

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-77358; File No. SR-OCC-2016-004)

March 14, 2016

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing of Proposed Rule Change Related to the Adoption of an Options Exchange Risk Control Standards Policy

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on March 4, 2016, The Options Clearing Corporation (“OCC”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I and II below, which Items have been prepared 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 by OCC would adopt a new Options Exchange Risk Control Standards Policy (“Policy”), which details OCC’s policy for addressing the potential risks arising from erroneous trades executed on an options exchange (“Options Exchange” or “Options Exchanges,” as applicable)<sup>3</sup> that has not demonstrated the existence of certain risk controls (“Risk Controls”) that are consistent with a set of principles-based risk control standards (“Risk Control Standards”) developed by OCC in consultation with the exchanges. The proposed rule change would also revise OCC’s Schedule of Fees in accordance with the proposed Policy to

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> Current Options Exchanges are: (i) BATS Options Market, (ii) Box Options Exchange LLC, (iii) C2 Options Exchange, Inc., (iv) Chicago Board Options Exchange, Inc., (v) EDGX Options Exchange, (vi) International Securities Exchange, LLC, (vii) ISE Gemini LLC, (viii) ISE Mercury, LLC, (ix) MIAX Options Exchange, (x) NASDAQ OMX BX, Inc., (xi) NASDAQ OMX PHLX, LLC, (xii) NASDAQ Options Market, (xiii) NYSE Amex Options, and (xiv) NYSE Arca Options.

charge and collect from Clearing Members<sup>4</sup> a fee of two cents per each cleared options contract (per side) (“Fee”) executed on an Options Exchange that did not demonstrate sufficient Risk Controls designed to meet the proposed Risk Control Standards. The text of the proposed Policy and related changes to the OCC Schedule of Fees is attached as Exhibit 5. Material proposed to be added is marked by underlining and material proposed to be deleted is enclosed in bold brackets.

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

***Background***

OCC proposes to adopt a new Options Exchange Risk Control Standards Policy, which is designed to better protect OCC against risks related to erroneous transactions that may occur on Options Exchanges that have not implemented Risk Controls that are consistent with a defined set of principles-based Risk Control Standards, which were developed by OCC in consultation with the exchanges, and that are sent to OCC for a guarantee. The proposed Policy would, among other things, impose an additional Fee on cleared trades that are executed on an Options

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<sup>4</sup> See Article I, Section 1 of OCC’s By-Laws.

Exchange that has not certified the existence of Risk Controls that meet the Risk Control Standards in the following categories: (i) “Price Reasonability Checks;” (ii) “Drill-Through Protections;” (iii) “Activity-Based Protections;” and (iv) “Kill-Switch Protections” (in each case discussed more thoroughly below) along with OCC’s review to determine if the Risk Controls are consistent with the Risk Control Standards. The Policy would also require that any funds collected from the Fee be retained as earnings and, as such, be eligible for use for Clearing Member defaults under Article VIII, Section 5(d) of OCC’s By-Laws but prohibit such funds from being used for any other purpose.

OCC believes that the implementation of Risk Controls that are consistent with the proposed principles-based Risk Control Standards at Options Exchanges would guard against risks attendant to erroneous transactions on such Options Exchanges and serve OCC, its Clearing Members, and the financial markets OCC serves by helping to ensure the potential significant financial impact and elevated risk of disruption resulting from erroneous transactions is limited to the greatest extent possible. As a systemically important financial market utility and the sole clearing agency for the US listed options markets, OCC seeks to control risks presented to it that might have the effect of disrupting routine processes at OCC, and thus threatening the stability of the financial system of the United States. As described in more detail below, there have been numerous cases in the recent past where erroneous transactions have occurred that could have caused substantial damage to financial market entities and resultant damage to OCC. The options market is not immune to the harmful effects of erroneous transactions, and in fact OCC is more susceptible than other financial market entities to the risks attendant thereto by virtue of: (i) its role as a guarantor of all options transactions that are novated, and (ii) its lack of discretion to elect not to clear transactions executed on Options Exchanges. OCC believes that Options

Exchanges that apply the Risk Control Standards to all transactions executed on such Options Exchanges are better equipped to capture and eradicate erroneous and potentially disruptive transactions at the Options Exchange level, thereby reducing the likelihood that the risk inherent in such erroneous and potentially disruptive trades is transferred to OCC, its other Clearing Members, and the financial markets served by OCC. Furthermore, and as discussed in more detail below, OCC believes this proposal is complementary to efforts undertaken by the Commission to strengthen critical market infrastructure and improve its resilience, consistent with current Commission requirements<sup>5</sup> and international guidance,<sup>6</sup> and in furtherance of remarks made by Chair White after the latest in a series of prominent market disruptions to encourage self-regulatory organizations to consider such complementary efforts.<sup>7</sup>

