SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–73438; File No. SR–OCC–2014–15]

Self-Regulatory Organizations; The Options Clearing Corporation; Order Approving Proposed Rule Change To Process All Sell Transactions Prior to the Exercise of Long Options in Market-Maker Accounts To Ensure That Only Net Long Positions May Be Exercised

October 27, 2014.

I. Introduction

On July 17, 2014, The Options Clearing Corporation (''OCC'') filed with the Securities and Exchange Commission (''Commission'') the proposed rule change SR–OCC–2014–15 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Exchange Act'' or ''Act'') [1] and Rule 19b–4 thereunder.[2] The proposed rule change was published for comment in the **Federal Register** on July 31, 2014.[3] The Commission received five comment letters on the proposal.[4] On September 4, 2014, OCC extended the time for Commission action on the proposed rule change to October 27, 2014. For the reasons discussed below, the Commission is granting approval of the rule change, as proposed.

II. Description

Background

According to OCC, the purpose of the dividend play trading strategy is to capture the dividend income of a stock through the exercise of in-the-money call options on the day prior to the stock's ''ex-dividend'' date, which is the date that determines whether the holder of a stock is entitled to the stock's dividend. Where stock is transferred before the ex-dividend date, the new owner of the stock is entitled to the dividend. In order to capture this dividend income, a trader will buy 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 write an offsetting number of call options of the same series on the same stock at the same price. Because the two transactions are exactly offsetting and executed at the same price, the trader's position in the call options is net neutral and has limited market risk. At the end of the day, the trader then exercises all of its long call options even though the trader's net position is neutral.

OCC, using its current standard assignment process, assigns all of that day's exercised long call options of the same series across all options writers. OCC processes exercises after option purchases but before options sales. This processing sequence permits a market-maker executing a dividend play to buy and sell equal quantities of call options of a given series and exercise the purchased call options even though the market-maker's position is neutral. OCC believes this would make the conventional dividend play impossible. OCC currently processes exercises before sales in order to reduce operational risk for clearing members clearing options transactions in accounts other than market-makers.

In December 2012, the Securities Industry and Financial Markets Association's (''SIFMA'') Listed Options Trading Committee requested that OCC formally review dividend plays.[5] According to OCC, SIFMA expressed a concern that OCC could suffer losses as a result of an operational error in processing dividend plays. Because successful dividend plays rely in part on the dividend trader's having a large position compared to the pre-existing open interest in the series of options subject to the dividend play, SIFMA believed 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.

Following receipt of the SIFMA letter, OCC initiated a review of dividend plays. Upon completion of a comprehensive review, OCC noted that dividend plays generally may be perceived negatively in the marketplace and have been criticized as unfair to retail investors and as distorting options transactions volume. OCC determined that while it should not take action to eliminate or restrict dividend plays based on these factors, nor should it facilitate these transactions. OCC's processing sequence, under which sale transactions are processed after exercises, was designed to reduce the operational risk to clearing members that results from potential miscoding of, for example, an opening trade for the account of one clearing member customer as a closing trade for the account of another clearing member customer in accounts that are carried on a gross basis.[6] However, this coding risk does not exist with respect to market-maker accounts, where positions are carried on a net basis. Accordingly, OCC concluded that its processing sequence unnecessarily allowed certain market-makers to execute dividend plays and, therefore, proposed to change the processing sequence so that for these accounts sale transactions are processed before exercises. OCC believes that the change would have the effect of significantly restricting dividend plays because large long positions that would otherwise be exercised would be offset by sale transactions.

Proposed Amendment

OCC is proposing to amend its rules to add an interpretation and policy to Rule 801 and to Rule 805 to state that, with respect to Market-Maker Accounts,[7] sell transactions will be processed before exercises. If OCC processed sales before exercises, market-makers' purchases and sales on a given day would offset each other, and when OCC processed the exercises, there would be no net long call positions to exercise. OCC is also proposing to modify its systems to make a corresponding change in the processing sequence. According to OCC, this change in the processing sequence would only apply to Market-Maker Accounts (and, potentially subaccounts in JBO Participants' accounts), and would not change the processing

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] Securities Exchange Act Release No. 72677 (July 25, 2014), 79 FR 44480 (July 31, 2014).

