the proposed rules are designed to address in a targeted and proportionate manner specific issues and potential risks to OCC arising from those FFI Clearing Members whose membership creates potential withholding obligations for OCC under the revised tax provisions. The Commission therefore finds that the proposed rule change does not unfairly discriminate

among participants in the use of the clearing agency. Based on the above, the Commission finds that the proposed rule change is consistent with Section 17A(b)(3)(F) of the Act.<sup>29</sup>

### III. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change, as modified by Amendment No. 1, is consistent with the Act. Comments may be submitted by any of the following methods:

#### Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-OCC-2016-014 on the subject line.

#### Paper Comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-OCC-2016-014. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed

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<sup>29</sup> 15 U.S.C. 78q-1(b)(3)(F).

with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filings also will be available for inspection and copying at the principal office of OCC and on OCC's website at [http://www.theocc.com/components/docs/legal/rules\\_and\\_bylaws/sr\\_occ\\_16\\_014.pdf](http://www.theocc.com/components/docs/legal/rules_and_bylaws/sr_occ_16_014.pdf).

All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

All submissions should refer to File Number SR-OCC-2016-014 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

#### IV. Accelerated Approval of Proposed Rule Change, as Modified by Amendment No. 1

As discussed above, OCC submitted Amendment No. 1 in order to adjust and clarify the date by which affected Clearing Members would need to demonstrate compliance with the proposed rule change. Amendment No. 1 does not raise any novel issues, and the filing has been designed to facilitate OCC's compliance with the requirements of another applicable regulatory regime. Accordingly, the Commission finds good cause, pursuant to Section 19(b)(2) of the Act,<sup>30</sup> to approve the filing, as modified by Amendment No. 1, on an accelerated basis prior to the 30th day after the

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<sup>30</sup> 15 U.S.C. 78s(b)(2).

date of the publication in the Federal Register of the Notice and the notice of Amendment No. 1 to the filing.

V. Conclusion

On the basis of the foregoing, the Commission finds that the proposal is consistent with the requirements of the Act, and in particular, with the requirements of Section 17A of the Act<sup>31</sup> and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>32</sup> that the proposed rule change (SR-OCC-2016-014), as modified by Amendment No. 1, be, and it hereby is, approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>33</sup>

Eduardo A. Aleman  
Assistant Secretary

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<sup>31</sup> In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. *See* 15 U.S.C. 78c(f).

<sup>32</sup> 15 U.S.C. 78s(b)(2).

<sup>33</sup> 17 CFR 200.30-3(a)(12).