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<sup>5</sup> See Clearing Agency Standards, Securities Exchange Act Release No. 68080 (October 22, 2012), 77 FR 66220 (November 2, 2012). More specifically, the Release states, “The Commission notes however that under Section 17A(b)(3)(F) of the Exchange Act, a clearing agency is charged with responsibility to coordinate with persons engaged in the clearance and settlement of securities transactions, not just other clearing agencies. . . . Further, the Commission notes that during the clearance and settlement process, a registered clearing agency is confronted with a variety of risks that must be identified and understood if they are to be effectively controlled. To the extent that these risks arise as a result of a registered clearing agency’s links with another entity involved in the clearance and settlement process, Rule 17Ad- 22(d)(7) should help ensure that clearing agencies have policies and procedures designed to identify those risks.”

*Id.* at 66251.

<sup>6</sup> See Principle 20 of the Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions (“CPSS-IOSCO”), Principles for Financial Market Infrastructures (April 16, 2012), available at <http://www.bis.org/publ/cpss101a.pdf> (“PFMI Report”).

<sup>7</sup> See SEC Chair White Statement on Meeting with Leaders of Exchanges, September 12, 2013. (“Today’s meeting was very constructive. I stressed the need for all market participants to work collaboratively – together and with the Commission – to strengthen critical market infrastructure and improve its resilience when technology falls short.”) See also Chair White, Statement on Nasdaq Trading Interruption, August 22, 2013. (“The continuous and orderly functioning of the securities markets is critically important to the health of our financial system and the confidence of investors. Today’s interruption in trading, while resolved before the end of the day, was nonetheless serious and should

### ***Proposed Options Exchange Risk Control Standards Policy***

Under the proposed Policy, if an Options Exchange does not submit a signed certification sufficiently demonstrating that it has certain Risk Controls in place that are consistent with the proposed Risk Control Standards, OCC will charge and collect a fee<sup>8</sup> in accordance with its Schedule of Fees for each trade executed on such Options Exchange until such time that the Options Exchange completes the certification process, which is described in more detail below. Funds collected through the imposition of the Fee are segregated for recordkeeping purposes from other funds generated by clearing fees and would not be available for a Clearing Member refund or Stockholder Exchange dividend under OCC's approved Capital Plan. These funds would be available for use by OCC, with unanimous approval by the Stockholder Exchanges, in accordance with Article VIII, Section 5(d) of OCC's By-Laws<sup>9</sup> and as provided for in the Policy.

#### Risk Control Standards

The proposed Options Exchange Risk Control Standards Policy details each of the Risk Control Standards to which an Options Exchange must attest so that the proposed Fee would not be applied to trades executed on that Options Exchange. The proposed Risk Control Standards, which were developed by OCC in consultation with the Options Exchanges, are principle-based and designed to provide the flexibility for each Options Exchange to develop specific Risk

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reinforce our collective commitment to addressing technological vulnerabilities of exchanges and other market participants.”)

<sup>8</sup> OCC is proposing to collect a fee of two cents per each cleared options contract (per side). Any changes to this fee would be subject to a future rule filing with the Commission.

<sup>9</sup> See Article VIII, Section 5(d). Under Article VIII, Section 5(d), usage of current or retained earnings may be considered after the defaulting clearing member's margin has been exhausted, and it may be used to reduce in whole or in part the pro rata contribution otherwise made from the Clearing Fund to cover the loss. *Id.*

Controls that best suit its own marketplace while still guarding against the types of risks contemplated by the Policy. The proposed Risk Control Standards are described below.

### 1. Price Reasonability Checks

Mandatory Price Reasonability Checks prevent limit orders,<sup>10</sup> complex orders,<sup>11</sup> and market maker quotes from being entered and displayed on an Options Exchange if the price on such order or quote is outside a defined threshold set in relation to the current market price or National Best Bid or Offer (“NBBO”). For example,<sup>12</sup> an Options Exchange may set a Price Reasonability Check that would reject an order that is priced at a certain percentage above the set parameter or a quote entered by a market maker that is priced a certain dollar amount higher than the set threshold.<sup>13</sup> Options Exchanges’ Price Reasonability Checks would include:

- (i) Mandatory limit order, complex order and quote Price Reasonability Checks;
- (ii) Application to all trading sessions, including market openings; and
- (iii) If the checks do not prevent the display and execution of quotes, the Options Exchange would have other means by which it mitigates the risks

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<sup>10</sup> A limit order is an order placed on an Options Exchange to buy or sell a specific amount of options contracts at a specified price or better. (*See, e.g.*, International Securities Exchange Rule 715(b).)