[4] *See* letters from Suzanne Shatto, dated August 18, 2014 (''Shatto Letter''); Robert P. Bramnik, Duane Morris, LLP, and James D. Van De Graaf, Katten Muchin Rosenman LLP, on behalf of Bedrock Trading LP, Elm Trading LP, First Derivative Traders LP, Keystone Trading Partners, and Largo Trading LP (''Duane Morris''), dated August 19, 2014 (''Duane Morris Letter''); Elle Greene, Vice President, Securities Industry and Financial Markets Association (''SIFMA''), dated August 21, 2014 (''SIFMA Letter''); Abraham Kohen, President, AK FE Consultants LLC, dated August 24, 2014 (''Kohen Letter''); James E. Brown, Executive Vice President, General Counsel and Secretary, OCC, dated September 9, 2014 (''OCC Letter'').

[5] *See* OCC Letter citing to Letter from Ellen Greene, Vice President of SIFMA, to Wayne P. Luthringshausen, Chairman and Chief Executive Officer of OCC (December 3, 2012) available at *http://www.sifma.org/issues/item.aspx?id=8589942317*.

[6] According to OCC, accounts that are carried on a gross basis can be both long and short the same series. This means that trades must be coded as opening or closing transactions.

[7] ''Market Maker Account'' is a defined term in Article I of OCC's By Laws. Because the definition of ''Market-Maker Account'' in Article 1 of OCC's By-Laws includes a JBO Participants' account, the interpretation and policy clarifies that this netting will not be applied to a JBO Participants' account until such time as OCC determines on not less than 30 days' notice to clearing members that OCC is able to identify, on a subaccount basis, the transactions of a JBO Participant within a JBO Participants' account, in which case a JBO Participants' account shall be considered a Market-Maker Account.

sequence applicable to clearing member accounts other than Market-Maker Accounts.

III. Summary of Comments Received and OCC's Responses

The Commission received five comment letters in response to the proposed rule change; two comment letters supporting the proposal,[8] one comment letter suggesting a possible alternative to the proposal,[9] one comment letter opposing the proposal,[10] and one comment letter responding to the comment letter opposing the proposal.[11] The Commission has reviewed and taken into full consideration all of the comments received.

The Shatto Letter and SIFMA Letter, express support for the proposed rule change.[12] The Shatto Letter notes that the proposal will provide clarity to the process and reduce risk for all parties. The SIFMA Letter supports the proposal because it believes the risk of engaging in dividend trade strategies outweighs any potential profit for those who participate in such a strategy. Further, the SIFMA Letter ''applauded'' the rigorous approach taken by OCC to evaluate the risks and other factors associated with dividend trade strategies and evaluate whether any issues or unintended consequences would occur as a result of changing the processing sequence for market makers. The SIFMA Letter recommends that OCC continue its efforts to prevent and eliminate the dividend play trading strategy. The Kohen Letter does not express support or opposition to OCC's proposal, but rather proposes an alternative proposal that would require market-makers to mark all their transactions as opening or closing and process trades and exercises notices in the same manner OCC processes transactions in non-market-maker accounts.

The Duane Morris Letter, representing five market-makers, opposes OCC's proposal and advocates the Commission disapprove the proposed rule change. Below is a discussion of the issues raised by Duane Morris and OCC's response to those concerns.

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

The Duane Morris Letter contends that the proposed rule change is not consistent with Section 17A(a)(2)(A) of the Exchange Act[13] because it does not display ''due regard'' for the maintenance of fair competition among brokers and dealers, and asserts that the ''true'' purpose of the proposed rule change is to eliminate a specific trading practice at the expense of, and detriment to, certain market makers. Additionally, the Duane Morris Letter argues that SRO rules relating to trades and trading practices are the province of national securities exchanges and that it is beyond the jurisdiction of a clearing agency to neutralize trading and a trading strategy effected on a national securities exchange simply because a clearing broker may make an operational error. The Duane Morris Letter also contends that the proposed rule change, if approved, would essentially negate the rules of various options exchanges concerning opening and closing transactions without any statutory or regulatory authority to do so.

The Duane Morris Letter further contends that OCC's statutory basis for the proposed rule change was not valid. Specifically, the Duane Morris Letter asserted that OCC concedes that any potential operational risk posed by dividend plays is at most ''de minimis'' since OCC acknowledges in the proposed rule change that dividend plays represent only a small number of OCC cleared options, the majority of which are cleared through two large and well-capitalized clearing members that have a robust risk management process.

