OCC

July 17, 2014

VIA ELECTRONIC MAIL

Melissa Jurgens
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: Rule Filing SR-OCC-2014-15 Rule Certification

Dear Secretary Jurgens:

Pursuant to Section 5c(c)(1) of the Commodity Exchange Act, as amended ("Act"), and Commodity Futures Trading Commission Regulation ("CFTC") 40.6, enclosed is a copy of the above-referenced rule filing submitted by The Options Clearing Corporation ("OCC"). The date of implementation of the rule is at least 10 business days following receipt of the rule filing by the CFTC or the date the proposed rule is approved by the Securities and Exchange Commission (the "SEC") or otherwise becomes effective under the Securities Exchange Act of 1934 (the "Exchange Act"). This rule filing has been, or is concurrently being, submitted to the SEC under the Exchange Act.

In conformity with the requirements of Regulation 40.6(a)(7), OCC states the following:

Explanation and Analysis

This proposed rule change would add an interpretation and policy to Rules 801 and 805, respectively, stating that OCC will, in respect of Market-Maker accounts, process all sell transactions prior to the exercise of long options in the account, to ensure that only net long positions may be exercised. This proposed change, coupled with the related system modifications, would have the effect of implementing a policy approved by the OCC Board of Directors intended to curtail use of a trading strategy known as "dividend plays" in the options industry.

Background

Dividend plays are an options trading strategy that has been executed on options exchanges for many years. The purpose of the 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 standard assignment process, then assigns all of that day's exercised long call options of the same series across all options writers. If all in-the-money long call options of the same series were exercised on the day prior to the ex-dividend date, the trader, and all other market participants in the relevant option series, would be assigned all its short call positions and would not have a resulting long stock position that is entitled to the dividend. However, a certain percentage of open interest in in-the-money call options goes unexercised on the day prior to the ex-dividend date. Generally, this failure is due to a number of factors, including transaction costs, the ignorance of certain market participants of the mechanics of call options and ex-dividend dates, inattentiveness by certain market participants in monitoring their positions and irrationality.[1] Because traders executing a dividend play exercise 100% of their long call options, it increases the overall percentage of open interest that gets exercised. OCC's standard assignment processing will close out a large portion of a traders' short position 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, and a larger share of unassigned short positions will be left to the dividend play trader. For every short call position that is not assigned, a trader executing the dividend play does not have to deliver stock and is able to capture the dividend payment for the shares of stock it remains long.

The vast majority of dividend play activity occurs in Market-Maker accounts and OCC's processing sequence makes it possible for market makers to execute conventional dividend plays, as described above. OCC processes exercises after option purchases but before options sales, also known as "writing" transactions. 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. 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 no net long call positions to exercise. This would make the conventional dividend play impossible. However, OCC processes exercises before sales in order to reduce operational risk for clearing members clearing

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1 *See e.g.*, Veronica K. Pool, Hans R. Stool, Robert E. Whaley, *Failure to exercise call options: An anomaly and a trading game*, 11 J. Fin. Markets 1 (2007); Jia Hao, Avner Kalay, Stewart Mayhew, *Ex-Dividend Arbitrage in Options Markets*, 23 Rev. Fin. Stud. 271, Issue 1 (2009).

options transactions in accounts other than Market-Maker accounts. Positions in accounts other than Market-Maker accounts are carried on a gross basis, meaning that an account can be both long and short the same series. This means that trades must be coded as opening or closing transactions. If OCC processed sales before exercises in an account other than a Market-Maker account, a coding error could cause rejection of exercise instructions that could result in substantial losses. However, coding errors do not present a risk with respect to Market-Maker accounts, where positions are carried on a net basis and trades do not have to be coded as opening or closing transactions.

OCC Review of Dividend Plays

In December 2012, the Securities Industry and Financial Markets Association's ("SIFMA") Listed Options Trading Committee requested that OCC formally review dividend plays.[2] 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 on part in 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 comprehensive review of dividend plays.

In connection with its review of dividend plays OCC noted that these transactions represent only a small number of OCC cleared options, and that most of the dividend play trading is cleared through two large clearing members that are large and well-capitalized and have robust risk management processes. OCC's therefore concluded that dividend plays did not materially increase OCC's risk. As requested by OCC's Board of Directors, OCC's Operations Roundtable further evaluated the proposed change in OCC's processing sequence to determine whether there were any unintended consequences to implementing the proposed change. The Operations Roundtable, which consists of operations staff of a cross-section of OCC's clearing members and operations staff of the options exchanges, carefully reviewed the proposal over several months and concluded that no material unintended consequences would result from its implementation.

