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**VIA FACSIMILE TRANSMISSION
AND OVERNIGHT COURIER**

Mr. Michael A. Macchiaroli
Associate Director
Securities and Exchange Commission
Division of Market Regulation
Mail Stop 5-1
450 5th Street, N.W.
Judiciary Plaza
Washington, D.C. 20549

Re: **Definition of "Customer" for Purposes of the Hypothecation Rules**

Dear Mr. Macchiaroli:

I am writing on behalf of The Options Clearing Corporation ("OCC") to request that the Commission staff take a "no action" position that would permit OCC Clearing Members to treat certain affiliates ("Member Affiliates") for which they maintain options accounts as "non-customers" for purposes of Rules 8c-1 and 15c2-1 (the "Hypothecation Rules").¹ Permitting a Member Affiliate to be treated as a non-customer will allow the positions of the Member Affiliate to be commingled with the positions of the Clearing Member in the latter's firm account at OCC, which will result in more favorable clearing margin treatment. More importantly, this relief will

¹"Customer" is defined in the Hypothecation Rules to exclude any general or special partner or any director or officer of a broker or dealer, or any participant, as such, in any joint, group or syndicate account with such broker or dealer or with any partner, officer or director thereof. Business affiliates controlling, controlled by or under common control with, the clearing member are not, as such, excluded from the definition.

permit the Member Affiliate's transactions and positions to be included in the Clearing Member's proprietary cross-margining account.

OCC proposes to define a Member Affiliate as an affiliate of an OCC Clearing Member that is (i) a Related Person of the Clearing Member;² (ii) a person who is not a "customer" for purposes of the Commission's Rule 15c3-3;³ and (iii) a person who has given consent to being treated as a non-customer and having its claims subordinated to the claims of "customers" in a liquidation under the Securities Investor Protection Act.

In order to ensure that a Member Affiliate is not a Rule 15c3-3 "customer," OCC will require that each Member Affiliate that is not a broker-dealer must execute a subordination agreement and otherwise conform to the conditions established by the Commission staff whereby "accounts maintained pursuant to Non-Conforming Subordination Agreements that are entered into with a non broker affiliated entity shall not be considered a customer for purposes of SEA 15c3-

²"Related Person" (of a Clearing Member) is defined in OCC's bylaws as a person who: (1) is a business affiliate that controls, or is controlled by or under common control with, the clearing member or any officer, director or general or special partner of the clearing member; (2) is a spouse or minor dependent living in the same household as any such person or of any non-customer of the clearing member; or (3) is an employee whose duties include: (A) managing the business of the clearing member or any portion thereof, (B) handling the transactions, positions or funds of any customer of the clearing member or of such clearing member itself, (C) maintaining the records which relate to trades or funds of any customer of the clearing member or of such clearing member, or (D) signing or cosigning any checks or drafts on behalf of the clearing member; provided, however, that the term Related Person shall not include any person who is a non-customer of the clearing member. For purpose of this definition, direct or indirect ownership of 10% or more, in the aggregate, of the equity of any entity is deemed conclusively to confer control of that entity. This definition is consistent with the list of persons whose property is to be carried in a "proprietary account" for purposes of Regulation 1.3(y) promulgated by the Commodity Futures Trading Commission ("CFTC") under the Commodity Exchange Act ("CEA").

³"Customer" is defined in Rule 15c3-3 as "any person from whom or on whose behalf a broker or dealer has received or acquired or holds funds or securities for the account of that person." Rule 15c3-3, states, in pertinent part, "the term [customer] shall not include a broker or dealer . . . or general partners or directors or principal officers of the broker or dealer or any other person to the extent that that person has a claim for property or funds which by contract, agreement or understanding, or by operation of law is part of the capital of the broker or dealer or is subordinated to the claims of creditors of the broker or dealer."

3.⁴ Those conditions, and OCC's proposed method of assuring compliance with them, are as follows:

1. A written non-conforming subordination agreement exists.⁵

OCC will require in its rules that each Member Affiliate who desires to have its positions carried in the firm account of its affiliated Clearing Member must execute a subordination agreement (the "Subordination Agreement") in a form specified by OCC and included in its rule filing with the Commission on Form 19b-4.

2. There is a written acknowledgment by the affiliate that the account is not covered by the provisions of the Securities Investor Protection Act of 1970 and the balances are funds that are not subject to foreign customer protection. In addition, appropriate disclosure of these two points has been made by the affiliate if the assets being pledged are not proprietary.

This acknowledgment, and a representation that such disclosure, if applicable, has been made, will be set forth in the Subordination Agreement.

3. There is an opinion of counsel that the affiliated entity executing the agreement is legally authorized to make the subordinated loan of the funds.

This requirement must be reworded to refer to a "subordinated claim" rather than a "subordinated loan." The transaction contemplated in the present situation is the maintenance of a trading account by the clearing member for its affiliate, not the extension of a subordinated loan by the affiliate to the clearing member. Accordingly, the Subordination Agreement will require an opinion of counsel that the affiliated entity executing the agreement is legally authorized to subordinate its claim in respect of such account; provided, however, that if the Member Affiliate provides a written representation that all positions in the subject to the subordination agreement are its own proprietary positions and not those of any other person or entity, then no such opinion would be required. OCC believes that the right of the Member Affiliate to agree to subordinate a claim to its own property would be clear and would not need to be supported by an opinion of counsel. As assured by the following requirement, the account could in no event contain the positions or property of any person who is a U.S. customer.

⁴Commission staff to NYSE, No. 96-3, April, 1996 and No. 97-6, October, 1997, published in the New York Stock Exchange Interpretation Handbook as Interpretation /021 to Rule 15c3-3(a)(1).

