



March 2, 2012

Via Electronic Mail

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: File Number SR-OCC-2011-19: Response to Comments Submitted by
J.P. Morgan and FINRA

Dear Ms. Murphy:

The Options Clearing Corporation (“OCC”) submits this letter in response to comment letters received by the Securities and Exchange Commission (the “Commission”) from J.P. Morgan (“JPM”)¹ and the Financial Industry Regulatory Authority (“FINRA”)² in response to OCC’s proposed rule changes providing for the clearance and settlement of index options that are negotiated bilaterally in the over-the-counter (“OTC”) market and submitted to OCC for clearance (“OTC Options”).³ A full description of the OTC Options is included in the OTC Options Rule Filing. We appreciate the thoughtful comments provided by JPM and FINRA and their strong support of this clearing initiative, which will bring increased oversight and decreased systemic risk to the applicable OTC markets.⁴ We would like to address certain issues raised in

¹ Letter from Alessandro Cocco, Managing Director, JPM, to the Commission, dated January 30, 2012 (the “JPM Letter”), available at <http://www.sec.gov/comments/sr-occ-2011-19/occ201119-2.pdf>.

² Letter from Gary L. Goldsholle, Vice President and Associate General Counsel, Regulatory Group, FINRA, to the Commission, dated January 31, 2012 (the “FINRA Letter”), available at <http://www.sec.gov/comments/sr-occ-2011-19/occ201119-3.pdf>.

³ Securities Exchange Act Release No. 66090 (January 3, 2012), 77 FR 1107 (January 9, 2012) (the “OTC Options Rule Filing”). Note that while the OTC Options Rule Filing currently provides for clearing by OCC of OTC index options generally, it is OCC’s intention to amend the OTC Options Rule Filing to limit the initial product set to include only OTC Options on the S&P 500 Index.

⁴ See FINRA Letter indicating that “[FINRA is] supportive of the OCC’s initiative in this area, and will work expeditiously with the OCC and Securities and Exchange Commission staff to develop an appropriate regulatory framework.” See also JPM Letter indicating, in relevant part, that “JPMorgan would like to confirm its strong support for this important clearing initiative. Although Title VII of the [Dodd-Frank Act] does not require central clearing of options on securities and indexes of securities, [JPM] concur[s] with OCC’s assessment . . . 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 [JPM] believe[s] 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.”

Elizabeth M. Murphy, Secretary

March 2, 2012

Page 2

the JPM Letter and FINRA Letter in order to assist the staff in completing the process necessary to approve the OTC Options Rule Filing.

The FINRA Letter

As noted in the FINRA Letter, most of OCC's clearing members are also members of FINRA and, accordingly, will be subject to applicable FINRA rules in connection with their clearing of OTC Options. We have been engaged in ongoing discussions with FINRA staff concerning the appropriate treatment of the OTC Options under FINRA Rules 2360 (Options) and 4210 (Margin Requirements). On February 16, 2012, OCC staff and OCC's outside counsel met with FINRA staff⁵ to discuss the application of those rules to the OTC Options.

FINRA Rule 2360 distinguishes between a "conventional option," which is the term ordinarily used to refer to uncleared, bilateral OTC options, and a "standardized option," which is the term ordinarily used to refer to exchange-traded options cleared by OCC, which are also "standardized options" as defined in Commission Rule 9b-1 and are the subject of an options disclosure document or "ODD" meeting the requirements of that rule. Cleared OTC Options would be treated as "standardized options" under Rule 2360 as presently drafted, even though they are not standardized options within the definition of Rule 9b-1. While cleared OTC Options have certain characteristics of both conventional options and standardized options, OCC believes they should be treated as "conventional options" for most purposes under FINRA Rule 2360.

FINRA Rule 4210 uses the term "listed" to apply to options that are exchange-traded and cleared by OCC and the term "OTC" to refer to options that are not issued by OCC. Cleared OTC Options would fall under neither of these definitions as FINRA rules are presently drafted. OCC believes that, because OCC options are "guaranteed" by OCC in precisely the same way as all other OCC-issued options, they should be treated the same as "listed" options for margin purposes.

We have been engaged with FINRA staff in discussions about potential amendments to Rules 2360 and 4210 to ensure the appropriate treatment of OTC Options. We understand that FINRA has submitted to the Commission staff an outline of proposed changes to these rules for their consideration. We look forward to continuing to work with FINRA and Commission staff on these rule changes.

The FINRA Letter indicated that amendments to FINRA Rules may be necessary or desirable in the following areas in order to accommodate the unique characteristics of the OTC Options: position and exercise limits, aggregation, hedging, reporting obligations, sales practices and margin treatment.

At this time, OCC is seeking approval from the Commission to clear only OTC Options on the S&P 500 index.⁶ Options on the S&P 500 index are not currently subject to position or exercise

⁵ Present at the meeting were Thomas Gira, Kathryn M. Moore and Gary L. Goldsholle. Glen Garofalo, Rudolph R. Verra, Steve Yannolo and others participated via phone.

