WILLKIE FARR & GALLAGHER LLP

HOWARD L. KRAMER
[redacted]

1875 K Street, NW
Washington, DC 20006-1238
Tel: 202 303 1000
Fax: 202 303 2000

By Electronic Mail (rule-comments @sec.gov)

February 20, 2015

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: SR-OCC-2015-02 (The OCC Capital Plan)

Dear Sir:

I am writing on behalf of the six options market maker firms listed at the end of this letter (the "MMs") who represent a substantial portion of the displayed market maker liquidity in listed options. The MMs have serious concerns about the above-referenced rule filing ("the Proposal" or the "Plan") submitted by the Options Clearing Corporation ("OCC") to the Securities and Exchange Commission (the "SEC").

In the Proposal, OCC claims a need for significant new capital but does not adequately substantiate that need. It proposes to meet this newly-asserted need by allowing OCC's five shareholder options exchanges (the "five owners") to make capital contributions to OCC at non-competitive and overly generous rates of return while providing them with broad protections against investment losses – all of which will require revenue ultimately paid at great expense by the investment community. The SEC should not approve this filing. Instead, the SEC should work with OCC and other market participants to definitively establish the level of funding needed and explore funding alternatives that would not jeopardize the fair and equitable operation of OCC in its position as the sole clearing agency for U.S. listed options trading.

The Plan Needs More Vetting by the Options Industry

While we understand the need for OCC to raise capital, the proposed Plan is fraught with material flaws that would gravely impact the options markets, and should be fully vetted by the options industry. Indeed, we question the urgency to implement it without a full vetting by the industry. As explained below, the extent of OCC's capital needs does not appear justified by the rationale in the Proposal, and OCC has failed to show the need to pay the five owners an exorbitant dividend for their proposed capital contribution. We are extremely concerned about the Plan's inherent conflict of interest that could transform OCC from an impartial operator of a non-profit utility into a fee and revenue stream for the five owners. These are issues that require more debate and detail.

OCC has not Fully Justified the Need for such Dramatic Action

In its efforts to justify its Plan, OCC cited proposed SEC Rule 15Ad-22(e)(15), which requires, in pertinent part, (1) the holding of liquid net assets funded by equity equal to the greater of six months operating expenses or an amount sufficient to ensure a recovery or orderly wind-down; and (2) a viable plan for raising additional equity should its equity fall close to or below said liquid net asset amount. It also cited the provision of Principle 15 of the Principles for Financial Market Infrastructures published by the Bank for International Settlements and the International Organization of Securities Commissions, that a financial market utility should identify, monitor and manage its general business risk and hold sufficient liquid net assets funded by equity to cover potential general business losses so that it can continue to operate as a going concern.

In order to meet these provisions for 2015, OCC claims that it needs to accumulate $117 million, reflecting six months operating expenses (labeled "Baseline Capital Requirement"), plus an additional $130 million to address operational, business, and pension risk (labeled "Target Capital Buffer") Added together, OCC asserts it has a Target Capital Requirement totaling $247 million. In addition, OCC asserts that it needs a commitment for the provision of additional callable capital up to a maximum of the Baseline Capital Requirement, which at present would be another $117 million. This brings OCC's total perceived capital need for 2015 to $364 million.

Besides the absence of detailed support for these specific figures generally, OCC does not substantiate the need for its proposed $130 million Target Capital Buffer. It is not required under proposed Rule 17Ad-22, and OCC's general reference to Principle 15 is questionable for at least two reasons. First, Principle 15 has been in effect since April 2012, and OCC has made no showing of any need for additional capital beyond what it has relied upon to comply with Principle 15 since 2012. OCC's clearing members are collectively liable for option transaction counter-party default risk, and OCC has neither detailed nor quantified any business or operational risk beyond default risk (OCC included pension risk as part of the Target Capital Buffer even though this factor is not mentioned in either Rule 17Ad-22 or Principle 15). Second, OCC has made no case for the prospect that the funds required to comply with Principle 15 should be distinct from and in addition to the funds used to comply with proposed Rule 15Ad-22; and there is no such requirement in either authority.

Further, the proposed Rule 15Ad-22 provision for a viable plan for raising additional equity does not require that OCC's additional equity commitment equal its Baseline Capital Requirement amount. Accordingly, OCC has offered neither legal nor financial support for the vast majority of its claimed capital needs, and has not justified its Plan and attendant high dividends as an appropriate means of capitalization.