⁵A "non-conforming subordination agreement" is one which does not meet the requirements of Rule 15c3-1, Appendix D.

4. There must be a written representation that the subordinated assets (funds and securities) are not those of U.S. customers.

This representation will be included in the Subordination Agreement.

5. The non-conforming subordination must be subject to approval by the broker dealer's Designated Examining Authority.

This requirement also will be included in the Subordination Agreement.

The relief requested in this letter is actually only a modest expansion of relief already granted by the Commission Staff. In 1992, the Division of Market Regulation (the "Division") granted a similar request by OCC, indicating that it would take no action against OCC if OCC were to treat two classes of persons affiliated with broker-dealers ("Affiliated Customers") as "non-customers" under the Hypothecation Rules.⁶ The two classes of Affiliated Customers whose securities the Division permitted to be commingled with the securities of other non-customers or with the firm's securities were "associated market-makers"⁷ and "proprietary market professionals."⁸ The Division required, in effect, that in order to be included in either of these categories, the person or entity seeking "non-customer" status must be: (i) a Related Person of the Clearing Member;⁹ (ii) a person who is not a "customer" for purposes of the Commission's Rule

⁶See enclosure.

⁷An "associated market-maker" is a market-maker (i.e. broker-dealer) that has a direct or indirect affiliation with a clearing member of OCC (i.e. a broker-dealer who uses OCC's clearing services). In particular, an "associated market-maker" is a person maintaining an account with a Clearing Member as a market-maker, specialist, stock market-maker, stock specialist or Registered Trader that is a Related Person of the Clearing Member and shall include any participant, as such, in an account of which 10% or more is owned by one or more associated market-makers. See enclosure at page 2 and note 6.

⁸A "market professional" is defined as a person who is either (1) a market-maker, specialist, or Registered Trader as defined in OCC Rules or (2) a member of a commodity clearing organization participating in a cross-margining program with OCC, to the extent that such member is trading for his own account and not for others. A "proprietary market professional" is a market professional that is: (A) a non-customer of the Clearing Member or (B) a Related Person of the Clearing Member that (I) is not a customer of such Clearing Member under Securities Exchange Act Rule 15c3-3, (ii) does not carry the accounts of persons who are customers of such market professional, and (iii) has consented to be treated as a proprietary market professional. The term "proprietary market professional" includes any participant, as such, in an account of which 10% or more is owned by a proprietary market professional. See enclosure at page 3 and note 8.

⁹See note 2, *supra*, for the definition of "Related Person" under OCC's bylaws.

15c3-3;¹⁰ (iii) a person who has given consent to being treated as a non-customer and having its claims therefore subordinated to the claims of "customers" in a liquidation under the Securities Investor Protection Act; and (iv) either an options market maker or a member (or member firm) of a commodity exchange. The present request would eliminate this last requirement that an affiliate would need to be a "market professional," *i.e.*, an options market maker or a member of a commodity exchange, in order to be eligible for cross-margining. It also would permit an affiliate to have its positions included in a firm account at OCC regardless of whether the account is a cross-margining account.

OCC's reasons for seeking this relief are similar to its reasons for seeking the earlier no action letter with respect to "market-makers" and "market professionals." Positions of a Member Affiliate that is a customer for purposes of the Hypothecation Rules but whose account is a "proprietary account" under the CFTC's Regulation 1.3(y) (see fn 2 above) may not be able to be placed in either a proprietary or a non-proprietary cross-margining account without violating either the Hypothecation Rules or the segregation rules under Section 4d(2) of the CEA. The requested relief would permit such a Member Affiliate to consent to inclusion of its positions in a proprietary cross-margining account. OCC believes that Member Affiliates that are engaged in sufficient cross-market trading to benefit from having their positions included in a cross-margining account should be encouraged to do so because OCC believes that cross-margining of cross-market activity enhances the strength and stability of financial clearing systems generally.

Even where cross-margining is not involved, OCC would prefer to see Member Affiliate activity in a proprietary account. OCC believes that, in the event of the failure of the firm, positions of public customers could be transferred to another firm more easily if they were not commingled with the positions of a Member Affiliate, which may also be insolvent. In this context, OCC believes that the Hypothecation Rules' definition of "customer" is too broad when used as the demarcation line between firm and other activity.


OCC now has approximately seven years of experience operating under the no-action relief granted by the Division in the March 27, 1992 letter referred to above. Allowing "associated market-makers" and "proprietary market professionals" to be treated as non-customers has been successful, and OCC is not aware of any legal or operational problems that have been experienced with respect to this treatment.

OCC's previous no-action request was limited to "market professionals" and "market-makers" only because the circumstances at the time directed OCC's attention in particular to these two groups. It has since become apparent that there are additional categories of Member Affiliates whose accounts should be treated as "non-customers" under the Hypothecation Rules. We are requesting, therefore, that the staff take a "no-action" position that would allow Clearing Members to carry accounts of Member Affiliates in the firm account or a proprietary cross-

¹⁰See note 3, *supra*, for the definition of "customer" under Rule 15c3-3.

margin account if the Member Affiliate consents to such treatment. Like the Division's 1992 no-action position, the requested no-action position would, of course, apply only to persons who are not customers for the purposes of Rule 15c3-3.¹¹ We believe that such a no-action position would be consistent with the Commission's interest in the soundness of the clearing system as well as its policy of support for cross-margining.

Sincerely,



William H. Navin

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¹¹See note 3, *supra*, for the definition of "customer" under Rule 15c3-3.