

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-65386; File No. SR-OCC-2011-10)

September 23, 2011

Self-Regulatory Organizations; The Options Clearing Corporation; Order Approving Proposed Rule Change to Revise its By-Laws and Rules to Establish a Clearing Fund Amount Intended to Support Losses under a Defined Set of Default Scenarios

I. Introduction

On August 3, 2011, The Options Clearing Corporation (“OCC”) filed with the Securities and Exchange Commission (“Commission”) proposed rule change SR-OCC-2011-10 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder.² The proposed rule change was published for comment in the Federal Register on August 17, 2011.³ The Commission received no comment letters. This order approves the proposed rule change.⁴

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 34-65119 (August 12, 2011), 76 FR 51087 (August 17, 2011).

⁴ This proposed rule change replaced a previously filed and later withdrawn proposed rule change by OCC regarding clearing fund sizing. File No. SR-OCC-2010-04, Securities Exchange Act Release 34-62371 (June 24, 2010), 75 FR 37864 (June 30, 2010) (Notice of Filing of Proposed Rule Change To Revise its By-Laws and Rules To Establish a Clearing Fund Amount Intended to Support Losses Under a Defined Set of Default Scenarios). OCC withdrew its earlier proposed rule change in order that it could: incorporate amendments that had been proposed for the previous proposed rule change; discuss the adaptation of the methodology underlying the formula to take into account the effects of implementing its “Collateral in Margins” rule change (Securities Exchange Act Release No. 34-58158 (July 15, 2008), 73 FR 42646 (July 22, 2008) (SR-OCC-2007-20)); give itself time to prepare updated comparative data about the impact of the proposed clearing fund sizing formula; and make additional changes to improve the overall readability of the proposed rule text.

II. Description of the Proposal

This proposed rule change would revise OCC's By-Laws and Rules to establish the size of OCC's clearing fund as the amount that is required within a confidence level selected by OCC to sustain the possible loss under a defined set of scenarios as determined by OCC. Currently the size of the clearing fund is calculated each month and is equal to a fixed percentage of the average total daily margin requirement for the preceding month provided that this calculation results in a clearing fund of \$1 billion or more.⁵

Under the revised formula for determining the size of the clearing fund, the amount of the fund will be equal to the larger of the amount of the charge to the fund that would result from (i) a default by the single "clearing member group"⁶ whose default would be likely to result in the largest draw against the clearing fund or (ii) an event involving the near-simultaneous default of two randomly-selected "clearing member groups" in each case as calculated by OCC with a confidence level selected by OCC. Initially, the confidence levels employed by OCC in calculating the charge likely to result from a default by OCC's largest "clearing member group" and the default of two randomly-selected "clearing member groups" will be 99% and 99.9%, respectively. However, OCC will have the discretion to employ different confidence levels in these calculations in the future provided that OCC will not employ confidence levels of less than 99% without filing a rule change with the Commission.⁷ The size of the clearing fund will

⁵ If the calculation does not result in a clearing fund of \$1 billion or more, the percentage of the average total daily margin requirement for the preceding month that results in a fund level of at least \$1 billion is applied provided that in no event will the percentage exceed 7%.

⁶ "Clearing member group" will be defined in Article I ("Definitions") of OCC's By-Laws to mean "a Clearing Member and any Member Affiliates of such Clearing Member."

⁷ Proposed Interpretation and Policy .02 to OCC Rule 1001.

continue to be recalculated monthly based on a monthly averaging of daily calculations for the previous month and subject to a requirement that the total clearing fund be not less than \$1 billion.⁸

The new formula is designed to more directly take into account anticipated losses resulting from the clearing member default scenarios described above and thereby establish the clearing fund at a size that is sufficient to cover such losses without relying on any rights of OCC to require clearing members to replenish the clearing fund. OCC believes the formula is generally consistent with the current “Recommendations for Central Counterparties” published by the Bank for International Settlements and the International Organization of Securities Commissioners. Among the recommendations in the publication are that a clearing organization “maintain sufficient financial resources to withstand, at a minimum, a default by the clearing member to which it has the largest exposure in extreme but plausible market conditions.” The publication further advises clearing organizations to plan for the possibility of a default by two or more clearing members in a short time frame.⁹

⁸ Proposed Interpretation and Policy .01 to OCC Rule 1001.