OCC's Plan is a Dramatic Departure from its Historic Business Model

Under the Plan, OCC would raise additional capital funds to meet its stated regulatory needs by (i) maintaining its recently-elevated transaction fee schedule (increased last year by over 70%, resulting in additional fee collections for 2014 of $112 million), (ii) raising $150 million in additional capital from the five owners and (iii) securing a commitment from the five owners to provide additional capital funding should circumstances require that additional OCC capital be on hand ("the Replenishment Capital" or "RC").[1]

In order to achieve the $247 million Target Capital Requirement, OCC intends to use $25 million in shareholder equity (as of 12/31/13), $72 million

[1] OCC has left itself the option to alter the terms of its Capital Plan by its disclaimer that "Certain details of the [Capital Plan] Term Sheet may change..." Its qualifier that OCC does not "anticipate" any "material" changes is subjective and uncertain.

from last year's retained earnings (from the $112 million excess above operating expenses due to last year's 70% fee increase), plus $150 million in capital it plans on securing from the five owners. It also plans on keeping the higher fees from last year in place (the ones it represented last year as "temporary") and create a 25% budget excess fee-buffer (the "budget buffer") to finance and safeguard its ability to meet its budget obligations. According to the Plan, the budget buffer revenue amounts are designed to create excess funds from which dividends can be paid to the five owners and rebates can be paid to the clearing members.

Before the 70% fee increase of last year, OCC fees were routinely set at levels that covered operational costs plus a reasonable excess for unforeseen expenses or drops in revenue. If such unforeseen events did not arise, the excess revenues would be largely rebated back to clearing members, which is in keeping with OCC's role as an industry utility. While a reserve capital account has also been maintained by OCC for other potential expenses, it has routinely been maintained at a lower level than the amount proposed in the filing. While there is a case for raising the capital reserve amounts, the current Plan is a complete departure from the manner of OCC's previous operations, for which explanatory detail is severely lacking.

Conflicts of Interest and the OCC Budget

The current Proposal would expand OCC's financials in all directions. It would continue the fee increase changes from last year and introduce a dramatically different structure going forward with regard to reserve capital. This new structure would encourage ever-larger budgets that would, in turn, unjustly reward the five owners with increasingly exorbitant dividend payments and potentially new equity reserve contributions from revenues (i.e., OCC capital reserves might be claimed as assets of the five owners). This arrangement would unfairly enrich the five owners and create a conflict in the performance of their positions on OCC's Board of Governors. We question how they could fairly guide OCC on budget efficiencies in years to come when larger budgets would serve to increase their dividend and claimed capital asset values. This new structure introduces a for-profit element for the five owners that should not be part of any Plan by OCC to meet new regulatory costs and capital needs.

Further, larger dividends and reserves may be the by-product of OCC's natural growth, but they may also be the by-product of inefficiencies in OCC's budget and operations. Such inefficiencies can occur, for example, when budgets are unnecessarily high or gaps occur when more revenues are collected than needed for budget expenses. In this regard, the options industry relies heavily on the OCC's Board of Governors to help monitor costs and keep transaction fees at reasonable levels. This is why any conflict of interests with the OCC Board of Governors must be earnestly addressed. The question now becomes whether OCC, under the Plan, will become complaisant to budgetary desires by the five owners that unnecessarily increase retained earnings and/or reserve capital amounts at the expense of investors. OCC's budgets, of course, are approved by the OCC Board of Governors – upon which the five owners sit. If ever-larger budgets occur, it should not happen without the ability of market participants, who ultimately finance OCC through transaction fees, to be assured that OCC (as the only clearing agency for U.S. listed options) continues to operate with the public marketplace foremost in mind.

Thus, this process should be as transparent as possible to market participants, yet the Proposal substantially lacks transparency. This was also the case with last year's 70% fee increase, which was proffered as OCC's response to new budget and capital needs as a newly designated SIFMU[2]. In its SEC filing for that increase, OCC represented that it needed to add $68 million to its reserve capital base of $25 million.[3] It explained that the $165 million operating budget for 2013 would increase appreciably for 2014 due to the need for new SIFMU related regulatory expenses. When the higher rates garnered OCC about $112 million in new revenue over the last nine months of the year, it appeared to be an adequate amount for regulatory needs expressed by OCC at that time. After collecting this new revenue, however, OCC decided to rebate $40 million to clearing members while contributing the other $72 million to the capital reserve account. Thus, there was a change in direction by OCC with regards to the collection and allocation of revenues collected last year. But this change in direction has not yet been fully explained by OCC. Nor has OCC provided a full explanation of the new regulatory costs that were a critical component of last year's fee increase.