<sup>11</sup> A complex order is an order involving the execution of two or more different options series in the same underlying security occurring at or near the same time. (*See, e.g.*, Chicago Board Options Exchange Rule 6.53C(a)(1).)

<sup>12</sup> Examples herein are illustrative only, and the specifics of such examples are not necessarily required for an Options Exchange to certify having specific Risk Controls sufficient to meet the Risk Control Standards.

<sup>13</sup> By way of example, assume the market is \$1.00 bid at \$1.10. An Options Exchange Price Reasonability Check could reject orders greater than 5 cents above the offer or below the bid. Accordingly, if a broker wanted to buy an option for \$1.10, but inadvertently “fat fingers” the limit price for \$11.00 on the order, the Options Exchange would reject the order prior to execution because the limit on the order is greater than the Price Reasonability Check limit.

associated with the display and execution of quotes outside the specific threshold.

Trades executed on an Options Exchange that occur at prices that were input erroneously and are substantially removed from other trades executed in the same product have the potential to result in large trading losses. In 2013, a trading firm's internal algorithm used to satisfy market demand for equity options inadvertently produced orders with inaccurate price limits and sent those orders to Options Exchanges ("2013 Trading Firm Error"). Though many of the erroneous trades were later canceled, it has been estimated that the trading firm could have faced approximately \$500 million in losses.<sup>14</sup> If these potential losses were realized and if the OCC Clearing Member clearing and settling those trades was unable to honor them, OCC and its remaining Clearing Members would have been exposed to significant losses and a potential disruption to the operations of OCC.

## 2. Drill-Through Protections

Drill-Through Protections are closely related to Price Reasonability Checks and would require all orders, including market orders,<sup>15</sup> limit orders, and complex orders, to be executed within pre-determined price increments of the NBBO. Drill-Through Protections also restrict orders from immediately trading up or down an unlimited number of price intervals and allow

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<sup>14</sup> See In the Matter of Goldman, Sachs & Co., Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 15(9b) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order (June 30, 2015) (Release No. 34-75331).

<sup>15</sup> A market order is an order to buy or sell a stated number of options contracts at the best price obtainable when the order reaches the Options Exchange in which the order was sent to. (See, e.g., Chicago Board Options Exchange Rule 6.53).

market liquidity to be refreshed prior to the execution of further trades.<sup>16</sup> Options Exchanges' Drill-Through Protections would include:

- (i) Mandatory Drill-Through Protections with reasonably quantifiable limits;
- (ii) Application to all orders; and
- (iii) Application to all trading sessions, including market openings.

Options orders that are large in size may, due to the available contra orders, be partially executed at reasonable prices with the remainder of the same order executed at prices that are far from the NBBO, and thus have the potential to result in large trading losses. For example, in 2012, a trading firm erroneously sent more than 4 million orders to equity exchanges over a period of forty-five minutes, creating a loss of over \$450 million that nearly resulted in the trading firm's insolvency ("2012 Trading Firm Error" and collectively with the 2013 Trading Firm Error, the "Trading Firm Errors").<sup>17</sup> If the trading firm was unable to absorb the loss and honor the trades, the clearing agency and its surviving Clearing Members would have been exposed to significant losses and a potential disruption to their operations. While detailed facts surrounding the incident are not publicly known, Drill-Through Protections could have helped limit the losses by preventing execution of orders that would have traded through a large number of price increments in a short period of time.

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<sup>16</sup> By way of example, assume the market is \$1.00 bid at \$1.10 and the size, or liquidity provided on the bid, or offered on the ask, is 100 contracts by 100 contracts. Assume an order is entered as a market order to buy 1000 contracts and the Drill-Through Protection is set at 5 cents and 500 milliseconds (or half a second). The Drill-Through Protection would allow the order to trade up to the price limit set, or \$1.15. At \$1.15, the order would be halted by the Options Exchange and either routed to another Options Exchange or manually executed. Also, after executing 100 contracts for \$1.10, the Drill-Through Protection would temporarily halt the order for 500 milliseconds (or half a second) to allow market makers to refresh their market and size.

<sup>17</sup> See <http://www.reuters.com/article/2012/10/17/us-knightcapital-results-idUSBRE89G0HI20121017>.