In response, OCC contends that Section 17A(a)(2)(A) of the Exchange Act[14] does not set forth the standards specifically applicable to registered clearing agency rule changes, which are instead contained in Section 17A(b) of the Exchange Act.[15]

Further, OCC claims that it has the authority under Section 17A(b)(3)(F) of the Exchange Act[16] and Rule 17Ad–22(d)(4)[17] to implement a policy that has been approved by OCC's Board of Directors . Specifically, OCC cites to Section 17A(b)(3)(F) of the Exchange Act,[18] which requires registered clearing agencies to have rules designed to promote the prompt and accurate clearance and settlement of securities transactions and, in general, to protect investors and the public interest. OCC further cites to Rule 17Ad–22(d)(4),[19] which requires registered clearing agencies to identify sources of operational risk and to develop appropriate systems, controls, and procedures to minimize those sources.

OCC also emphasizes that it does not seek to police registered national securities exchanges or broker-dealers trading options on such exchanges.[20] OCC notes that it began investigating the potential risks that dividend plays posed to OCC and market participants following a well-publicized trading error and approximately $10 million loss, which OCC believed to be related to the dividend trading strategy. OCC further notes that market participants through SIFMA also requested that it investigate the dividend trading strategy in light of its negative perception in the marketplace and criticism that it is unfair to retail investors and distorts options transactions volume.

OCC also contends that its trade processing sequence, in which sales are processed after exercises, is the primary reason why dividend plays are even possible. According to OCC, it has historically used such a sequence to address a potential miscoding of opening and closing transactions—a risk not applicable to market-maker accounts—and that it did not anticipate that certain market-makers would use this sequence to execute net neural transactions with limited market risk, resulting in a reallocation of unassigned short positions from retail investors to market-makers executing the trading strategy. As originally expressed in the rule change, as proposed, OCC reiterates that while it should not act to eliminate or restrict dividend plays based on negative perception and the abuse of retail investors, neither should it facilitate these transactions. Thus, according to OCC, upon the urging of market participants and after a comprehensive review of the trading strategy, OCC decided to adopt a policy of not facilitating dividend plays, which are made possible primary by OCC's legacy choice of a particular processing sequence.

Finally, OCC also contends that it has a valid statutory basis supporting the proposed rule change to curtail the use of dividend plays. OCC asserts that neither Section 17A(b)(3)(F) of the Exchange Act[21] or Rule 17Ad–22(d)(4)[22] limit OCC to only addressing

[8] *See* Shatto Letter and SIFMA Letter.

[9] *See* Kohen Letter.

[10] *See* Duane Morris Letter.

[11] *See* OCC Letter.

[12] *See* Shatto Letter and SIFMA Letter.

[13] 15 U.S.C. 78q–1(a)(2)(A).

[14] 15 U.S.C. 78q–1(A)(2)(A).

[15] 15 U.S.C. 78q–1(b).

[16] 15 U.S.C. 78q–1(b)(3)(F).

[17] 17 CFR 240.17Ad–22(d)(4).

[18] 15 U.S.C. 78q–1(b)(3)(F).

[19] 17 CFR 240.17Ad–22(d)(4).

[20] OCC asserted that it is not aware of any exchange rules that specifically address dividend plays. According to OCC, the rules cited in the Duane Morris Letter concerning ''opening'' and ''closing'' transactions are relevant for many other purposes other than exercises, and, therefore, are not negated by the proposed rule change.

[21] 15 U.S.C. 78q–1(b)(3)(F).

[22] 17 CFR 240.17Ad–22(d)(4).

risks that are posed to itself. Rather, OCC notes its belief that it 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. While OCC concedes that dividend plays currently do not present a material risk to OCC, OCC maintained that this may not always be the case and that OCC's rules and by-laws do not limit the clearing of dividend plays to firms that are well-capitalized.

B. *The Proposed Rule Change Is Per Se Anticompetitive and Favors One Group of Brokers-Dealers Over Another Group of Broker-Dealers*

The Duane Morris Letter asserts that the proposed rule change is per se anticompetitive because it would only affect trading in market-maker accounts. The Duane Morris Letter contends that OCC's revision of its rules to preclude the acceptance of exercise notices on new long options positions on an intra-day basis would effectively nullify OCC Rule 801(c) solely for the accounts of market-makers.

In response, OCC contends that the proposed rule change is not intended to address competitive issues nor does it have the effect of eliminating or reducing competition. OCC states that all market-makers holding options positions established on national securities exchanges would be subject to the same processing sequence. Furthermore, according to OCC, a market-maker would still be able to 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 ex-dividend date, so long as its long positions are not fully offset with short position at the end of the trading day.

