J.P.Morgan

January 30, 2012

Ms. Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

Re: SR-OCC-2011-19

Ladies and Gentlemen:

J.P. Morgan Clearing Corporation ("JPMCC") and J.P. Morgan Securities LLC (JPMS and together with JPMCC, "JPMorgan") welcome the opportunity to provide comments to the Securities and Exchange Commission (the "Commission") regarding the proposed rule change by The Options Clearing Corporation ("OCC") that would amend its by-laws and rules to allow it to provide central clearing of OTC options.[1] Both JPMCC and JPMS are OCC clearing members and have been actively working with OCC and other clearing members to prepare for the commencement of clearing OTC options. Subject to obtaining necessary internal approvals, they expect to be part of a small subset of OCC clearing members that will be the initial participants in the imminent launch of the cleared OTC options product.

As an initial matter, JPMorgan would like to confirm its strong support for this important clearing initiative. Although Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[2] does not mandate clearing of options on securities and indexes of securities, we concur with OCC's assessment, which it articulated in its January 13, 2012 petition to the Commission for rulemaking and request for exemptive relief,[3] that the exclusion of such options from the clearing mandate did not reflect congressional intent that their clearing would not be beneficial or should not be encouraged, and we believe that clearing of OTC options – if properly structured – will further central objectives of Title VII, such as the reduction of counterparty risk and systemic risk.

We also wish to commend the efforts of OCC in progressing the initiative. Its representatives have worked diligently and expeditiously, and we greatly appreciate all their hard work and dedication.

With respect to OCC's proposed amendments to its by-laws and rules, we have two comments.

[1] *See* Notice of Filing of Proposed Rule Change, as Modified by Amendment No. 1 Thereto, Relating to the Clearance and Settlement of Over-the-Counter Options, 77 Fed. Reg. 1107 (proposed January 9, 2012), available at http://www.gpo.gov/fdsys/pkg/FR-2012-01-09/pdf/2012-112.pdf (hereinafter, the "Proposed Rule Change Notice").

[2] Public Law 111-203 (July 21, 2010).

[3] *See* Petition for Rulemaking and request for Exemption from Provisions of the Securities Act of 1933 and Securities Exchange Act of 1934 for Cleared OTC Options (January 13, 2012), http://www.sec.gov/rules/petitions/2012/petn4-644.pdf. JPMorgan supports, and urges the Commission to move promptly to grant, OCC's request for exemptive relief.

First, we believe that proposed Rule 1106(e)(2) should be deleted in its entirety. Under this proposed rule, if OCC determines that it is not feasible to close out any open position of a suspended clearing member in OTC options at an appropriate value through an auction (or any other means permitted under Rule 1106), it could fix a cash settlement value to the position and force an unwind, at that cash settlement value, of open positions in the same series of options held by non-defaulting clearing members and their customers.[4] As OCC has explained in its statement of purpose of the proposed rule change, "[t]his procedure would mean that one or more clearing members having the opposite side of options of the same series as those held by the defaulting clearing member could have their positions involuntarily closed out and would be required to accept or pay the close-out value of the positions as determined by OCC."[5] As we discuss in greater detail below, we believe that with the forced unwind mechanism, the cleared OTC options product would not further the Title VII objectives of reducing counterparty and systemic risk. Indeed, we would assert that the mechanism would actually *increase* both of these risks. Moreover, we are concerned that if clearing members and their customers conclude that the mechanism renders the cleared product relatively more risky than uncleared OTC options, the proposed rule, if adopted, could potentially dampen interest in the cleared product and ultimately undermine its successful offering.

Second, we believe that it is important that the proposed rule change include auction procedures that have been developed by OCC in close consultation with clearing members. It is our view, as further described below, that the need for a forced unwind provision can be obviated by putting in place robust auction procedures that would ensure successful auctions of cleared OTC option positions.

Proposed Rule 1106(e)(2)

The Close-Out Process and Impact of Forced Unwind

Absent the utilization of the forced unwind mechanism, in the close-out of a suspended clearing member's open positions, a counterparty would purchase the open long positions, and assume the obligations under the open short positions, of the suspended clearing member, either through the regular OTC market or through an auction process. The counterparty would then either owe a net amount to OCC or be owed a net amount by OCC in respect of its purchase and assumption of the positions. If the counterparty was owed a net amount, and the suspended clearing member's margin and clearing fund contributions were insufficient to cover that amount, OCC would have to fund the deficiency using clearing fund contributions of non-defaulting clearing members (stated differently, the losses sustained by OCC in closing out the positions would be "mutualized" among the non-defaulting clearing members in respect of their clearing fund contributions). Thus, the probability and the magnitude of a draw on the clearing fund contributions of non-defaulting clearing members would be driven by the soundness of OCC's risk management process (with respect to ensuring OCC has obtained adequate margin and clearing fund contributions from the suspended clearing member) and its success in obtaining in an auction or the OTC market appropriate value for the positions (by maximizing the amounts receivable in

[4] The proposed rule states that OCC could assign a cash settlement value in respect of a suspended clearing member's position in OTC options pro rata to one or more clearing members with long or short positions in the same series of OTC options. Nothing in the proposed rule would limit its impact to positions in the house accounts of the non-defaulting clearing members. Thus, presumably, OCC could also forcibly unwind customers' positions pursuant to the proposed rule.

