Re: File No. SR-OCC-2024-001, Release No. 34-99393 Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing of Proposed Rule Change by The Options Clearing Corporation Concerning Its Process for Adjusting Certain Parameters in Its Proprietary System for Calculating Margin Requirements During Periods When the Products It Clears and the Markets It Serves Experience High Volatility

Commenter: Larry Douglas, American Investor

Body:

Dear Ms. Countryman,

Thank you for the opportunity to comment on File No. SR-OCC-2024-001, Release No. 34-99393 Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing of Proposed Rule Change by The Options Clearing Corporation Concerning Its Process for Adjusting Certain Parameters in Its Proprietary System for Calculating Margin Requirements During Periods When the Products It Clears and the Markets It Serves Experience High Volatility. Please note my opposition to the codification of these rules for the OCC, and my strenuous and grave objection to their de facto current implementation pre-codification.

The proposed process for calculating and adjusting margin requirements put forward by this proposal is discretionary and extremely opaque, made obvious by the considerable redactions (in fact at least 205 pages in the exhibits provided in supporting evidence) and non public information required to understand this proposed system in any real technical way. This system serves to reduce accountability and transparency of the regulatory process, creates perverse incentives with significant moral hazard, and opens up new opportunities for regulatory capture and corruption. Reducing the protection margin provides at the cost of vastly increased systemic risk, without any of the advantages that would be provided by a more rules-based and transparent approach. The OCC and its clearing members will benefit from these lower margin requirements, encouraging excessive highly leveraged speculation, and risk taking during periods of increased volatility, while increasing systemic risk during those same times when it is most crucial for risk to be properly managed.

Reduced margin requirements will create imbalances in supply and demand, and increase the market's sensitivity to volatility, in precisely a time when that volatility is increased. Just as the leveraged positions during the 2008 crisis experienced margin calls and led to a feedback effect creating crashes and fire sales. This is because reduced margin requirements and thus increased leverage can blunt temporary volatility by allowing investors to remain in positions longer than they otherwise might be able to (temporarily preventing liquidation), but it also increases the risk that should material market conditions not change and volatility remain sustained that these now more highly leveraged and thinly capitalized positions and firms when liquidated could lead to financial contagion. This also increases risk for not only the clearing firm and its members but all manner of stakeholders. Even well capitalized stakeholders with otherwise sufficient risk management. Essentially this tends to move risk off rampant speculators playing an all or nothing game to cash investors, pension funds, and others on the buy side by removing prudential standards and the disciplining effect of margin. This disciplining effect is essential for the market to self regulate so much as it is able to.

This is because reducing margin requirements does nothing to prevent potential damage from overleveraged and poorly managed positions unless the time of margin forbearance is used to deleverage those positions or market conditions move favorably for those positions. In fact this punishes those with long term and unleveraged positions, as they are covered 1:1 and thus aren't contributing to the underlying problem of insufficient margin, excessive speculation, overleveraging, and poor risk management, but instead are left to deal with the consequences on the market of these positions and the effects of any attempt at remedial measures. Reducing margin and collateral requirements is not a permanent solution for the same reason that raising margin requirements during increased volatility is not a proper solution. Though this would increase safety of the clearing firms, or brokers who implemented the increased requirements, it will likely also reduce liquidity and therefore stability, while increasing volatility. A better solution is to instead have clearly defined and transparent requirements that are reasonable and sufficient and enforcing proper position and risk management while also having an orderly plan in place in the case of a default event. In times where heroic measures are needed, there must be transparency and accountability, or we will see these circumstances become more and more common as backroom players add taking advantage of such occurences more and more in to their strategy. Why shouldn't they if they can prevent risk and losses to themselves, and indeed generate tremendous profit, all while preserving the appearance of stability? It can also lead to a degenerative loop of lowering margin requirements to prevent margin calls, and simply lowering them further should the market continue to move against these leveraged positions to avoid yet more margin calls. Increasing leverage and risk during each averted margin event. Essentially doubling down on the bet each time, with no actual risk until systemic risk is manifest. This may seem like a win-win situation to those benefitting from it, but each time leverage is increased the surrounding market becomes more distorted by it with liquidity surges and droughts, and undervalued assets becoming even more undervalued while overvalued assets become even more overvalued. With more diversified assets like broad market indexes, the problem can be more muted, as a rising tide raises all boats, but with single stocks and securities receiving similar preferential treatment the effect could be disastrous, and overleverage as well as lax prudential standards in any context can lead to bubbles and following busts.

This makes the so-called idiosyncratic controls of a particular and alarming concern, especially as they seemed to be relied on all the more commonly. Very little consideration has been given to adverse effects on investors in securities identified as individual risk factors. The fact that almost no consideration has been made brings in to question the legitimacy of these idiosyncratic controls and the wider proposal, and seems to indicate a lack of due dilligence and necessary concern for the protection of investors. Investors in these securities could face greater uncertainty and volatility in the value and liquidity of their investments brought about by the reduced margin requirements encouraging leveraged speculation, poor risk management, and arbitrage in affected securities. This could distort price discovery and inhibit proper risk management. This would increase systemic risk and create the potential for even greater losses, along with compromising the stability and integrity of the clearing system. This could expose the affected participants to the consequences of a default or insolvency event within the OCC or one of its clearing members. These idiosyncratic controls inexorably produce lower transparency and less predictability of the margin system, as well as the wider market, with their opaque and discretionary nature undermining confidence and trust in regulation and oversight. While it's impossible to tell for certain given their opaque nature, they appear to be exactly the sort of thing I would suggest if I wanted to protect large concentrated positions and overleveraged speculative positions in specific securities from margin calls and remedial measures.