⁶ See note 3, supra.

limits, as discussed with FINRA staff on February 16. As discussed in that meeting, so long as OCC clears only OTC Options on the S&P 500 Index we see no need to address position or exercise limits at this time, as neither standardized nor conventional OTC options on the S&P 500 Index are subject to such limits. We therefore believe it is unnecessary to address the aggregation and hedging topics referred to in the FINRA Letter, as those concepts are related to position and exercise limits. We also believe that FINRA's reporting and sales practice rules for "conventional options" should apply to the cleared OTC Options. We are working with FINRA staff to address these issues.⁷

In relation to the application of Rule 4210, FINRA staff asked whether a FINRA member will know whether an OTC Option trade has been accepted or rejected by OCC in time to make a determination concerning whether listed or OTC margin rules should apply with respect to that option. As discussed with FINRA staff, OCC's acceptance or rejection of an OTC Option transaction for clearing will occur essentially in real time⁸ and the result will be communicated immediately to the relevant clearing members.⁹ We therefore believe clearing members will have sufficiently timely information to determine the appropriate margin treatment for OTC Options.

The meeting that OCC staff and OCC's outside counsel had with FINRA staff, as well as subsequent telephone conversations and e-mail exchanges, were very productive. OCC will continue to work with FINRA to ensure that the OTC Options are treated appropriately under FINRA rules.

The JPM Letter

The JPM Letter expressed "strong support" for OCC's initiative in clearing OTC options. However, the letter objected to one specific provision in the one-hundred-twelve page OTC Options Rule Filing. JPM stated that it believes proposed Rule 1106(e)(2) should not be included in OCC's final rules. Rule 1106(e)(2) provides that, if OCC determines that it is not feasible to close out long or short positions in OTC Options carried by a suspended clearing member through any of the other methods permitted under OCC's Rules, then OCC could invoke an early termination remedy whereby OCC could terminate the options and fix a cash settlement value for the option, which one or more clearing members having the opposite side (short or

⁷ FINRA sales practice rules will apply to the cleared OTC Options by their terms. *See, e.g.*, FINRA Rules 2360(b)(16), (19) and (20).

⁸ Trades in OTC Options that are submitted to OCC for clearance by 5:00 p.m. Central Time will be processed by OCC for premium settlement on the next business day. Trades received after 5:00 p.m. Central Time will be processed for premium settlement on the second business day.

⁹ If an OTC Option transaction is rejected by OCC and the parties to such transaction have an agreement in place to form a bilateral option contract in lieu of an OTC Option, such bilateral option contract would not be treated as a "listed option" for margin purposes.

long) of such OTC Options would be obligated to pay or receive in consideration of the termination of their positions.¹⁰

OCC's Rule 1106 provides broad authority for OCC to close out open positions in options carried by a suspended clearing member "in the most orderly manner practicable." Just as listed options are ordinarily closed out by submitting buy-in and sell-out orders to the exchanges, cleared OTC Options may be closed out in the OTC market. In addition, the Commission recently approved an OCC rule change providing OCC the express authority to use an auction process as one of the means for closing out the open positions of a suspended clearing member.¹¹ This auction process would be available for cleared OTC Options as well as listed options. Rule 1106(e)(2) was proposed as an additional "fail safe" method of close-out in view of the fact that positions in cleared OTC Options are expected to be large and that there might be no active trading market in options with terms precisely identical to the terms of the cleared OTC Options in question. Because it would affect positions of non-defaulting clearing members and, potentially, their customers, the provision would be invoked only in extraordinary circumstances.

While we respect JPM's views with respect to the early termination remedy in proposed Rule 1106(e)(2), we believe that the JPM Letter greatly overstates the potential adverse consequences of the rule. The JPM Letter states that it believes that proposed Rule 1106(e)(2), "if ever utilized by OCC, would actually increase, rather than decrease, systemic risk." We strongly disagree with this assertion. Rule 1106(e)(2) would not impose any forfeiture on a non-defaulting clearing member. OCC intends that non-defaulting clearing members whose positions are terminated would be compensated for the market value of any terminated long positions and required to pay no more than the market value for any terminated short positions, including any change in the value of their position between the default and termination dates. OCC would ensure the return of any collateral/margin that was pledged by a clearing member having a short position that is closed out.

Furthermore, it is important to recognize that early termination is a common remedy under existing bilateral OTC derivative trading relationships. Dealers as well as end users in the current OTC derivatives market face the risk of early termination in the event that their counterparty becomes insolvent. This risk would actually be substantially reduced, not increased, as the result of submitting those transactions for clearance even where clearing organization rules provide early termination as a remedy of last resort. The likelihood of the remedy being invoked is greatly reduced given the alternative means of close-out available to a clearing organization. And, in any event, the resources of the clearing organization protect the

¹⁰ The text of the provision in question is as follows:

In respect of open positions in OTC options, if the Corporation determines in its discretion that it is not feasible for the Corporation to close out any such position through any of the other means provided under this Rule, the Corporation may fix a cash settlement value with respect to such position and assign such cash settlement value pro rata to one or more Clearing Members with long or short positions in the same series of OTC options.