### 3. Activity-Based Protections

Activity-Based Protections extend an Options Exchange's Risk Controls to factors beyond price and are most commonly designed to address risks associated with a high frequency of trades in a short period of time. Activity-Based Protections may address the maximum number of contracts that may be entered as one order, the maximum number of contracts that may be entered or executed by one firm over a certain period of time, and the maximum number of messages that may be entered over a certain period of time. Options Exchanges' Activity-Based Protections would include:

- (i) Application to all traded products available on the Options Exchange;
- (ii) Mandatory use of available Activity-Based Protections by its members where the use of such protections is consistent with sound risk management practice; and
- (iii) Maximum number of contracts or orders that may be executed over a certain period of time.

Options Exchanges that don't have Activity-Based Protections have a greater likelihood of facilitating erroneous trades by not imposing limits based on factors other than price. Trading errors that result in a large number of orders or quotes could magnify the trading losses that result from the error and could cause the default of a Clearing Member if the Clearing Member cannot meet its obligations due to such losses. For example, Activity-Based Protections could have limited the loss associated with the 2013 Trading Firm Error mentioned above.

### 4. Kill-Switch Protections

Kill-Switch Protections provide Options Exchanges, and their market participants, with the ability to cancel existing orders and quotes and/or block new orders and quotes on an

exchange-wide or more tailored basis (e.g., symbol specific, by Clearing Member, etc.) with a single message to the Options Exchange after established trigger events are detected. A trigger event may include a situation where a market participant is disconnected from an Options Exchange due to an abnormally large order or manual errors in the system by a market participant causing multiple erroneous trades to occur. Kill-Switch Protections are considered a last line of defense, applicable where, for example, a severe trading problem occurs or an Options Exchange market participant loses connectivity to the Options Exchange. Options Exchanges' Kill-Switch Protections would include:

- (i) The availability, and required use in the case of Options Exchange market makers, of “heartbeat monitoring,” a function that periodically sends an electronic signal between the Options Exchange and the market participant that subsequently cancels all quotes and/or orders if the market participant does not respond to the signal in a certain period of time;
- (ii) The ability for participants of the Options Exchange to “cancel-on-disconnect;”
- (iii) The ability to cancel all quotes and/or orders with a single message to the Options Exchange, with the availability of backup alternative messaging systems; and
- (iv) Restricted automated reentry to trading after the activation of a kill-switch.

Trades executed on Options Exchanges without Kill-Switch Protections increase the risk that trading malfunctions or other harmful events could lead to erroneous trades being executed on an Options Exchange and sent to OCC for clearance and settlement. If the Clearing Member for these trades was not able to absorb losses associated with them, it could potentially expose

OCC and its surviving Clearing Members to significant losses and a disruption of operations. For example, the potential severity of the 2012 Trading Firm Error could have been substantially limited if a Kill-Switch Protection temporarily restricted the trading firm's ability to trade.

#### Certification Process<sup>18</sup>

OCC has developed, in conjunction with the Options Exchanges, the following process to evaluate each Options Exchange's Risk Controls. Under the proposal, each Options Exchange would certify to OCC that the Options Exchange implemented Risk Controls consistent with the Risk Control Standards using a form provided by OCC and signed by an executive officer of the Options Exchange.<sup>19</sup> Provided regulatory approval is received, Options Exchanges that submit documentation would receive a determination from OCC regarding their Risk Controls by a date no sooner than June 30 of each year ("Evaluation Completion Date").<sup>20</sup>

Under the Policy, OCC would evaluate each Options Exchange's Risk Controls and the Risk Controls' compliance with the Risk Control Standards by the Evaluation Completion Date based on a review of its certification and supporting materials, which will include, but will not be limited to, proposed rule changes filed with the Commission, approved Options Exchange rules,

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<sup>18</sup> OCC intends to begin the collection of certifications from the Options Exchanges after appropriate regulatory approval has been obtained.

<sup>19</sup> The signed certification signed by an executive officer of the Options Exchange will attest to the validity, efficacy and implementation of Risk Controls satisfying each of the above described Risk Control Standards. As part of the certification, the executive officer of the Options Exchange will certify that the Options Exchange has met the Risk Control Standards as described in this proposed rule change as approved by the Commission.