[2] Systemically Important Financial Market Utility

[3] OCC Fee Increase Filing/ Release No. 34-71769

OCC did, however, submit a letter to the SEC on May 15, 2014, in response to comments and concerns (the "2014 Response")[4] wherein it provided some answers to the question of regulatory expenses. In that letter, OCC spoke of 51 new employees and 46 consultants and said that new regulatory requirements would result in an increase of over 15% to the operating budget for 2014. OCC's explanations have not, however, fully explained how the 2015 operating budget rose from that $165 million in 2013 to the $234 million set for 2015. Certainly, the 97 new employee/consultant positions did not come at a cost of more than $700,000 per person to account for this difference, and it would seem that many of those consultants would be temporary. We make note of this concern about transparency issues with OCC's budget because under the Plan the level of concern with transparency rises considerably.

Even without a bias for larger budgets, OCC's budget has routinely grown at a high rate over recent years. But disturbing the checks and balances process in the fashion described above invites even larger growth and inefficiencies in future OCC budgets. In this connection, under the Plan, dividend amounts and reserve contribution amounts at OCC can be expected to be higher than what might otherwise be the case. The chart below reflects budget growth and performance over recent years.

	2008	2009	2010	2011	2012	2013	2014	2015 *
Revenue +	175m	192m	196m	229m	207m	216m	**302m	**>300m
Expenses	111m	134m	138m	145m	152m	165m	**190 m	**234m
Refund	64m	57m	38m	79m	50m	46m	**40m	**78m/split

* Projected

\+ Pre-Refund

** Information for the chart above was gleaned from OCC's web page, but not all information for the years of 2014 and 2015 were available. Thus, numbers with the double asterisk (**) were derived as estimates from available documents relating to this Proposal.

Why did OCC Abandon the Plan to Raise the Capital through the Fee Increases of 2014?

[4] Letter from James E. Brown of May 15, 2014, in response to comments on Release No. 34-71769

While OCC states that transaction fees should go down under the Plan, we believe the Plan will nonetheless lead to larger OCC budgets, as described above. Of course, fees are at historic highs after last year's increase and so, it would seem, are OCC revenues. This raises the question of why OCC did not simply accumulate the needed capital through the revenue excesses of recent years (rather than pay rebates), especially after the fee increase of last year. The additional revenue could have substantially met the new requirements if the rebates for 2013, 2014 and 2015 were instead contributed to the reserve account along with the dividend planned for 2015.

More specifically, OCC ended 2013 with $25 million in reserve and then: issued a $47 million rebate for 2013, a $40 million rebate for 2014, a $72 million excess that went to capital for 2014 and plans (as we estimate) $78 million excess for 2015. This could have addressed much of the capital concern if it had instead decided for recent years to gather the reserve amounts through the fee increases and suspend rebates/dividends. When added together, without consideration for tax or other expense issues, OCC would theoretically have had an estimated $262 million in reserves.

It should be noted, however, that while the approach described above would have avoided a proposal calling for payments of large dividends into perpetuity, it still would not have addressed the troubling issue of creating large reserves that could eventually be monetized as profits for the five owners in the event of a demutualization. The monetization issue is one of the major issues of concern with respect to the Plan. Importantly, the $72 million deposited in the reserve account from last year's fee increases should not be allowed to become the property of the five owners.

<u>The Budget Buffer has not Been Fully Explained</u>

As mentioned above, OCC intends to charge clearing members inflated fees by means of its budget buffer to create a purported 25% buffer after paying all operating expenses. OCC would then give half of the excess to the clearing members as a rebate and distribute the after-tax remainder to the five owners as a dividend on their capital contributions.