Dividend plays generally may be perceived negatively in the marketplace and have been criticized as unfair to retail investors and as distorting op ions transactions volume.[3] 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

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

3 SIFMA Letter, p. 1.

which sale transactions are processed after exercises, is generally 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. 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 is proposing to change it so that for these accounts sale transactions are processed before exercises. 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 proposes to amend the Rules to add an interpretation and policy to Rule 801 and to Rule 805 to state, with respect to Market-Maker accounts, that sell transactions will be processed before exercises. Because the definition of "Market-Maker Account" in Article 1 of OCC's By-Laws would include a JBO Participants' account, the interpretation and policy clarifies that this netting will not be applied to JBO Participants' accounts 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 JBO Participants' accounts, in which case JBO Participants' accounts shall be considered Market-Maker accounts. OCC also proposes to modify OCC's systems to make a corresponding change in the processing sequence. This change in the processing sequence would only applied to Market-Maker accounts (and, potentially subaccounts in JBO Participants' accounts), and would not change the processing sequence, and the associated protection against coding errors, applicable to clearing member accounts other than Market-Maker accounts.

OCC reviewed the derivatives clearing organization ("DCO") core principles ("Core Principles") as set forth in the Act. During this review, OCC identified the following Core Principle as potentially being impacted:

Risk Management. OCC believes that by implementing the proposed rule change it will be better able to manage the risks associated with discharging its responsibilities as a DCO as set forth in the DCO Core Principles because it will, through the adoption of the proposed interpretation and policy and a related system modification, curtail the use of a trading strategy known as "dividend plays" in the options industry. Specifically, the proposed interpretation and policy 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.

<u>Opposing Views</u>

No opposing views were expressed related to the rule amendments.

<u>Notice of Pending Rule Certification</u>

OCC hereby certifies that notice of this rule filing has been be given to Clearing Members of OCC in compliance with Regulation 40.6(a)(2) by posting a copy of the submission on OCC's website concurrently with the filing of this submission.

<u>Certification</u>

OCC hereby certifies that the rule set forth at Item 1 of the enclosed filing complies with the Act and the CFTC's regulations thereunder.

Should you have any questions regarding this matter, please do not hesitate to contact me.

Sincerely,

Stephen Szarmack
Vice President and Associate General Counsel

Enclosure

SUBMISSION COVER SHEET

IMPORTANT: **Check box if Confidential Treatment is requested** ☐

Registered Entity Identifier Code (optional): SR-OCC-2014-15

Organization: **The Options Clearing Corporation**

Filing as a: ☐ **DCM** ☐ **SEF** ☒ **DCO** ☐ **SDR** **Please note - only ONE choice allowed.**

Filing Date (mm/dd/yy): 07/17/2014 Filing Description: OCC proposes 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.

SPECIFY FILING TYPE **Please note only ONE choice allowed per Submission.**

Organization Rules and Rule Amendments

- ☒ Certification § 40.6(a)
- ☐ Approval § 40.5(a)
- ☐ Notification § 40.6(d)
- ☐ Advance Notice of SIDCO Rule Change § 40.10(a)
- ☐ SIDCO Emergency Rule Change § 40.10(h)

Rule Numbers: Rule 801 – Chapter VIII

New Product **Please note only ONE product per Submission.**

- ☐ Certification § 40.2(a)
- ☐ Certification Security Futures § 41.23(a)
- ☐ Certification Swap Class § 40.2(d)
- ☐ Approval § 40.3(a)
- ☐ Approval Security Futures § 41.23(b)
- ☐ Novel Derivative Product Notification § 40.12(a)
- ☐ Swap Submission § 39.5

Official Product Name: ______________________________

Product Terms and Conditions (product related Rules and Rule Amendments)

- ☐ Certification § 40.6(a)
- ☐ Certification Made Available to Trade Determination § 40.6(a)
- ☐ Certification Security Futures § 41.24(a)
- ☐ Delisting (No Open Interest) § 40.6(a)
- ☐ Approval § 40.5(a)
- ☐ Approval Made Available to Trade Determination § 40.5(a)
- ☐ Approval Security Futures § 41.24(c)
- ☐ Approval Amendments to enumerated agricultural products § 40.4(a), § 40.5(a)
- ☐ "Non-Material Agricultural Rule Change" § 40.4(b)(5)
- ☐ Notification § 40.6(d)