<sup>20</sup> OCC notes that the implementation of the Policy and resulting Evaluation Completion Date for 2016 are subject to regulatory approval of the proposed rule change. After receiving regulatory approval, OCC will notify Options Exchanges, its Clearing Members, and market participants of the Evaluation Completion Date for 2016 by issuing an Information Memo on its public website. The Evaluation Completion Date for 2016 will be set for a date not sooner than 30 days after issuing the Information Memo (which may be later than June 30, 2016).

information circulars, and/or written procedures, if any, in each case consistent with the date of receipt of the certification. If OCC is unable to determine that an Options Exchange has Risk Controls sufficient to meet Risk Control Standards, OCC would furnish the Options Exchange with a concise written statement of the reason(s) as soon as reasonably practicable. The Options Exchange may, within 30 days of receipt of the written statement providing the reason OCC was unable to find the Options Exchange maintained sufficient Risk Controls to meet the proposed Risk Control Standards, present further evidence of such sufficient Risk Controls to OCC. OCC would then conduct a second review and make a recommendation to OCC's Risk Committee<sup>21</sup> whether the Options Exchange has sufficient Risk Controls within 30 days of receiving the evidence of such Risk Controls from the Options Exchange. OCC's Risk Committee would, within 30 days of receipt of the recommendation, review the recommendation and the Options Exchange's supporting materials, as appropriate, to determine whether the Options Exchange has Risk Controls sufficient to meet the Risk Control Standards ("Risk Committee Review"). OCC would furnish the Options Exchange with a concise written statement of the Risk Committee determination and the reason for such determination as soon as reasonably practicable following the Risk Committee Review.

Pursuant to the proposed Policy, on June 30 of each year (with the potential exception of 2016, as noted above),<sup>22</sup> OCC would post a notice to its website to which Clearing Members (but not the general public) have access advising Clearing Members, with respect to each Options Exchange, whether: 1) the Options Exchange has implemented sufficient Risk Controls to meet

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<sup>21</sup> OCC's Risk Committee is chaired by a public Director and it does not currently have an Options Exchange representative. In the event OCC's Risk Committee has an exchange representative at some time in the future, such representative would be recused from a decision on the appeal of a determination of an Options Exchange's compliance with the Risk Control Standards.

<sup>22</sup> See *supra* note 19.

the Risk Control Standards; 2) OCC was unable to determine the Options Exchange has sufficient Risk Controls that meet the Risk Control Standards; or 3) a certification has not been submitted by the Options Exchange.<sup>23</sup>

#### Collection of Proposed Fee

Beginning on the first business day that is at least 60 days after OCC posts such notice, OCC would charge and collect the Fee in accordance with the Policy for trades executed on an Options Exchange that was determined not to have sufficient Risk Controls to satisfy the Policy.<sup>24</sup> In the event the Fee is charged, it would continue to be charged to and collected from Clearing Members,<sup>25</sup> and the notice would remain posted on OCC's website to which Clearing Members (but not the general public) have access, until the Options Exchange has demonstrated it has Risk Controls that satisfy the Policy.<sup>26</sup> OCC believes that implementing this Fee may incentivize Options Exchanges to maintain Risk Controls that are consistent with the proposed

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<sup>23</sup> For annual certifications commencing in 2017 and thereafter, beginning June 30 of the calendar year for which the certification is being made, OCC would post a notice to its website to which Clearing Members (but not the general public) have access advising members, with respect to each Options Exchange, whether: (i) OCC has determined the Options Exchange has sufficient Risk Controls that meet the Risk Control Standards; (ii) OCC was unable to determine the Options Exchange has sufficient Risk Controls that meet the Risk Control Standards; or (iii) a certification has not been submitted by the Options Exchange. In addition, OCC will continue to keep a record posted of the history of each Options Exchange's compliance submission status, and any changes made to that status, with the Risk Control Standards on the same OCC website to which Clearing Members (but not the general public) have access in order for Clearing Members to properly keep internal records.

<sup>24</sup> Exhibit 5A contains an updated Schedule of Fees reflecting the Fee. As proposed, the Fee will be applied to all trades executed on an Options Exchange that has not completed the certification process.

<sup>25</sup> The Accounting and Finance Department is responsible for the collection of the Fee and segregation of those funds from other monies collected by OCC.

<sup>26</sup> The National Operations Group is responsible for operationally updating each Options Exchange's certification status, and associated Fee date, as applicable, within the OCC system.

Risk Control Standards, thereby reducing the likelihood that erroneous trades are submitted to OCC and the attendant risk identified above comes to fruition.<sup>27</sup> However, the primary reason for the Fee is to provide additional funds for OCC to manage the elevated risk that would be presented to OCC absent the Risk Control Standards and for which OCC has no reasonable means to predict, measure, or consider otherwise. OCC believes the Fee is reasonable, as it represents less than half but more than a third of a premium over the base rate of five cents per contract, and, since clearing fees represent two percent or less of the total execution cost, should not materially impact a Clearing Member that chooses to execute a transaction on an Options Exchange that has not certified its Risk Control Standards.