As described below, however, the Plan would actually create a 33% buffer instead of a 25% buffer. This is because, as set out in the Fee Policy explanation in the Proposal, "OCC would calculate an annual revenue target based on a forward twelve months expense forecast divided by the difference between one and the [budget buffer] of 25%, i.e., OCC will divide the expense forecast by .75." Accordingly, dividing OCC's forecasted 2015 budget of $234 million by .75 yields $312 million, which is an excess of $78 million above the $234 million budget. $78 million, of course, equals 33% of $234 million. Thus, the actual OCC methodology results in an apparent 33% excess rather than a 25% excess.

This would appear to represent an increase over the 31% historic 10 year average claimed by OCC, rather than the reduction that OCC purported would "permit OCC to charge lower fees to market participants rather than maximizing refunds to clearing members and dividend distributions to [the five owners]." In fact, this buffer excess would result in a rate of return of over 18% to the five owners. The OCC needs to explain this function of the Proposal in more detail, as it is a critical component.

The Replenishment Capital Element is More Loan than Capital

The RC is structured so that the likelihood of its ever being called is very low. In addition, the Plan ensures that alternative remedies to avoid invoking RC (such as raising transaction fees and reducing services) will be largely available in all but the most improbable cases. While the concept of securing a promise for capital from the five owners is unprecedented, and obscure circumstances may be depicted as a liability by the owners, it is not justification for the payment of a dividend. Moreover, the Plan calls for the repayment in full of funds provided pursuant to RC, including the draconian measure of permanently terminating clearing member rebates if RC repayment is not fully completed within two years. Thus, the RC commitment is in the nature of a loan, thereby contravening the Rule 17Ad-22 requirement for a plan to raise additional equity rather than debt.

OCC is Primarily Supported with Fees Paid by Market Participants

The Plan will benefit the five owners unfairly at the expense of others, and also unjustly enrich those clearing members who choose not to pass the annual rebates back to their customers.[5] Unfortunately, everyone else will suffer higher fees and a resultant decrease in the quality of options liquidity. To understand this concern, one must first understand how OCC collects revenue – and who pays. Almost all OCC revenue comes from transaction charges that are paid by clearing members who pass the charges to their investor and trader clients; including customers, options market makers and execution firms. In turn, execution firms pass the charges on to their customers while market makers routinely widen their quotes to account for the increases. Consequently, OCC fee increases are ultimately paid by investors, either through higher charges or wider quotes. The five-owner exchanges, except perhaps for specialized circumstances such as linkage trades, do not pay OCC transaction fees as they themselves are not standard OCC investor-types (i.e., customer, firm or market maker).

As options market makers provide over 90% of the displayed liquidity in listed options and routinely participate in the majority of OCC trades, they pay the greatest amount of OCC fees. Thus, when fees were raised last year by over 70% a significant percentage of quotes became wider to account for the higher fees. Wider quotes result in higher costs of liquidity, less customer interest, less effective hedging, and poorer risk management by market makers, facilitators and investors. Although this harmful effect on the options market should be an important consideration in the adoption of significantly higher OCC transaction fees, it was not addressed in last year's filing or the present Proposal. The SEC should address this issue with OCC in detail.

Paying its five owners an unreasonably high back-door annuity into perpetuity at the expense of the investing public will re-shape OCC into an entity that will essentially operate as a for-profit company. Once OCC transaction fees become a profit-leveraging incentive for the five owners, the longstanding practice of keeping OCC costs low to encourage growth for all constituents will be greatly diminished. OCC will migrate away from its role as the impartial trade matcher and guarantor serving all constituents in an equivalent manner. Instead, it will increasingly become a profit tool for the five owners to monetize and leverage at the expense of public investors and market participants.[6]

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[5] Due to consolidation of the options exchanges into several large exchange groups, the number of distinct exchange owners is actually less than five and could shrink further. Thus, the benefit of the Plan's dividend to the five owners could grow even greater.

[6] This role is at odds with the OCC mission statement of promoting "financial stability and integrity in every market we serve" by unfairly advantaging the five owners and penalizing market makers and public investors.