Official Name(s) of Product(s) Affected: ______________________________
Rule Numbers: ______________________________

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 19b-4

Proposed Rule Change
by

THE OPTIONS CLEARING CORPORATION

Pursuant to Rule 19b-4 under the
Securities Exchange Act of 1934

Item 1. **Text of the Proposed Rule Change**

This proposed rule change by The Options Clearing Corporation ("OCC") would add an interpretation and policy to Rules 801 and 805, respectively, 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. This proposed change, coupled with the related system modifications, would have the effect of implementing a policy approved by the OCC Board of Directors intended to curtail use of a trading strategy known as "dividend plays" in the options industry. Material proposed to be added to OCC's Rules as currently in effect is marked by underlining.

THE OPTIONS CLEARING CORPORATION

RULES

* * *

CHAPTER VIII

* * *

Exercise of Options

RULE 801.

(a) – (d) [No Change]

. . . ***Interpretations and Policies:***

.01 – .03 [No change]

<u>.04 With respect to any Market-Maker account, the Corporation shall process sell transactions in respect of American option contracts prior to exercises in respect of such contracts; provided that, for the purposes of this Interpretation and Policy, JBO Participants'</u>

accounts shall not be considered Market-Maker accounts until such time as the Corporation on not less than 30 days' notice to Clearing Members is able to identify, on a subaccount basis, the transactions of a JBO Participant within JBO Participant accounts, in which case JBO Participant accounts shall be considered Market-Maker accounts.

* * *

Expiration Exercise Procedure

RULE 805.

(a) – (m) [No Change]

. . . ***Interpretations and Policies:***

.01 – .03 [No change]

.04 With respect to any Market-Maker account, the Corporation shall process sell transactions in respect of option contracts prior to exercises in respect of such contracts; provided that, for the purposes of this Interpretation and Policy, JBO Participants' accounts shall not be considered Market-Maker accounts until such time as the Corporation on not less than 30 days' notice to Clearing Members is able to identify, on a subaccount basis, the transactions of a JBO Participant within JBO Participants' accounts, in which case JBO Participants' accounts shall be considered Market-Maker accounts.

Item 2. Procedures of the Self-Regulatory Organization

The proposed change was approved for filing with the Commission by the Board of Directors of OCC at a meeting held on May 21, 2013.

Questions should be addressed to Stephen Szarmack, Vice President and Associate General Counsel, at (312) 322-4802.

Item 3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

A. Purpose

This proposed rule change would add an interpretation and policy to Rules 801 and 805, respectively, stating that OCC will, in respect of Market-Maker accounts, process all sell transactions prior to the exercise of long options in the account, to ensure that only net long positions may be exercised. This proposed change, coupled with the related system modifications, would have the effect of implementing a policy approved by the OCC Board of Directors intended to curtail use of a trading strategy known as "dividend plays" in the options industry.

Background

Dividend plays are an options trading strategy that has been executed on options exchanges for many years. The purpose of the 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 standard assignment process, then assigns all of that day's exercised long call options of the same series across all options writers. If all in-the-money long call options of the same series were exercised on the day prior to the ex-dividend date, the trader, and all other market participants in the relevant option series, would be assigned all its short call positions and would not have a resulting long stock position that is entitled to the dividend. However, a certain percentage of open interest in in-the-money call options goes unexercised on the day prior to the ex-dividend date. Generally, this failure is due to a number of factors, including transaction costs, the ignorance of certain market participants of the mechanics of call options and ex-dividend dates, inattentiveness by certain market participants in monitoring their positions and irrationality.[1] Because traders executing a dividend play exercise 100% of their long call options, it increases the overall percentage of open interest that gets exercised. OCC's standard assignment processing will close out a large portion of a traders' short position 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, and a larger share of unassigned short positions will be left to the dividend play trader. For every short call position that is not assigned, a trader executing the dividend play does not have to deliver stock and is able to capture the dividend payment for the shares of stock it remains long.