OCC believes ensuring that funds collected through imposition of the Fee are available for use as current or retained earnings in accordance with Article VIII Section 5(d) of OCC's By-Laws is an integral component of the proposed rule change, as it provides OCC with increased financial means to cover potential losses stemming from a default caused by erroneous trades that would be presented to OCC absent the Risk Controls and for which OCC has no reasonable means to predict, measure, or consider.

#### Exception and Escalation Processes

The proposed Policy also provides that, on rare occasion, OCC may grant exceptions to the Policy in order to appropriately address immediate business issues and provides for an escalation process to report breaches of the Policy.

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<sup>27</sup> OCC notes, however, that an Options Exchange that does not maintain Risk Controls consistent with the Risk Control Standards is not prevented from submitting transactions to OCC.

### ***Commission Rules and Statements on Critical Market Infrastructure***

Exchange Act Rule 15c3-5 (“Market Access Rule”)<sup>28</sup> and Regulation Systems Compliance and Integrity (“Regulation SCI,” collectively with “Market Access Rule,” “Market Integrity Rules”)<sup>29</sup> provide some requirements for the resiliency of critical market infrastructures. The Market Access Rule, which was adopted in November, 2010, generally prohibits broker-dealers from providing “unfiltered” or “naked access” to the securities markets through an exchange or automated trading system. To comply, broker-dealers must establish and maintain a system of risk management controls and supervisory procedures that are reasonably designed to systematically limit the financial, regulatory, and other risks related to the business activity of any customer utilizing the broker-dealer for access to the national market system. OCC believes that the Risk Control Standards contemplated by the Policy are in no way designed to interfere with, contradict, or undermine the Market Access Rule and are in fact designed to be complementary to the Market Access Rule. The proposed Risk Control Standards, which are based upon calculated prices of orders, bids, and offers, and activity of each Options Exchange participant, as described in more detail above, would provide an additional layer of protections at the Options Exchange level to guard against the risks associated with erroneous trades and would thereby complement the Market Access Rule, which is primarily aimed at controlling access to the marketplace at the firm level. While the Market Access Rule has no doubt contributed to a more resilient market infrastructure, OCC believes there remain gaps in critical market infrastructure with respect to erroneous transactions that should be addressed; in fact, each of the Trading Firm Errors discussed above occurred while the Market Access Rule was in place.

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<sup>28</sup> See 17 CFR 240.15c3-5.

<sup>29</sup> See Securities Exchange Act Release No. 73639 (November 19, 2014), 79 FR 72252 (December 5, 2014) (Reg SCI Adopting Release).

In addition, OCC believes that the Risk Control Standards complement Regulation SCI. Regulation SCI is focused on the need for market participants to bolster the operational integrity of automated systems, whereas the Risk Control Standards are designed to adopt more granular controls around the actual entry of an order that occurs outside the four walls of OCC before a trade is settled or cleared by OCC. As such, OCC believes the Risk Control Standards set specific standards to better further the intent of Regulation SCI. Regulation SCI mandates that an applicable entity have reasonable policies, procedures, and controls in place to ensure the integrity of its systems, but the rule doesn't necessarily prescribe what those controls should be. As proposed, the Risk Control Standards complement the objectives of Regulation SCI by applying specific risk controls related to the execution of trades on Options Exchanges. Because the Risk Control Standards would act to further the intentions of the Market Integrity Rules, rather than undermine or act contrary to them, OCC believes the implementation of the Risk Controls by Options Exchanges consistent with the proposed Risk Control Standards would promote market resiliency when working alongside these Market Integrity Rules.

Finally, OCC believes the proposed Risk Control Standards are consistent with Commission rules requiring clearing agencies to establish and enforce written policies reasonably designed to evaluate the potential sources of risks that can arise when the clearing agency establishes links to clear and settle trades, and to ensure that these risks are managed prudently on an ongoing basis.<sup>30</sup>

OCC also notes that the proposed Risk Control Standards are principle-based in nature and do not prescribe any specific method for satisfying the standards, which would allow each Options Exchange to develop specific Risk Controls that are best suited for its marketplace.

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<sup>30</sup> See 17 CFR 240.17Ad-22(d)(7). OCC notes that these links are not limited in scope to linkages between clearing agencies. See *supra* note 5 at 66250-66251.