C. The Proposed Rule Change is Per Se Anticompetitive and Favors Certain National Securities Exchanges Over Others

The Duane Morris Letter asserts that the purpose and intent of the proposed rule change is to reduce trade volume reported by NASDAQ OMX PHLX, so as to artificially increase the relative market share reported on other exchanges particularly the International Stock Exchange (''ISE'').

In response, OCC contends that this particular assertion is ''unsupported.'' OCC alleges that the composition of its Board of Directors, which is composed of two management directors, three public directors, nine clearing member directors and five exchange directors, makes it impossible that a limited number of exchanges, let alone one exchange, could have caused the proposal to be approved for an improper purpose. Additionally, OCC cites to the fact that various market participants through SIFMA encouraged OCC to initiate the inquiry into dividend plays.

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

The Duane Morris Letter asserts that market participants may have differing reasons, methodologies and strategies in connection with their options trading, which, according to Duane Morris, explains why occasionally the holder of an in-the-money call position will not exercise before the ex-dividend date. If OCC curtails dividend plays, Duane Morris contends, options pricing will become less stable and predictive, resulting in less liquidity and depth in the options market.[23] Duane Morris further contends that dividend plays serves a public purpose as it alerts public customers to the ex-dividend date and highlights the need for public customers to consider whether it is in their interests to adjust their positions.

In response, OCC contends that the proposed rule change is not targeting market participants based on whether or not they exercise call options. OCC characterizes the Duane Morris assertion concerning the proposal's effect on options pricing as ''speculation'' that is unlikely to match the actual outcome. The notion that dividend plays add liquidity and stability to the options market is, OCC notes, ''questionable at best'' since, according to OCC, 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.

In addition, OCC disputes the Duane Morris assertion that dividend plays pose no harm public investors. OCC states that dividend plays are only profitable because the strategy results in a larger share of unassigned short positions being allocated away from market participants, including public investors, to dividend play traders. Furthermore, according to OCC, the timing (*i.e.,* end of trading day) and manner (*i.e.,* through a floor broker) in which dividend plays are executed cuts against Duane Morris's public purpose argument.

IV. Discussion and Commission Findings

Section 19(b)(2)(C) of the Exchange Act directs the Commission to approve a proposed rule change of a self-regulatory organization if it finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to such organization. [24] Section 17A (b)(3)(F) of the Exchange Act requires that the rules of a clearing agency be designed to promote the prompt and accurate clearance and settlement of securities transactions, to foster cooperation and coordination with persons engaged in the clearance and settlement of securities transactions, to remove impediment 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.[25] Rule 17Ad–22(d) requires a registered clearing agency to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide for a well-founded, transparent and enforceable legal framework for each aspect of its activities in all relevant jurisdictions [26] and to identify sources of operational risk and minimize them through the development of appropriate systems, controls, and procedures.[27]

After careful review of the proposal and the comment letters and the comment letters in response thereto, as described above and below, the Commission finds that OCC's rule change, as proposed, is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to a registered clearing agency. In particular, the Commission believes that OCC has the authority under the Exchange Act and the rules and regulations thereunder to adopt or amend existing rules to change its processing sequence to curtail or

[23] The Duane Morris Letter further claims that there is no underlying statutory basis for the proposal's net long requirement and market efficiency is not advanced by such a requirement. The Duane Morris Letter appears to base its claim on an alleged securities laws' requirement that an options holder must carry a net long position to act with respect to its position has been grounded in concerns of fraud and manipulation and that no harm is imposed on public investors by dividend play transactions. OCC characterizes this argument as a ''red herring.'' Moreover, OCC asserts that it is not relying on the narrow statutory basis that a market participant must be net long to take certain action, and that it has ample statutory authority under Section 17A(b)(3)(F) of the Exchange Act.

[24] 15 U.S.C. 78s(b)(2)(C).

[25] 15 U.S.C. 78q–1(b)(3)(F).

[26] 17 CFR. 240.17Ad–22(d)(1).

[27] 17 CFR 240.17Ad–22(d)(4).

eliminate the use of dividend plays in the accounts of market-makers in light of the identifiable improvements in the safety of its processes that are expected to result from the changes.