The vast majority of dividend play activity occurs in Market-Maker accounts and OCC's processing sequence makes it possible for market makers to execute conventional

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1 *See e.g.*, Veronica K. Pool, Hans R. Stool, Robert E. Whaley, *Failure to exercise call options: An anomaly and a trading game*, 11 J. Fin. Markets 1 (2007); Jia Hao, Avner Kalay, Stewart Mayhew, *Ex-Dividend Arbitrage in Options Markets*, 23 Rev. Fin. Stud. 271, Issue 1 (2009).

dividend plays, as described above. OCC processes exercises after option purchases but before options sales, also known as "writing" transactions. 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. 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 no net long call positions to exercise. This would make the conventional dividend play impossible. However, OCC processes exercises before sales in order to reduce operational risk for clearing members clearing options transactions in accounts other than Market-Maker accounts. Positions in accounts other than Market-Maker accounts are carried on a gross basis, meaning that an account can be both long and short the same series. This means that trades must be coded as opening or closing transactions. If OCC processed sales before exercises in an account other than a Market-Maker account, a coding error could cause rejection of exercise instructions that could result in substantial losses. However, coding errors do not present a risk with respect to Market-Maker accounts, where positions are carried on a net basis and trades do not have to be coded as opening or closing transactions.

OCC Review of Dividend Plays

In December 2012, the Securities Industry and Financial Markets Association's ("SIFMA") Listed Options Trading Committee requested that OCC formally review dividend plays.[2] 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 on part in 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 comprehensive review of dividend plays.

In connection with its review of dividend plays OCC noted that these transactions represent only a small number of OCC cleared options, and that most of the dividend play trading is cleared through two large clearing members that are large and well-capitalized and have robust risk management processes. OCC's therefore concluded that dividend plays did not materially increase OCC's risk. As requested by OCC's Board of Directors, OCC's Operations Roundtable further evaluated the proposed change in OCC's processing sequence to determine whether there were any unintended consequences to implementing the proposed change. The Operations Roundtable, which consists of operations staff of a cross-section of OCC's clearing members and operations staff of the options exchanges, carefully reviewed the proposal over several months and concluded that no material unintended consequences would result from its implementation.

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

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.[3] 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, is generally 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. 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 is proposing to change it so that for these accounts sale transactions are processed before exercises. 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 proposes to amend the Rules to add an interpretation and policy to Rule 801 and to Rule 805 to state, with respect to Market-Maker accounts, that sell transactions will be processed before exercises. Because the definition of "Market-Maker Account" in Article 1 of OCC's By-Laws would include a JBO Participants' account, the interpretation and policy clarifies that this netting will not be applied to JBO Participants' accounts until such time as

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3 SIFMA Letter, p. 1.

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 JBO Participants' accounts, in which case JBO Participants' accounts shall be considered Market-Maker accounts. OCC also proposes to modify OCC's systems to make a corresponding change in the processing sequence. This change in the processing sequence would only applied to Market-Maker accounts (and, potentially subaccounts in JBO Participants' accounts), and would not change the processing sequence, and the associated protection against coding errors, applicable to clearing member accounts other than Market-Maker accounts.

B. Statutory Basis

OCC believes that the proposed rule change is consistent with Section 17A(b)(3)(F) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"),[4] and the rules and regulations thereunder, including Rule 17Ad-22(d)(1)[5] and Rule 17Ad-22(d)(4),[6] because the changes are designed to provide a well-founded, transparent and enforceable legal framework for the exercise of long and short call options and to minimize sources of operational risk to clearing members through the development of appropriate systems, controls and procedures. The proposed change achieves this purpose by clearly stating in the rules that OCC will, in respect of Market-Maker accounts, process all sell transactions prior to the exercise of long options in the account, thereby making this processing sequence transparent, and by

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

5 17 CFR 240.17Ad-22(d)(1).

6 17 CFR 240.17Ad-22(d)(4).

instituting corresponding system changes in the processing sequence for exercised call options in Market-Maker accounts. The proposed rule change is not inconsistent with the existing rules of OCC, including any other rules proposed to be amended.

Item 4. Self-Regulatory Organization's Statement on Burden on Competition

OCC does not believe that the proposed rule change would impose any burden on competition.[7] The proposed interpretation and policy primarily affects market makers and would provide notice to all market makers of the change in OCC's processing sequence with respect to Market-Maker accounts. The proposed rule change would not unfairly inhibit access to OCC's services or disadvantage or favor any particular user in relationship to another user because the proposed rule change would be applied uniformly to all Market-Maker accounts. The change would have the effect of curtailing dividend plays, but this limitation will apply equally to all exchanges and all clearing members and by extension all market-maker customers of clearing members.

For the foregoing reasons, OCC believes that the proposed rule change is in the public interest, would be consistent with the requirements of the Exchange Act applicable to clearing agencies, and would not impose a burden on competition.

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7 15 U.S.C. 78q-1(b)(3)(I).

Item 5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

Written comments were not and are not intended to be solicited with respect to the proposed rule change and none have been received.