Moreover, the adoption of any Risk Control that would be deemed to be a “rule of an exchange”<sup>31</sup> under the Securities Exchange Act of 1934, as amended (the “Act”), would be subject to the rule filing requirements of Section 19(b) of the Act<sup>32</sup> and thereby subject to review by the Commission before it could be implemented by the Options Exchange.<sup>33</sup>

### ***Anticipated Risk Mitigation***

As discussed above and throughout the rule proposal, OCC believes that charging an additional fee for trades executed on Options Exchanges that have not implemented Risk Controls consistent with the proposed Risk Control Standards would mitigate potential risks to OCC, its Clearing Members, and the financial markets OCC serves, and mitigate any threat to the stability of the financial system of the United States. OCC believes the potential harm from the recent market disruptions described above would have been limited if Risk Control Standards were in place on the exchanges on which they occurred. As discussed above, OCC believes that market disruptions of this nature present additional risk to OCC for which it has no other means to reasonably predict, measure, or consider, and as a result presents otherwise uncovered risk to OCC’s Clearing Members and the financial markets OCC serves and, if left unchecked, could threaten the stability of the financial system of the United States. The imposition of the proposed Fee would provide additional financial resources to help OCC mitigate such risks.

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<sup>31</sup> See 15 U.S.C. 78c(a)(27).

<sup>32</sup> 15 U.S.C. 78(s)(b).

<sup>33</sup> Certain Options Exchanges have already filed proposed rule changes, and received approval for such rule changes, with the Commission to implement risk controls that are designed to guard against the same types of risks contemplated by the Risk Control Standards. See, e.g. Securities Exchange Act Release No. 76123 (October 16, 2015), 80 FR 62591 (October 16, 2015) (SR–NASDAQ–2015–096) (Order Approving Proposed Rule Change to Adopt a Kill Switch for NOM). See also Securities Exchange Act Release No. 77092 (February 9, 2016), 81 FR 7873 (February 16, 2016) (SR-BOX-2016-03) (Notice of Filing and Immediate Effectiveness of a Proposed Rule Change to Add Rule 7310 (Drill-through Protection) to Implement a New Price Protection Feature).

(2) Statutory Basis

OCC believes that the proposed rule change is consistent with Section 17A(b)(3)(F) of the Act<sup>34</sup> as it would help to promote the prompt and accurate clearance and settlement of securities transactions and assure the safeguarding of securities and funds which are in the custody and control of OCC or for which it is responsible. Absent the certification of Risk Controls consistent with the Risk Control Standards at Options Exchanges from which OCC has no authority or discretion to elect not to clear options transactions, OCC has no assurance that reasonable controls are in place at Options Exchanges to help mitigate the potential risks that may arise, for example, due to operational errors outside of OCC, that OCC has no ability to predict, measure, or consider. This otherwise uncovered risk increases the likelihood that an OCC Clearing Member would experience a default that would cause OCC to use the funds of other Clearing Members that are in its custody and control (Clearing Fund deposits).

While the Market Integrity Rules help to build a safe and reliable market structure environment, they do not provide absolute protections to OCC, its Clearing Members, and the financial markets OCC serves from risks attendant to the clearance of erroneous transactions that are nevertheless executed on Options Exchanges. OCC notes that the Trading Firm Errors described above occurred after the adoption of the Market Access Rule, and Regulation SCI does not mandate the implementation of Risk Control Standards as contemplated by the Policy. In the event an Options Exchange has not implemented Risk Controls designed to meet the proposed Risk Control Standards, imposition of the Fee would provide OCC with additional financial resources, which are derived from fees associated with the execution of transactions that are driving such risks, that would facilitate OCC's ability to promptly fulfill its settlement

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<sup>34</sup> 15 U.S.C. 78q-1(b)(3)(F).

obligations and contribute to the safeguarding of funds in OCC's custody and control by reducing the likelihood an erroneous trade that causes an OCC Clearing Member to default would exhaust the financial resources of the defaulting Clearing Member available to OCC so that OCC is required to use mutualized resources deposited by non-defaulting Clearing Members with OCC as Clearing Fund.

OCC also believes the proposed increase to fees for transactions executed on an Options Exchange that does not implement sufficient Risk Controls to meet the Risk Control Standards is an equitable allocation of reasonable fees among its participants, as required by Section 17A(b)(3)(D) of the Act.<sup>35</sup> The proposed Fee would be charged only to Clearing Members that execute trades on Options Exchanges that have not implemented Risk Controls designed to meet the proposed Risk Control Standards. The transactions executed on these Options Exchanges generate risk for OCC by increasing the likelihood that a guaranteed erroneous trade would exhaust OCC's financial resources available in the event of a Clearing Member default and that OCC would use mutualized resources deposited by non-defaulting Clearing Members to cover at least part of the loss. The two cent charge will better enable OCC to allocate fees to transactions that are driving that risk.