⁹ Bank for International Settlements and International Organization of Securities Commissions, Recommendations for Central Counterparties (November 2004), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD176.pdf> (“2004 Recommendations”). OCC notes that in December 2009 the Committee on Payment and Settlement Systems of the Bank for International Settlements (“CPSS”) and the Technical Committee of the International Organization of Securities Commissions (“IOSCO”) began a comprehensive review of the 2004 Recommendations in order to strengthen and clarify such recommendations based on experience and lessons learned from the recent financial crisis. In March 2011, CPSS and IOSCO published for comment the results of its review with comments requested by July 29, 2011. Bank for International Settlements and International Organization of Securities Commissions, Principles for financial market infrastructures (March 2011), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD350.pdf>

In considering whether to revise the current formula for determining the size of the clearing fund, OCC compared the size of the clearing fund that would have resulted from application of the revised formula to the actual size of the clearing fund for each month from February 2008 through September 2009. This analysis revealed that for this time period the size of the clearing fund under the revised formula would have been on average 10% larger than under the current formula. In September and October 2008, which were two months of extreme volatility in the U.S. securities markets, the revised formula would have resulted in a clearing fund size of approximately 31% and 27% greater than under the current formula. The average monthly change in the size of the clearing fund and the standard deviation of clearing fund size from month-to-month for this time period under the two formulas were broadly similar.¹⁰

Since deciding in September 2009 that it wished to adopt the revised formula, OCC has continued to compare the size of the clearing fund under the revised formula with the size under the current formula. During 2010 the methodology underlying the revised formula was adapted to incorporate the effects of the implementation of the changes described in its Collateral in Margins rule change.¹¹ Under those changes, certain types of securities accepted as collateral are analyzed for margin purposes together with positions in cleared products as a single portfolio to afford a more accurate measurement of risk. During the period February 2008 through January 2010 (i.e., prior to the implementation of the Collateral in Margins Filing) for which comparative data is available, the size of the clearing fund under the revised formula would have been on

¹⁰ Note the comparative data described in this paragraph was obtained using confidence levels set at 99% and higher. OCC estimates that using only a 99% confidence level for the months referenced would have lowered by an average of approximately ½% the total size of the clearing fund as determined by the proposed methodology.

¹¹ Securities Exchange Act Release No. 34-58158 (July 15, 2008), 73 FR 42646 (July 22, 2008) (SR-OCC-2007-20). Supra note 4.

average 3% larger than under the current formula. Including also the months of July 2010 through June 2011 (i.e., since the implementation of the Collateral in Margins rule change) for which comparative data is available, the corresponding percentage increase is 2%.

The existing formula for determining the size of the clearing fund was intended to establish the fund at a level reasonably designed to cover losses resulting from one or more clearing member defaults, and OCC believes that it has served that purpose adequately. Nevertheless, OCC believes that the revised formula presents a more accurate prediction of the actual losses that would be likely to result from such defaults. The existing formula takes potential losses into account only indirectly by setting the size of the clearing fund as a percentage of average margin requirements. The revised formula will directly take into account various types of default scenarios and therefore in OCC's view will be more likely to result in a level for the clearing fund that is adequate in the event such scenarios occur. The new formula is designed to more closely align the size of the clearing fund with its intended purpose of protecting OCC from any losses that could result from clearing member defaults and should thereby better help avoid a disruption of the clearance process even during extreme market conditions.

Article VIII, Section 6 of OCC's By-Laws, which obligates clearing members to make good deficiencies in their clearing fund deposits resulting from pro rata charges or otherwise will remain unchanged.¹²

¹² OCC's members' obligation to make good deficiencies in their clearing fund deposits will continue to be subject to a cap equal to 100% of a clearing member's then required deposit if it promptly withdraws from membership and closes out or transfers its open positions.

III. Discussion

Section 17A(b)(3)(F) of the Act¹³ requires, among other things, that the rules of a clearing agency be designed to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible. The Commission believes that because the proposed rule change creates a more direct correlation between OCC's clearing fund size and potential losses from a defined set of default scenarios, it should better enable OCC to fulfill this statutory obligation.

IV. Conclusion

On the basis of the foregoing, the Commission finds that the proposal is consistent with the requirements of the Act and in particular with the requirements of Section 17A of the Act¹⁴ and the rules and regulations thereunder.

¹³ 15 U.S.C. 78q-1(b)(3)(F).

¹⁴ 15 U.S.C. 78q-1

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁵ that the proposed rule change (File No. SR-OCC-2011-10) be, and hereby is, approved.¹⁶

For the Commission by the Division of Trading and Markets, pursuant to delegated authority.¹⁷

Elizabeth M. Murphy
Secretary

¹⁵ 15 U.S.C. 78s(b)(2).

¹⁶ In approving the proposed rule change, the Commission considered the proposal's impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

¹⁷ 17 CFR 200.30-3(a)(12).