[5] Proposed Rule Change Notice at 1111.

respect of the sale of long positions and minimizing amounts payable in respect of assumption of short positions).

Success in obtaining value in respect of a portfolio of the suspended clearing member's positions would be a function of any number of different variables, such as the sizes of the positions, the level of trading activity in options with terms the same as those of the options in the portfolio and the robustness of its auction procedures and their ability to maximize the number of counterparties providing bids and to incentivize them to provide competitive bids. In the case of OTC options, it is expected that position sizes will be large and that there may be no active trading market in options with terms precisely identical to the terms of the OTC options in question.[6]

As a result, OCC believes it needs the forced unwind mechanism as a "failsafe" that it could utilize if it was unable to find a counterparty willing to purchase long positions, and assume the obligations under the short positions, of the suspended clearing member "at an appropriate value."[7] OCC does not specify what would constitute "appropriate value." Would it be a value equivalent to OCC's mark for a position? Would it be a value sufficient to ensure that there is no draw on the clearing fund? Or would it be a value sufficient to ensure that the clearing fund is not exhausted? Neither the actual text of the proposed rule nor OCC's statement of purpose of the proposed rule provides a clear answer to these questions.

However, what is clear is that the proposed rule would allow utilization of the forced unwind mechanism as a means (whether intentional or not) to reduce or altogether eliminate the chance of a draw on the clearing fund, since by determining it would not obtain "appropriate value" through an auction or in the OTC market, it could side-step both and thereby avoid the possibility that it would have to tap the clearing fund to make a payment to a counterparty to step into the shoes of the suspended clearing member. Instead, it could rely on the proposed rule to simply terminate the suspended clearing member's OTC positions, assign cash settlement values to them and forcibly unwind opposite positions of non-defaulting clearing members or their customers at those cash settlement values.

Nothing in the proposed rule sheds any light on how OCC would determine the cash settlement value for a position. We assume that it would be equal or at least close to a recent mark assigned to the position by OCC. In any case, it is possible that the cash settlement value assigned by OCC to any position could differ, and perhaps could differ quite materially (especially during a period of market dislocation), from the value at which the non-defaulting clearing member or customer carries the opposite position that is forcibly unwound. Moreover, the cash settlement value would not take into consideration costs related to re-establishing the position or re-establishing, unwinding or otherwise modifying any associated hedges. Such costs could be significant to a clearing member or its customer, particularly during periods of market stress.

We anticipate cleared OTC options to be relatively illiquid, at least in comparison to listed options and, thus, we could easily envision that if the forced unwind provision is invoked with respect to the positions of a suspended member, there might be only one or two non-defaulting members or customers with opposite positions that are forcibly unwound. Accordingly, we view the forced unwind mechanism

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[6] We cannot speak to the robustness of OCC's contemplated auction procedures and their ability to maximize bidders and incentivize competitive bidding since the procedures have not yet been shared with clearing members.

[7] *See* Notice of Proposed Rule Change at 1111.

as a means by which OCC may elect to force one or two non-defaulting clearing members – or their customers – to bear losses in connection with the close-out of a suspended clearing member as an alternative to mutualizing losses among all clearing members through a draw on the clearing fund. Given the general thrust of the Dodd-Frank Act and the regulatory reforms that it has engendered, singling out one or two non-defaulting clearing members or their customers to bear losses in order to avoid mutualizing losses among all clearing members through a draw on the clearing fund strikes us as an anomalous (as well as inequitable) result.

Systemic Risk

By forcing potentially outsized losses upon one or two clearing members rather than mutualizing losses across approximately 120 clearing members through a clearing fund draw, the forced unwind mechanism, if ever utilized by OCC, would actually increase, rather than decrease, systemic risk. If those clearing members are facing financial difficulties (or even if the market perceives them as financially stressed), such potential losses could increase the likelihood of their default (either directly or by prompting other market participants to cease trading with them or call upon them for additional collateral with respect to existing, uncleared trades). Such a cascade of subsequent clearing member defaults could further increase OCC's liquidity and credit risks and have a broader destabilizing market impact. In this regard, we believe that the cleared product, as currently structured, would fail to further the Title VII objective of reducing systemic risk.