Under the Plan, it is the revenue from the 70% fee increase that will fund OCC's new costs, which costs will be magnified due to the extraordinary rate of return on capital paid to the five owners – a rate far higher than what could reasonably be secured in the open market. In fact, the five owners are the chief benefactors of the Plan. As the five owners contribute capital to OCC they are making an extraordinarily attractive investment from which they are able to extract an extremely high dividend funded by monopolistic fees borne by market participants. It should also be noted that the dividend amount to be paid under the Plan is an after-tax estimate. The actual cost to OCC would be much higher than the capital contribution amount. That is, as it may appear for 2015, OCC may pay over $10 million in taxes for the privilege of paying the five owners an exceedingly high rate of return. Because this reduces the amount of OCC capital, the proposed dividend payment contravenes the stated purpose of the capital contribution.

<u>The Proposal is a Bad Plan – Especially Compared to Other Alternatives</u>

While the filing generally references other alternatives, it does not perform an exhaustive job of exploring those alternatives. One better alternative to be considered is provided below:

> *The SEC allow OCC time to develop a different plan where moderate amounts of excess transaction fee revenue – including last year's $72 million retained earnings - can accumulate over time to a level the SEC finds appropriate ("the Payer-Asset Approach"). The excess fee revenue would be escrowed to a Payer Asset Account that would not be an asset or claim for the benefit of the five owners; and, once the requisite capital reserve level is reached, any overage amounts would be returned to investors through rebates, lowered transaction fee rates, or other means. In the event of OCC demutualization, the Payer Asset Account would be similarly distributed to investors rather than be allocated to the five owners at the expense of the investors who paid into it.*
>
> *Until the Payer Asset Account reaches the initial designated capital level, the SEC could allow a capital contribution by the five owners if deemed absolutely necessary to reach such capital level in the interim, provided that the dividend amount be capped at a*

much lower rate than the rate the five owners negotiated with OCC's management; and that the capital contribution be withdrawn by the five owners and dividends discontinued once the Payer Asset Account reaches the required amount. At that time, the OCC fee increases that began in 2014 would revert to at or near previous levels. The fees could again be increased as a plan to raise additional capital if the OCC capital position fell close to or below the requisite reserve level, so long as the fees again reverted to their normal previous level once the additional capital requirement is met.

By denying the five owners the ability to convert the larger reserve account into a long-term asset of their own, the Payer-Asset Approach described above reflects the fact that it is investors who have historically provided the resources to pay OCC's budget. The reserve account under the Payer-Asset Approach would allow the capital to grow through retained earnings in a reasonable and fair fashion without conflicts among constituents.

Summary and Conclusion

The Proposal lacks full economic support or evidence of the need to raise capital via the Plan approach. Regardless of the fact that the MMs participate in the majority of OCC cleared trades and pay far more transaction fee revenue than any other account type, OCC has still not explained to us in any detail where the new SIFMU costs are arising from and how much will be needed to meet them.[7] The MMs asked for such information in a comment letter last year on the 2014 Fees and we make the same request in this letter. Moreover, the Proposal does not provide any explanation, studies, or analysis as to why the five owners should reap a high dividend for their capital contribution.

While we acknowledge that OCC has a new capital need, this need should not be exploited as an opportunity to create a wealth transfer vehicle by the five

[7] The high level description and figures mentioned in the rule filing were proffered by OCC without any supporting analysis whatsoever. Even on its face, OCC advised that the 2015 Target Capital Requirement of $247 million reflected a Baseline Capital Requirement of $117 million plus a Target Capital Buffer of $130 million, but soon thereafter advised that the same $247 million Target Capital Requirement resulted from an "operational risk" of $226 million" and a "pension risk" of $21 million", without ever resolving this descriptive discrepancy.

owners. In this connection, there is no doubt that OCC's funding costs in the future will come from increased fees first, not from decreasing the profits of the five owners. This is the likely future trend that the Plan will carve out for the options industry going forward.

Last year's fee increase process is instructive in this regard. Although OCC repeatedly advised that the significant new fee increase was meant to be temporary, we now see that this is not so. We were also told how larger fees were necessary for new operational and capital needs. Yet, after the higher fees generated about an extra $112 million in retained earnings for last year, $40 million is being rebated to the clearing firms and the remaining $72 million is being transferred into a reserve account that, under demutualization, might be claimed as an asset of the five owners. Indeed, the OCC capital raising plans from last year and this year appear to be structured with OCC's demutualization in mind.

OCC says that the "reduction" in the budget buffer level will permit OCC to charge lower fees to market participants rather than maximize refunds to clearing members and dividend distributions to stockholder exchanges. In short, OCC is basically claiming that its 25% buffer was decided with investors first and foremost in mind. As noted above, however, the Fee Policy would imply that the Budget Buffer would be higher than 25% of the stated budget. This needs to be explained in detail.