¹¹ See Securities Exchange Act Release 65654 (October 28, 2011), 76 FR 68238 (November 3, 2011).

non-defaulting party against forfeiture of the market value of the position even where the collateral posted by the defaulting party is insufficient to cover those losses because unrecovered losses are mutualized among all clearing members.

A significant part, if not most, of JPM's concern appears to relate to the method by which OCC would establish a close-out value. JPM fairly notes that OCC's rule filing does not include a great deal of detail about how OCC would determine close-out values for terminated positions. As OCC has subsequently discussed with JPM, it is OCC's intention to fix these values at an objectively determined market value. OCC's rules require it to establish market prices for cash-settlement of options in other circumstances, and proposed Rule 1106(e)(2) is not unique in that regard.¹² OCC is a neutral counterparty and an industry utility operated not-for-profit, but as a service to its clearing members. Rule 1106(e)(2) was in no way intended as a means "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."¹³ OCC will calculate a value for each cleared OTC Option on a daily basis for margin purposes and would take into consideration substantially the same pricing inputs when calculating a close-out settlement value for purposes of Rule 1106(e)(2). OCC has no incentive to set that value at any level other than the fair market value on the date the position is closed out. JPM's concern in this regard should be addressed in an amended rule filing if Rule 1106(e)(2) is retained, and consideration may also be given to means of assuring the good faith of those who are responsible for fixing settlement values.

Recognizing that early termination is a common remedy in the existing OTC market, JPM makes a valid point in stating that, in a transaction governed by an ISDA Master Agreement, the non-defaulting party "would frequently have the ability to take into account hedging and transaction replacement costs . . . when calculating its damages resulting from its counterparty's close out." Alternative provisions in a typical ISDA Master Agreement would fix the close-out value in an early termination based upon the non-defaulting party's side of the market, rather than the mid-market value. While reasonable people might disagree as to the best or fairest standard, setting the value at a mid-market value rather than at the non-defaulting party's side of the market, would not plausibly lead to a difference in value so significant as to pose increased risk to the broader financial system.

For all of the foregoing reasons, it is OCC's opinion that systemic risk is significantly reduced as a result of clearing through a central counterparty and that an early termination provision such as provided under proposed Rule 1106(e)(2) does not alter that conclusion.

Notwithstanding the views expressed above, OCC is willing to give further consideration to JPM's concerns and is open to any potential improvement in, or alternative to, Rule 1106(e)(2). OCC has been engaged with JPM and other clearing members for an extended period of time,

¹² See, e.g., OCC By-Laws Article VI, Section 11 (Adjustment Panel Policies and Procedures), 11A (Adjustments for Stock Option Contracts) and 19 (Shortage of Underlying Securities).

¹³ JPM Letter in the carry-over paragraph at the top of p. 4.

Elizabeth M. Murphy, Secretary

March 2, 2012

Page 6

through a working group composed of legal and business staff at OCC and OCC's clearing members (the "Legal Working Group") to obtain information and feedback regarding OCC's proposed clearing solution for OTC Options. The involvement of the Legal Working Group in this process has helped ensure that OCC's clearing solution for OTC Options will be robust and appropriately structured for the relevant markets and market participants.

On February 13, 2012, OCC met with the Legal Working Group (represented in person and by phone), including representatives of JPM, to discuss proposed Rule 1106(e)(2). That discussion was very constructive. At that meeting, it was decided that a sub-committee of the full Legal Work Group would be formed to address close-out issues, including Rule 1106(e)(2) and the possible use of a coercive auction (*i.e.*, one in which clearing members active in the cleared OTC Options market would be effectively compelled to submit competitive bids) to close out a suspended clearing member's positions in OTC Options. OCC is committed to moving forward on an expedited basis to consider all aspects of the question, including the possible modification or elimination of Rule 1106(e)(2) and whether a coercive auction process would be an effective alternative to Rule 1106(e)(2) that would be preferred by clearing members.

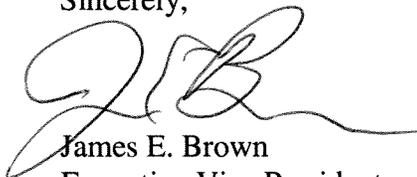
Elizabeth M. Murphy, Secretary

March 2, 2012

Page 7

Please do not hesitate to contact me at (312) 322-6855 or jbrown@theocc.com if you have any questions regarding this letter.

Sincerely,



James E. Brown
Executive Vice President
and General Counsel

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