Counterparty Credit Risk

As we noted above, if the proposed rule is adopted, the cleared OTC product would fail to provide clearing members and their customers with one of the central objectives of Title VII, counterparty risk reduction. One of the principal benefits of clearing – and one that clearing members, customers and the broader market associate with clearing – is that upon novation of a trade to a CCP, the counterparties that executed the trade assume credit risk and exposure to the CCP's itself and no longer have credit exposure to each other (or any parties other than the CCP). As part of this arrangement, each clearing member effectively outsources its credit risk management to the CCP and, as a result, places significant reliance on the CCP's risk and default management mechanisms to minimize losses to member clearing fund contributions. With the forced unwind provision, a party that executes an OTC trade could very well incur losses as a result of a default of a clearing member, either the clearing member it originally executed the trade with or another clearing member (whose creditworthiness may or may not have been previously diligenced or is actively covered by the party given the CCP's role). It either case, the party would be exposed to the clearing member's, not OCC's, credit risk post-novation, which for most participants in the clearing process would be an unanticipated and potentially undesirable result.

Relative Value

Because the Dodd-Frank Act does not mandate clearing of OTC options, parties will have the ability to utilize either the cleared or uncleared OTC product. Presumably, they will make their selection by assessing the relative value of the products based in large part on a comparison of their respective risk profiles.

While we suppose that one could possibly argue that a party is not worse off with respect to the unknown counterparty credit risk under the cleared product arising from this provision since it lives with the risk in the uncleared product,[8] we believe that a clearing member or customer assessing the relative risks of the two products could reasonably conclude that a significant disadvantage of the cleared product is that the cash settlement value assigned to a forcibly unwound position would not be calculated taking into consideration the party's mark of the position or the costs it would incur in connection with re-establishing the position or re-establishing, unwinding or otherwise modifying any associated hedges following the position's unwind. In contrast, if it executed an uncleared OTC option transaction governed by an ISDA master agreement, it would frequently have the ability to take into account hedging and transaction replacement costs into account when calculating its damages resulting from its counterparty's close-out.

For a clearing member, an additional drawback of the forced unwind mechanism (and one it does not confront in the uncleared product) is that forced unwind makes it difficult, if not impossible, to accurately estimate its potential liability as a clearing member. This point can best be illustrated by comparing the forced unwind mechanism to a clearing member's right to terminate its clearing membership in order to avoid an obligation to fund a clearing fund assessment. In the latter case, a clearing member can determine at any time and on an *ex ante* basis its potential liability in respect of the clearing fund by making an assumption regarding whether it would terminate its membership in response to a clearing fund assessment. In contrast, a clearing member would be unable to quantify on an *ex ante* basis its potential liability in respect of forced unwind. This inability to do so presents a clearing member with risk management concerns, and it also makes it impossible for its regulators to monitor with certainty the clearing member's CCP-related exposures. We view our need to quantify such exposures as both a business and a regulatory imperative.

Auction Procedures

As noted above, we believe the solution to the concern that drives the assumed need for the proposed rule is for OCC to develop and adopt, in conjunction with its clearing members, robust auction procedures designed to ensure successful auction. Properly designed auction procedures can insulate a CCP from the risk that it receives either no bids or uncompetitive bids and thus obviate the assumed need for forced unwind.

We have been considering different auction options and we are confident robust procedures can be designed for the OTC options product, and we believe that other clearing members can provide useful insights and assistance in this regard. We also believe that JPMorgan and other clearing members can work with OCC in developing such procedures expeditiously and without delaying the progress of the cleared OTC options initiative.

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[8] To be clear, we do not agree with that argument. Rationalizing the forced unwind provision by arguing that clearing members and their customers should get comfortable with it since they take counterparty credit risk in uncleared OTC options distracts from the provision's inconsistency with Title VII's goal of reducing counterparty credit risk. Moreover, if a clearing participant (either a member or a customer) may be subjected to a forced unwind as a result of the default of a clearing member with whom the participant never transacted, then *that* is *not* counterparty risk the participant would have with the uncleared OTC options product.

We thank the Commission for the opportunity to comment on this important clearing initiative. While we believe resolution of the points we have discussed herein is critical to the ultimate success of the cleared OTC options product, we also would like to reiterate our support for the initiative and our willingness to work with the Commission, OCC and our fellow clearing members to address the concerns we have raised.

We would also appreciate the opportunity to meet with Commission Staff to make our case directly and to answer any questions Staff may have.

If you have any questions regarding this letter or the matters raised herein, please do not hesitate to contact the undersigned at (212) 648-0254 or at alessandro.cocco@jpmorgan.com.

Sincerely,

Alessandro Cocco
Managing Director