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Via E-Mail

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: File No. SR-OCC-2006-01

To the Members of the Commission:

We are writing to respond to a second comment letter by Erik A. Hartog of Allagash Trading LLC regarding the captioned rule change filing. The filing was made on January 12, 2006 and published for comment on March 2, 2006.[1] It proposes to amend Article VI, Section 11A of OCC's By-Laws (i) to revise the definition of "ordinary dividends and distributions" to eliminate the so-called "10% rule" and (ii) to eliminate the need to round adjusted strike prices and units of trading when outstanding options are adjusted to reflect a stock dividend, stock split, or similar event.

On March 21, 2006, Mr. Hartog filed a comment letter opposing elimination of the 10% rule. On September 25, 2006, in response to comments by Mr. Hartog and others, OCC amended its proposed rule change to grandfather pre-existing positions. On September 29, 2006, OCC filed a letter responding to comments not addressed by the amendment.

[1] Rel. No. 34-53400 (Mar. 2, 2006).

OCC's amended rule change filing was published for comment on November 14, 2006.[2] On January 8, 2007, Mr. Hartog filed his second comment letter.

As Mr. Hartog acknowledges, his latest comment letter reiterates many of the same issues he raised previously. OCC staff discussed these issues with him in a telephone conversation last month. We believe that our response dated September 29, 2006 sufficiently addresses the issues raised in his most recent letter. These issues and our responses can be summarized as follows:

Uncertainty About "Special Dividends"

- *Concern that the need for a determination by an adjustment panel of the OCC Securities Committee whether a dividend is "special" (i.e., a non-ordinary dividend that would trigger an adjustment) will introduce uncertainty or delay when compared to the current policy.*

  As indicated in our earlier response, OCC believes that determining whether a dividend is "outside the normal practice of paying such dividends on a quarterly or other regular basis"--and hence non-ordinary and qualifying for adjustment--will normally be straightforward. Most "special dividends" will be clearly described as such by the company. Although the company's characterization of the dividend will not be binding on adjustment panels, it will be an important consideration, and OCC believes that in the vast majority of cases, the decision of the adjustment panel will be in accord with the company's own description of the dividend. In most cases, the panels will be able to announce their decisions within a day or two of the company's announcement. (In some cases, the new policy may improve upon the current approach because adjustment decisions will no longer need to be based on the percentage value of the dividend relative to the stock price on a future date.)

  Under OCC's By-Laws, all determinations to make adjustments are made by the appropriate adjustment panels. OCC is proposing no change to this process. OCC believes that the perceived "certainty"

[2] Rel. No. 34-54748 (Nov. 14, 2006).

under the current rule is itself largely a function of prompt and consistent action by adjustment panels.

- *Concern about dividends declared on foreign stocks or unique situations.*

In his original comments, Mr. Hartog raised "special case" examples such as Nucor Corporation's supplemental dividends. In his most recent comments, he also mentions Korean companies which may specify the amount of special dividends after the ex date. He feels it will be more difficult to address these unique situations under OCC's proposed policy.

As mentioned above, OCC believes problem cases will be the exception rather than the rule, and uncertainty will diminish over time as OCC publishes interpretations and policies and a body of precedent develops. As we observed in our earlier response, there will always be cases that require an exercise of judgment by adjustment panels. It is not possible to eliminate uncertainty altogether or to obviate the need for case by case decisions. This is why OCC convenes adjustment panels.

Mr. Hartog's reference to Korean companies is illustrative of this point. Mr. Hartog puts forward a "what-if" situation where a special dividend amount is determined *after* the ex date. OCC agrees this would be a situation that would require judgment by the adjustment panels. (OCC By-Laws provide that contract adjustments are generally effective on the ex date determined by the securities exchanges. Securities traded in the U.S. are adjusted by the dividend amount on their ex dates. If this amount is not known, U.S. markets may not quote the security "ex" the dividend). OCC notes that the situation raised by Mr. Hartog would also be problematic under the current policy-- e.g., what if a dividend determined after the ex date turns out to be greater than 10%? OCC and the exchanges are aware that foreign securities are often idiosyncratic with respect to corporate events or practices and have successfully addressed numerous issues posed by foreign securities. Mr. Hartog's example of Korean companies is interesting precisely because it is exceptional. As such, it is a good example of an item that adjustment panels would address based on the facts at hand at the time.

