

## **Testimony of Gary Katz on behalf of the U.S. Securities Markets Coalition before a U.S. Department of Labor Hearing on the Proposed Conflict of Interest Rule**

Good afternoon. I am Gary Katz, President and Chief Executive Officer of the International Securities Exchange (“ISE”) and a co-founder of the Company. ISE operates two U.S. options exchanges, the International Securities Exchange, LLC and ISE Gemini, LLC. I am testifying today on behalf of the U.S. Securities Markets Coalition (“Coalition”). The members of the Coalition are the U.S. options exchanges and their central clearinghouse The Options Clearing Corporation (“OCC”).<sup>1</sup> The Coalition follows legislative and regulatory developments in Washington and informs policymakers of its views on proposals impacting the use of exchange-traded (or listed) options. We appreciate the opportunity to testify today before the Department of Labor on its proposed “Conflict of Interest Rule” (“Proposal”). I am here because the exchanges and industry at large are very concerned that the Proposal would take away the current ability of individual investors to use listed options in their IRA accounts.

Equity options have been listed and traded on national securities exchanges - just like publicly traded stock - for over 40 years. Collectively, the twelve SEC-regulated options exchanges offer listed options on roughly 3,700 individual stocks, exchange-traded funds, and equity-related indices. In 2014, some 3.8 billion options contracts on individual equities were traded on U.S. options exchanges, with each contract typically covering 100 shares of the underlying stock.<sup>2</sup>

Listed options are a very valuable tool for individual investors to manage the risks associated with owning stock. OCC and the options exchanges, along with our brokerage firm partners, have been at the forefront of providing options education through the Options Industry Council (“OIC”) to individuals and other investors about the responsible use of listed options. Founded in 1992, the OIC is an industry cooperative that provides education about the benefits and risks of listed options. I am proud to say that I was one of the founding members of OIC. At the time it was created, there was a tremendous recognition among those of us in the industry that it was critically important to provide investors with education about how options worked and how they can be responsibly used in a portfolio to manage risks and generate additional income. This

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<sup>1</sup> The members of the Coalition (together with OCC) are BATS Options, BOX Options Exchange, Chicago Board Options Exchange, International Securities Exchange, NASDAQ Options Market, NASDAQ OMX PHLX, NYSE Arca, and NYSE Amex. All of these members are regulated by the Securities and Exchange Commission (“SEC”), and OCC is also regulated by the Commodity Futures Trading Commission and The Board of Governors of the Federal Reserve. NASDAQ Options Market and NASDAQ OMX PHLX are owned by the NASDAQ OMX Group, and NYSE Arca and NYSE Amex are owned by the IntercontinentalExchange Group.

<sup>2</sup> See (<http://www.optionsclearing.com/webapps/monthly-volume-reports>).

continues to be the case, and this educational effort has played a significant part in the growth of the options market as investors have had positive experiences adding options to their portfolio mix. Since the founding of OIC, the growth of the industry has been tremendous. In 1992, the total equity options volume was approximately 106 million contracts. By last year, that volume number had increased approximately 36-fold to 3.8 billion equity options contracts. A good portion of this growth is attributable to greater individual investor participation in the options market.

As we noted in our comment letter, the definition of fiduciary would be significantly expanded under the Proposal. This expanded definition would cause many brokers and other service providers to IRAs and ERISA plans who are not fiduciaries under current law to be considered fiduciaries under the Proposal. It also appears that many transactions relating to the trading of listed options by individual investors in their IRAs may become prohibited transactions for which the proposed new Best Interest Contract Exemption would be the only reasonably available exemption. Although that exemption defines the types of “Assets” that can be traded in IRA and plan accounts in reliance on the exemption, listed options are currently excluded. The end result is that the Proposal taken as a whole would deprive many individual investors of their current ability to invest in listed options using their IRA accounts. As such, we strongly believe that exchange-traded options should be added to the list of permissible products under the Best Interest Contract Exemption.