Finally, OCC believes the proposed rule change is consistent with Rule 17Ad-22(d)(7),<sup>36</sup> which requires OCC to establish, implement, maintain, and enforce written policies and procedures reasonably designed to ensure that risks that arise when OCC establishes links are managed prudently on an ongoing basis. Though the primary type of link arrangement contemplated by Rule 17Ad-22(d)(7) is between clearing agencies, the Commission declined to explicitly restrict application of Rule 17Ad-22(d)(7) to links between clearing agencies, noting

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<sup>35</sup> 15 U.S.C. 78q-1(b)(3)(D).

<sup>36</sup> 17 CFR 240.17Ad-22(d)(7).

that “during the clearance and settlement process, a registered clearing agency is confronted with a variety of risks that must be identified and understood if they are to be effectively controlled. To the extent that these risks arise as a result of a registered clearing agency’s links with another entity involved with the clearance and settlement process, Rule 17Ad-22(d)(7) should help ensure that clearing agencies have policies and procedures designed to identify those risks.”<sup>37</sup> OCC believes this proposed rule change is the product of thorough evaluation of risks presented to OCC arising from links with another entity involved with the clearance and settlement process.<sup>38</sup> Finally, the proposed rule change is not inconsistent with any existing OCC By-Laws or Rules, including those proposed to be amended.<sup>39</sup>

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

OCC believes the proposed rule change may impose a burden on competition amongst Options Exchanges, as Options Exchanges that do not implement sufficient Risk Control Standards to meet the Risk Control Standards will have the Fee added to the cost of transacting on such Options Exchange. OCC believes that the burden on competition is necessary and appropriate in furtherance of the Act because, as discussed above, imposition of the Fee would provide OCC with a means to accrue funds to help cover additional risk that OCC has no other means to predict, measure, or consider, and as a result presents otherwise uncovered risk to

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<sup>37</sup> See *supra* note 5.

<sup>38</sup> The Commission’s proposed Standards for Covered Clearing Agencies would also require a covered clearing agency to establish, implement, maintain and enforce written policies and procedures reasonably designed to identify, monitor, and manage risks related to any link the covered clearing agency establishes with among other things, trading markets. See Proposed Rule 17Ad-22(e)(20), Standards for Covered Clearing Agencies, Proposed Rule, Securities Exchange Act Release No. 71699 (March 12, 2014), 79 FR 29507 (May 22, 2014).

<sup>39</sup> OCC also notes that many of the Risk Controls require regulatory approval prior to implementation on the Options Exchanges. As such, OCC does not believe that any of the Risk Controls will be in conflict with any other rules of the exchanges.

OCC's Clearing Members and the financial markets OCC serves and, if left unchecked, could threaten the stability of the financial system of the United States. The additional risk to OCC, its Clearing Members, and the financial markets it serves that results from the increased likelihood that an erroneous transaction will cause an OCC Clearing Member to default and cause OCC to cover the loss in part through mutualized resources available in its Clearing Fund must be addressed by OCC in furtherance of Sections 17A(b)(3)(F)<sup>40</sup> and 17A(b)(3)(D)<sup>41</sup> of the Act and Rule 17Ad-22(d)(7) thereunder,<sup>42</sup> as described above.

While the proposed Fee would be charged to Clearing Members that execute on Options Exchanges that do not implement sufficient Risk Controls to meet the Risk Control Standards, OCC does not believe that this charge results in a burden on competition between Clearing Members. OCC believes that differential fees are not, in and of themselves, burdens on competition amongst industry participants that pay those fees; in fact, OCC's current fee structure applies differential fees for Clearing Members based on the number of contracts within a trade. Furthermore, while the Fee is important for OCC to properly manage risks attendant with the provision of clearing services in a market that does not have Risk Control Standards, it represents an incremental increase -- less than half but more than a third of a premium over the base rate of five cents per contract of what is an infinitesimal component -- approximately two percent -- of the total execution costs for an options contract.

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<sup>40</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>41</sup> 15 U.S.C. 78q-1(b)(3)(D).

<sup>42</sup> 17 CFR 240.17Ad-22(d)(7).

(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.

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 Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-OCC-2016-004 on the subject line.

Paper Comments:

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

All submissions should refer to File Number SR-OCC-2016-004. 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 Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filings 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\\_16\\_004.pdf](http://www.theocc.com/components/docs/legal/rules_and_bylaws/sr_occ_16_004.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-2016-004 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.<sup>43</sup>

Robert W. Errett  
Deputy Secretary

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<sup>43</sup> 17 CFR 200.30-3(a)(12).