- *Question about "temporary dividend suspensions".*

  Mr. Hartog asks whether adjustments would be made for temporary suspensions of dividends or for other changes in a company's cash flow situation. OCC is puzzled by this question because both the current and proposed policies are only concerned with dividends actually declared.

  Mr. Hartog's question about temporary suspension of dividends may perhaps be considered along with others that have been raised previously, namely how the adjustment panels will handle *initial* dividends or *increases* to dividends. In our filing, we addressed these two questions specifically: initial dividends declared by a company that previously did not pay regular dividends would not trigger an adjustment. Likewise, an increase to a regular dividend would not trigger adjustment. OCC has reiterated this clarification in Information Memos concerning the proposed policy. As indicated in our previous response, OCC and the exchanges intend to publish informational material providing additional guidance about how the new policy will be implemented. Since all adjustments are determined by adjustment panels based on an evaluation of the facts at hand, it will not be possible to provide complete answers to all "what-if" questions that can be raised. But OCC and the exchanges are confident that there will be ample time before the proposed effective date of February 1, 2009 to identify special situations and provide further guidance.

<u>Option Illiquidity</u>

- Mr. Hartog claims that when options are adjusted for special dividends, bid/ask spreads widen due to illiquidity in the adjusted options, and customers are thereby harmed. It is commonly understood that bid/ask spreads may widen as a result of uncertainty. If there is uncertainty about whether an option will be adjusted in response to a dividend, or in what amount, market spreads may temporarily widen. However, once an adjustment decision is made, that uncertainty is dispelled.

Mr. Hartog suggests that adjusted options inherently become illiquid because they are no longer the "benchmark" for the underlying security and thus become less desirable and more difficult to trade. He feels this increases chances for trading error and, in turn, wider bid/ask spreads. Mr. Hartog believes "it is easy to envision a scenario where there are no quotes being updated for a particular illiquid series." OCC addressed concerns about liquidity in our earlier response: "Despite the thousands of contract adjustments made over the 33+ years of options trading on U.S. markets, we know of no case where a market has ceased to exist for an adjusted series. We cannot speak for European markets, but market-makers on U.S. options exchanges are numerous, highly competitive, quick to exploit arbitrage opportunities, and in many cases obligated by exchange rules to make markets in every series of every class in which they quote. We have never heard of a complaint that adjusted series (including series adjusted for special cash dividends above the 10% level) have become illiquid to the point of harming investors. We therefore believe that this concern [about liquidity] is misplaced."

OCC's earlier response also addressed the issue of option symbol and series proliferation which may be associated with Mr. Hartog's concerns about liquidity. We acknowledged the operational overhead that will result from more frequent option adjustments but noted that the number of new option symbols would not be material; the need for additional symbols would end when the industry converts to decimal strikes (scheduled for November 2009, a short time after the new adjustment policy is effective); and the strong belief that the inequities caused by the 10% Rule outweigh any operational costs associated with the incremental option symbol and series proliferation.

Effect on Buy-Write Strategy

- Mr. Hartog observes that many retail customers pursue buy-write strategies (utilizing short calls) that benefit from the current policy. For that reason, he contends that any view that retail customers will benefit from the proposed policy because they tend to be long calls is incorrect.

  The proposed policy was not intended to favor any particular class of option investors (e.g., public customers versus market professionals).

Rather, it was intended to address structural inequities that can impose unjustified financial burdens (and corresponding windfalls) for holders of certain options positions. Specifically, call holders/exercisers and put writers/assignees will benefit by avoiding adverse financial consequences in the event of an unanticipated special dividend. Insofar as any investor – retail investor or professional-- buys calls or sells puts, that investor will benefit from the new policy.

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Questions regarding this response may be addressed to John Peplinski at 312-322-6290, Gina McFadden at 312-322-6294, or the undersigned.

Very truly yours,

William H Navin

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