Item 6. Extension of Time Period for Commission Action

OCC does not consent to an extension of the time period for Commission action on the proposed rule change.

Item 7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2) or Section 19(b)(7)(D)

Not applicable.

Item 8. Proposed Rule Change Based on Rule of Another Self-Regulatory Organization or of the Commission

Not applicable.

Item 9. Security-Based Swap Submissions Filed Pursuant to Section 3C of the Act

Not applicable.

Item 10. Advance Notices Filed Pursuant to Section 806(e) of the Payment, Clearing and Settlement Supervision Act

Not applicable.

Item 11. Exhibits

Exhibit 1A. Completed Notice of Proposed Rule Change for publication in the Federal Register.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, The Options Clearing Corporation has caused this filing to be signed on its behalf by the undersigned hereunto duly authorized.

THE OPTIONS CLEARING CORPORATION

By: Stephen Szarmack

Stephen Szarmack
Vice President and Associate General Counsel

EXHIBIT 1A

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-[_______________]; File No. SR-OCC-2014-15)

July 17, 2014

Clearing Agency; The Options Clearing Corporation; Notice of Filing of 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

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder[2] notice is hereby given that on July 17, 2014, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II and III below, which Items have been prepared primarily by OCC. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Clearing Agency's Statement of the Terms of Substance of the Proposed Rule Change

This proposed rule change, coupled with the related system modifications, will curtail use of a trading strategy known as "dividend plays" in the options industry. OCC proposed to add an interpretation and policy to Rules 801 and 805, respectively, 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.

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

2 17 CFR 240.19b-4.

II. Clearing Agency's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, OCC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. OCC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of these statements.

(A) Clearing Agency's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

This proposed rule change would add an interpretation and policy to Rules 801 and 805, respectively, stating that OCC will, in respect of Market-Maker accounts, process all sell transactions prior to the exercise of long options in the account, to ensure that only net long positions may be exercised. This proposed change, coupled with the related system modifications, would have the effect of implementing a policy approved by the OCC Board of Directors intended to curtail use of a trading strategy known as "dividend plays" in the options industry.

Background

Dividend plays are an options trading strategy that has been executed on options exchanges for many years. The purpose of the 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 standard assignment process, then assigns all of that day's exercised long call options of the same series across all options writers. If all in-the-money long call options of the same series were exercised on the day prior to the ex-dividend date, the trader, and all other market participants in the relevant option series, would be assigned all its short call positions and would not have a resulting long stock position that is entitled to the dividend. However, a certain percentage of open interest in in-the-money call options goes unexercised on the day prior to the ex-dividend date. Generally, this failure is due to a number of factors, including transaction costs, the ignorance of certain market participants of the mechanics of call options and ex-dividend dates, inattentiveness by certain market participants in monitoring their positions and irrationality.[3] Because traders executing a dividend play exercise 100% of their long call options, it increases the overall percentage of open interest that gets exercised. OCC's standard assignment processing will close out a large portion of a traders' short position 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

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3 *See e.g.*, Veronica K. Pool, Hans R. Stool, Robert E. Whaley, *Failure to exercise call options: An anomaly and a trading game*, 11 J. Fin. Markets 1 (2007); Jia Hao, Avner Kalay, Stewart Mayhew, *Ex-Dividend Arbitrage in Options Markets*, 23 Rev. Fin. Stud. 271, Issue 1 (2009).

that will be closed out, and a larger share of unassigned short positions will be left to the dividend play trader. For every short call position that is not assigned, a trader executing the dividend play does not have to deliver stock and is able to capture the dividend payment for the shares of stock it remains long.

The vast majority of dividend play activity occurs in Market-Maker accounts and OCC's processing sequence makes it possible for market makers to execute conventional dividend plays, as described above. OCC processes exercises after option purchases but before options sales, also known as "writing" transactions. 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. 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 no net long call positions to exercise. This would make the conventional dividend play impossible. However, OCC processes exercises before sales in order to reduce operational risk for clearing members clearing options transactions in accounts other than Market-Maker accounts. Positions in accounts other than Market-Maker accounts are carried on a gross basis, meaning that an account can be both long and short the same series. This means that trades must be coded as opening or closing transactions. If OCC processed sales before exercises in an account other than a Market-Maker account, a coding error could cause rejection of exercise instructions that could result in substantial losses. However, coding errors do not present a risk with respect to Market-Maker accounts, where positions are carried on a net basis and trades do not have to be coded as opening or closing transactions.