Individual investors are significant participants in the listed options market. On behalf of the Coalition, the TABB Group, a prominent industry research firm, is conducting a study on the amount of options volume originating from individual investors.<sup>3</sup> While the study is not fully completed, they have shared some of their findings with us. TABB estimates that approximately 29% of options volume in 2014 is attributable to self-directed individual investors. They further estimate that approximately 15% of this individual investor volume comes from IRA accounts. Based on the 2014 equity options volume figure cited previously, this equates to approximately 165 million contracts traded by individual investors last year in their IRA accounts. They further estimate that approximately 3.5 million accounts in 2014 had approval from their brokerage firms to trade listed options, with some 1.1 million (or approximately 32%) of these accounts executing at least one options trade over the past two years. This is a very meaningful number and, as an industry, we are deeply concerned about preserving the ability of these investors to trade options in their IRAs should they choose to do so.

In order to trade listed options, an individual needs to apply to his or her brokerage firm to receive approval to do so. Under FINRA and options exchange rules, before approving a customer’s account for trading options, a broker must exercise due diligence to ascertain the

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<sup>3</sup> This forthcoming study will serve as an update on a previous TABB Group analysis of 2013 options volume from individual investors that is cited in the Coalition’s comment letter (<http://www.tabbgroup.com/PageDetail.aspx?PageID=16&ItemID=1309>).

essential facts relative to the customer, including his or her financial situation and investment objectives as well as his or her investment experience and knowledge, and must determine whether to approve the account for options trading based upon such information. If a broker determines to permit the customer to trade listed options, it typically uses “levels” to determine the types of options transactions in which the customer may engage. Level 1, the level at which customers new to options trading begin, typically authorizes conservative options strategies, a couple of which I will describe shortly. The requirement to conduct the screening is based on the rules of FINRA and the options exchanges, and the determination that the customer is eligible for his or her account to be approved for listed option trading is not presented as a recommendation to engage in such trading.

As we note in our comment letter, we are concerned that conducting this screening - which is intended to identify customers who have sufficient investment knowledge and experience to engage in options trading - may inappropriately cause a broker to be deemed a fiduciary under the Proposal. We are similarly concerned that the valuable options education provided by firms to their customers – which is designed to promote the responsible use of listed options – would cause such firms to be considered fiduciaries under the Proposal. We recommend that the Proposal be clarified such that neither of these important activities would cause a broker to be considered a fiduciary under the Proposal.

As far as listed options strategies engaged in by individual investors in IRA accounts, we understand from brokerage firms catering to self-directed investors that, consistent with their interpretations of applicable regulatory requirements, they limit the types of options strategies that IRA account owners can use to conservative strategies such as selling “covered” call options. In this respect, we understand that selling - or writing - covered calls is the most popular strategy engaged in by individual investors in IRA accounts. In covered call transactions, individuals sell call options on stock that they hold in order to generate additional income from the premiums they receive for selling the calls. Another strategy engaged in by individuals in such accounts is buying protective puts. In protective put transactions, individuals holding stock during a time of market unrest may buy a put option on the stock to protect against a significant decline in the value of the stock. Buying a put option is essentially like buying insurance against a decline in the value of the stock, and it is an important risk management tool for individual investors.

Providing individual investors with the right tools to save for their own retirement is now more important than ever. As evidenced by the figures cited previously, individuals have found options to be valuable tools to help them save for retirement, whether by generating additional income by selling covered calls or protecting their stock holdings through protective puts. I and the other options industry leaders who are part of this Coalition believe that it would be a very unfortunate outcome if the Proposal – which is designed to help individual investors better save for retirement – takes away this valuable and long-proven tool from them. Accordingly, we

recommend that the definition of “Asset” in the Best Interest Contract Exemption be amended to include exchange-traded options. I appreciate again the opportunity to testify and am happy to answer any questions you might have.