As noted above, the $72 million in retained earnings from last year was put into a reserve account that might ultimately be claimed as an asset of the five owners. This helps explain why we disagree with the OCC when it claims that the "buffer reduction" will permit OCC to charge lower fees to market participants rather than maximize refunds to clearing members and dividend distributions to stockholder exchanges. That $72 million should be escrowed in an account to be returned to investors through transaction fee reductions in the event of a future demutualization of OCC. We ask that the SEC pursue this course of action with OCC.

We do not dispute that OCC has significant new regulatory costs or that its current status of operating as a not-for-profit entity makes financing challenging. But regulatory costs should be shared by members and owners and not used as an excuse to monetize OCC at the expense of investors. OCC's very existence as the sole clearing agency for listed options was the result of exchanges and clearing members advising the SEC almost 40 years ago (when other exchanges followed the CBOE with SEC filings to trade options) that it would be best for all investors if the options industry had one central clearing agent. All parties at the time envisioned a central clearing agent that would be ecumenical in its approach, free from conflicts of interest, and fiercely efficient in keeping costs down for everyone in the marketplace – brokers, traders, clearing members, exchanges and the investing public. On this point, OCC can be proud of its accomplishments and the trust it has built with all parties over the years. Indeed, OCC clearly serves a critical and central role to the market deserving of the SIFMU designation. The irony with OCC's current Proposal is that it responds to this need to bolster a critical U.S. non-profit public utility by monetizing itself for profit by the five owners who, as a group overall, have as many pecuniary interests in other markets, including overseas markets, as they do in the United States listed options market.

If the SEC allows the five owners to monetize OCC in this fashion, the conflicts of interest will diminish the prospect that OCC will perform efficiently to keep transaction fees low and operating expenses under control. Obviously, bigger budgets will make the budget-buffer larger and, consequently, the dividend and rebate amounts larger. While the OCC staff has done an exceptional job over the years of controlling costs, the OCC Board of Governors ultimately controls costs and fees in the aggregate. Given the potential of the dividend to increase with the size of OCC's budget, we are concerned where transaction fees may go in the future. Although it is normally permissible for the five owners to utilize their assets in the pursuit of profits, as they are now "for profit" companies, it is inappropriate for them to exploit OCC as an asset as set out in the Plan. This attempt is an abuse of OCC's government approved monopoly position as the sole clearing facility for listed options.

For all the reasons discussed above, the Proposal is inconsistent with the Securities Exchange Act of 1934 ("Exchange Act") and should be disapproved. Specifically, Sections 17A(b)(3)(D and I) of the Exchange Act requires that the rules of a clearing agency such as OCC provide for the equitable allocation of reasonable dues, fees, and other charges among its participants and do not impose any burden on competition not necessary or appropriate in furtherance of the purpose of the Exchange Act. It is clear that the fees and charges under the Plan are neither equitable nor reasonable, and that the use of transaction fees to fund dividend payments to the five owners is not necessary or appropriate in furtherance of the purposes of the Exchange Act. OCC attempts to use Section

17A(b)(3)(f) and Rule 17Ad-22(d)(6) (and particularly subsection (e)(15) of that proposed rule) of the Exchange Act as justifications for an inequitable and unfair fee structure. The former requires OCC to promote the prompt and accurate clearance of securities. The latter is a proposed rule that requires OCC to hold sufficient liquid net assets funded by equity to cover potential general business losses. Aside from the dubious legality of using a rule proposed a year ago and not yet adopted as justifications for OCC rule changes last year and this year to its funding structure, we believe that the Plan is not necessary or appropriate to achieve the goal of increased regulatory capital or promote the prompt and accurate clearance of securities. As described in this letter, there are alternative means to obtain capital that are far less burdensome on options market participants, are less likely to degrade options market quality, and do not unjustly enrich the five owners at the expense of the investing public.

Thank you again for this opportunity to respond.

Howard L Kramer

Howard L. Kramer, on behalf of

Belvedere Trading
CTC Trading Group
IMC Financial Markets
Integral Derivatives
Susquehanna Investment Group
Wolverine Trading

CC: Stephen Luparello, SEC