OCC Review of Dividend Plays

In December 2012, the Securities Industry and Financial Markets Association's ("SIFMA") Listed Options Trading Committee requested that OCC formally review dividend plays.[4] 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 on part in 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 comprehensive review of dividend plays.

In connection with its review of dividend plays OCC noted that these transactions represent only a small number of OCC cleared options, and that most of the dividend play trading is cleared through two large clearing members that are large and well-capitalized and have robust risk management processes. OCC's therefore concluded that dividend plays did not materially increase OCC's risk. As requested by OCC's Board of Directors, OCC's Operations Roundtable further evaluated the proposed change in OCC's processing sequence to determine whether there were any unintended consequences to implementing the proposed change. The Operations Roundtable, which consists of operations staff of a cross-section of OCC's clearing

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

members and operations staff of the options exchanges, carefully reviewed the proposal over several months and concluded that no material unintended consequences would result from its implementation.

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.[5] 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, is generally 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. 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 is proposing to change it so that for these accounts sale transactions are processed before exercises. 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 proposes to amend the Rules to add an interpretation and policy to Rule 801 and to Rule 805 to state, with respect to Market-Maker accounts, that sell transactions will be processed before exercises. Because the definition of "Market-Maker Account" in Article 1 of

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5 SIFMA Letter, p. 1.

OCC's By-Laws would include a JBO Participants' account, the interpretation and policy clarifies that this netting will not be applied to JBO Participants' accounts 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 JBO Participants' accounts, in which case JBO Participants' accounts shall be considered Market-Maker accounts. OCC also proposes to modify OCC's systems to make a corresponding change in the processing sequence. This change in the processing sequence would only applied to Market-Maker accounts (and, potentially subaccounts in JBO Participants' accounts), and would not change the processing sequence, and the associated protection against coding errors, applicable to clearing member accounts other than Market-Maker accounts.

2. Statutory Basis

OCC believes that the proposed rule change is consistent with Section 17A(b)(3)(F) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"),[6] and the rules and regulations thereunder, including Rule 17Ad-22(d)(1)[7] and Rule 17Ad-22(d)(4),[8] because the changes are designed to provide a well-founded, transparent and enforceable legal framework for the exercise of long and short call options and to minimize sources of operational risk to clearing members through the development of appropriate systems, controls and procedures. The proposed change achieves this purpose by clearly stating in the rules that OCC will, in respect of Market-Maker accounts, process all sell transactions prior to the exercise of

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6 15 U.S.C. 78q-1(b)(3)(F).

7 17 CFR 240.17Ad-22(d)(1).

8 17 CFR 240.17Ad-22(d)(4).

long options in the account, thereby making this processing sequence transparent, and by instituting corresponding system changes in the processing sequence for exercised call options in Market-Maker accounts. The proposed rule change is not inconsistent with the existing rules of OCC, including any other rules proposed to be amended.

(B) Clearing Agency's Statement on Burden on Competition

OCC does not believe that the proposed rule change would impose any burden on competition.[9] The proposed interpretation and policy primarily affects market makers and would provide notice to all market makers of the change in OCC's processing sequence with respect to Market-Maker accounts. The proposed rule change would not unfairly inhibit access to OCC's services or disadvantage or favor any particular user in relationship to another user because the proposed rule change would be applied uniformly to all Market-Maker accounts. The change would have the effect of curtailing dividend plays, but this limitation will apply equally to all exchanges and all clearing members and by extension all market-maker customers of clearing members.

For the foregoing reasons, OCC believes that the proposed rule change is in the public interest, would be consistent with the requirements of the Exchange Act applicable to clearing agencies, and would not impose a burden on competition.

(C) Clearing Agency's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

Written comments on the proposed rule change were not and are not intended to be solicited with respect to the proposed rule change and none have been received.

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[9] 15 U.S.C. 78q-1(b)(3)(I).

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period up to 90 days (i) as the Commission may designate if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove the proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commissions Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-OCC-2014-15 on the subject line.

Paper Comments:

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

All submissions should refer to File Number SR-OCC-2014-15. 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 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 Section, 100 F Street, N.E., Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing 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_14_15.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-2014-15 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission by the Division of Trading and Markets, pursuant to delegated Authority.[10]

Kevin M. O'Neill
Deputy Secretary

Action as set forth recommended herein APPROVED pursuant to authority delegated by the Commission under Public Law 87-592.
For: Division of Trading and Markets

By:_______________________________

Print Name:_________________________

Date:______________________________

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[10] 17 CFR 200.30-3(a)(12).