Through its internal governance process, OCC has determined that dividend play trades have the potential to pose certain risks to market participants, including OCC clearing members, and, in general, are not in the public interest. In making such a determination, OCC's proposed rule change will limit the use of dividend plays through the modification of the processing sequence by which these trades are cleared and settled at OCC. While the Commission acknowledges the point raised by Duane Morris and confirmed by OCC in its proposal, that dividend play trading does not present any current operational risk to OCC, the Commission believes that neither Section 17A of the Exchange Act nor Rule 17Ad–22 limit OCC to exclusively addressing risks that are currently present for the clearing agency alone. Given its important role in the national clearance and settlement system and its designation as a systemically important financial market utility by the Financial Stability Oversight Council in 2012, the Commission believes OCC is entitled under the Exchange Act to take into account the interests of its clearing members, as well as foreseeable effects of its actions on the financial system more generally, when reviewing and considering changes to its operational practices. There is a clearly articulated basis for believing the proposed action by OCC will improve the national clearance and settlement system by increasing the safety of the system in identifiable ways for at least a portion of OCC's membership as reflected in OCC's proposal and in the comment letters received, and the Commission believes such improvements are consistent with the relevant requirements of the Exchange Act. In particular, since the clearing of dividend play trades is not restricted based on clearing member capitalization and risk-management processes, the proposal serves to mitigate a foreseeable source of operational risk by precluding clearing members with less robust risk management processes from clearing such dividend trades in the future.

The Commission also finds that the proposal does not impose any burden on competition that is not necessary or appropriate in furtherance of the Exchange Act. The appropriate standard, as set forth in Section 17A(b)(3)(I) of the Exchange Act, requires that the rules of the clearing agency do not impose any burden on competition not necessary or appropriate in furtherance of the Exchange Act.[28] The Commission believes that the proposed rule change does not impose a burden on competition that is not necessary or appropriate in furtherance of minimizing potential sources of operational risk and promoting the prompt and accurate clearance and settlement of securities transactions. Moreover, since the majority of dividend plays occur in market-maker accounts, there is a reasonable basis for OCC to believe it is prudent risk management to start curtailing dividend play trading in the types of accounts in which it primarily occurs. Furthermore, the Commission notes that the proposed changes by OCC would not have the effects of ending dividend plays entirely for market-makers or any other participants in the options market. A market-maker, for example, will still have the ability to participate in the capturing of dividend after the operational changes proposed by OCC are in effect by exercising long in-the-money call options on the day prior to the ex-dividend date, so long as its position in the particular option is net long. While some consequential effects would necessarily follow from OCC implementing the proposed changes in its operational practices, absent action to eliminate dividend plays entirely, at this time the Commission believes OCC's choice to consider the beneficial effects of its operational changes outweigh any negative effects to be consistent with Section 17A(b)(3)(I) of the Exchange Act.[29]

Pursuant to Section 3(f) of the Exchange Act, in the review of a rule of a self-regulatory organization, the Commission shall consider whether the action will promote efficiency, competition, and capital formation.[30] As described above, Duane Morris argues that market efficiency is not advanced by the net long requirement for the processing of call options in Market-Maker accounts. Duane Morris appears to base its assertion on its belief that fraud and/or manipulation are not concerns with dividend play transactions, and that such trading imposes no harm to public investors. The Commission believes that Duane Morris has not provided ample evidence to support the assertion that the proposed rule change does not advance market efficiency.

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[31] and the rules and regulations thereunder.

It is therefore ordered, pursuant to Section 19(b)(2) of the Exchange Act,[32] that the proposed rule change (File No. SR–OCC–2014–15) be and hereby is *approved.*[33]

For the Commission by the Division of Trading and Markets, pursuant to delegated authority.[34]

Kevin M. O'Neill,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–73439; File No. SR–CBOE–2014–082]

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change Relating to the CBOE Trade Match System

October 27, 2014.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the "Act"),[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on October 24, 2014, Chicago Board Options Exchange, Incorporated (the "Exchange" or "CBOE") filed with the Securities and Exchange Commission (the "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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[28] 15 U.S.C. 78q–1(b)(3)(I).

[29] Any additional proposed rule change by OCC expected to have the effect of eliminating the use of dividend play trades would also have to be presented to the Commission for consideration prior to taking effect. Points such as those made in the Duane Morris Letter regarding expected effects on competition and other consequences resulting from such a proposed change would necessarily be reconsidered by the Commission in light of the rationales presented by OCC at that time.

[30] 15 U.S.C. 78c(f).

[31] 15 U.S.C. 78q–1.

[32] 15 U.S.C. 78s(b)(2).

[33] In approving the proposed rule change, the Commission considered the proposal's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

[34] 17 CFR 200.30–3(a)(12).

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.