What was it that allowed the financial crisis of 2008 to become as dire as it became? One extremely significant factor was sleepwalking in to overleveraged positions with inadequate margin requirements. Inadequate margin requirements negatively impacted the stability and efficiency of the financial system, primarily during periods of increased volatility, where beforehand the risk presented was unrecognized. They allowed investors and brokers to borrow more money to take larger positions in risky assets and securities, while the risk presented by those assets went unnoticed and unaccounted for. This increased the leverage of the entire financial system, and the exposure of that system to various market flucuations, which amplified losses and created liquidity issues when the value of these assets collapsed. All the while the protective cushion provided by sensible margin to the brokers and clearing houses was absent, compromising the stability and integrity of the entire system. These inadequate margin requirements also led to excessive risk taking in derivative markets many times the size of the market for the underlying, increasing leverage yet further and exacerbating crashes and contagion.

Knowing the SEC and OCC contains many brilliant individuals, many of whom were market professionals at that time, I assume organizationally they must be aware of these interrelated conditions. I can only hope that behind closed doors they are seeing something that I am not able to see, when from my perspective as a public market participant this entire proposal comes across as, frankly, nefarious and insidious. At the very least I would like to see the OCC address the adverse effects to investors in securities identified as individual risk factors for their idiosyncratic controls, and standardization of their criteria for determining which securities meet this threshold. Along with a better understanding of how global exceedances, as well as idiosyncratic exceedances beyond the account level, may be driving implementation of these controls.

As the proposal stands it's extremely worrying that it merely proposes codifying procedures that are assumedly routinely taking place at the central clearing firm. A preliminary look at the frequency of the idiosyncratic controls described seems to place the number at more than 50 annually. This is no doubt having an effect on the market, yet even more worryingly any potential damage done could be hidden until it's too late by the diversion from margin safeguards and the opaqueness of the protocols and proposal. The public could be blindsided to the point that they may not even recognize reduced margin requirements as a driving factor (even though it is so often the case during adverse market events and periods of increased volatility), as they haven't had the opportunity to view the evidence the OCC presents in favor of the proposal. How can the public make informed comment when they are specifically being denied the evidence supposedly relevant to any proposal? This gives the entire proposal, the OCC's current procedures, and the rulemaking process itself the character and appearance of a crime, as opposed to orderly evidence based rulemaking centered around rigorous prudential standards and a transparent democratic process.

Not only do I believe the proposal is unfit to move forward, the fact that it represents business as usual at the OCC is disturbing. "Codification" of these parameters and rules would represent the SEC rubber stamping procedures that shouldn't be taking place at all, let alone codified as the standard. If anything Congress or the SEC should initiate an investigation in to how these reduced requirements are determined, and which firms have positions which benefit the most from them. That is which accounts and firms would be subject to margin calls if not for the reduced margin and collateral requirements and lax prudential standards, along with firms with ties to the individuals in charge of determination and implementation of these controls at the OCC. As well as the frequency and nature of such occurrences. If it is one clearing member defaulting, their default should not be treated as an existential issue for the clearing firm itself. If it is existential to the central clearing firm then the defaulting firm has been granted improper preferential latitude within the clearing member group. If it is many or all firms defaulting all the more evidence of widespread failure of currently implemented margin procedures. Either issue would be resolved by proper sensible standardized collateral, margin, and prudential requirements. The focus should be on enforcing disciplined risk management, and winding down accounts of firms unable to manage their risk within the central clearing firm's parameters with as little effect on the wider market as is possible with an orderly process. Not rescuing firms with poorly managed positions at the expense of the entire system.

The core process outlined in this proposal appears to be designed for regulatory capture by the firms with the ability to influence the individuals in charge of the opaque discretionary controls for exploitation to their own benefit. Where a powerful firm or clearing member could lobby or influence the OCC to exercise their discretion to reduce margin requirements for the securities they trade, and thereby lower borrow costs, increase their leverage, and thus returns. Such a powerful firm could exploit the information assymetry and the opacity of the OCC margin system to generate risk-free profits by exploiting market inefficiencies for arbitrage. They could also transfer their own risks and losses on to the OCC itself or other participants who receive less favorable treatment under the margin system. They could then further exploit this risk by benefitting from remedial measures intended to mitigate it. Essentially removing risk from themselves (by, for example, avoiding the realized risk of a margin call), then having it ameliorated entirely in the name of protection of the public and central clearing entity (as when extraordinary measures are taken to preserve market stability, and the existence of the central clearing firm through things like injections by various liquidity facilities), compromising the stability and integrity of the entire system and tax-payer supported insitutions.

This all adds up to a glaring obvious danger to market integrity, without any benefits that couldn't be provided by a more transparent rules-based approach. The fact that the procedures outlined in the proposal are already commonplace within the OCC makes clear the need for regulation, but that regulation should not look anything like this proposal. There doesn't seem to be a prudent justification for the secrecy surrounding it. If it's to prevent exploitation of the parameters by clearing members these parameters already seem very preferential and exploitable and come at the cost of being unaddressable by and unaccountable to the public. I hope some of these cautions and concerns can be addressed by the rule-making process, but in my opinion this proposal and the margin system at the OCC need to be completely re-engineered and transparent.

Thank you very much for your time,
Larry Douglas