

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-87718; File No. SR-OCC-2019-010)

December 11, 2019

Self-Regulatory Organizations; The Options Clearing Corporation; Order Approving Proposed Rule Change Related to Proposed Changes to The Options Clearing Corporation's Rules, Margin Policy, Margin Methodology, Clearing Fund Methodology Policy, and Clearing Fund and Stress Testing Methodology to Address Specific Wrong-Way Risk

I. INTRODUCTION

On October 10, 2019, the Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change SR-OCC-2019-010 ("Proposed Rule Change") pursuant to Section 19(b) of the Securities Exchange Act of 1934 ("Exchange Act")¹ and Rule 19b-4² thereunder to revise OCC's Rules, margin policy and methodology, Clearing Fund policy, and Clearing Fund and stress testing methodology to adopt new margin charges and other risk measures to address the specific wrong-way risk presented by certain cleared positions.³ The Proposed Rule Change was published for public comment in the Federal Register on October 29, 2019.⁴ The Commission has received no comments regarding

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Notice of Filing infra note 4, at 84 Fed. Reg. 57890.

⁴ Securities Exchange Act Release No. 87387 (Oct. 23, 2019), 84 Fed. Reg. 57890 (Oct. 29, 2019) (SR-OCC-2019-010) ("Notice of Filing"). OCC also filed a related advance notice (SR-OCC-2019-807) ("Advance Notice") with the Commission pursuant to Section 806(e)(1) of Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, entitled the Payment, Clearing, and Settlement Supervision Act of 2010 and Rule 19b-4(n)(1)(i) under the Exchange Act. 12 U.S.C. 5465(e)(1). 15 U.S.C. 78s(b)(1) and 17 CFR 240.19b-4, respectively. The Advance Notice was published in the Federal Register on November 12, 2019. Securities Exchange Act Release No. 87476 (Nov. 6, 2019), 84 Fed. Reg. 61114 (Nov. 12, 2019) (SR-OCC-2019-807).

the Proposed Rule Change.⁵ This order approves the Proposed Rule Change.

II. BACKGROUND⁶

As a central counterparty (“CCP”), OCC is exposed to its Clearing Members’ positions. To the extent that the value of a Clearing Member’s positions is positively correlated with the creditworthiness of the Clearing Member, OCC faces specific wrong-way risk (“SWWR”).⁷ OCC proposes changes to address such SWWR. Specifically OCC proposes to: (1) adopt a new SWWR margin add-on charge for OCC’s margin methodology (“SWWR Add-on”); (2) introduce stress test scenarios to measure the SWWR, to the extent not addressed in margin, of cleared positions involving Clearing Member-issued exchange-traded notes (“ETNs”); and (3) impose restrictions on stock lending activity cleared by OCC.⁸

A. SWWR Margin Add-on

As a general matter, OCC uses its System for Theoretical Analysis and Numerical Simulations (“STANS”) methodology for calculating Clearing Member margin requirements. OCC also incorporates add-on charges to address risks not otherwise addressed by its STANS

⁵ Since the proposal contained in the Proposed Rule Change was also filed as an advance notice, all public comments received on the proposal are considered regardless of whether the comments are submitted on the Proposed Rule Change or Advance Notice.

⁶ Capitalized terms used but not defined herein have the meanings specified in OCC’s Rules and By-Laws, available at <https://www.theocc.com/about/publications/bylaws.jsp>.

⁷ SWWR arises when an exposure to a participant is highly likely to increase when the creditworthiness of that participant is deteriorating. See Securities Exchange Act Release No. 78961 (September 28, 2016), 81 Fed. Reg. 70786, 70816, n. 317 (October 13, 2016) (S7-03-14) (“Covered Clearing Agency Standards”).

⁸ OCC also proposes clarifying and conforming changes to the Clearing Fund Methodology Policy (“CFM Policy”) and Stress Testing and Clearing Fund Methodology Description (“Methodology Description”).

methodology.⁹ OCC proposes to adopt a new margin add-on to address SWWR at the Clearing Member account level (i.e., the SWWR Add-on). The SWWR Add-on would address SWWR presented by cleared positions involving equities and ETNs issued by a Clearing Member and its affiliates and would comprise three components: (1) “SWWR Equity Charge,” (2) “SWWR ETN Charge,” and (3) “SWWR Residual.” Each of these components is discussed below.

1. SWWR Equity Charge

The proposed SWWR Equity Charge is based on the assumption that, when a Clearing Member defaults, the value of any equity security issued by the Clearing Member or its affiliates would fall to zero. For purposes of calculating the SWWR Equity Charge, OCC would value a Clearing Member’s positions accordingly (i.e., all stocks, single stock futures, call options, and put options would be valued at zero).¹⁰ Any potential gain from the SWWR positions would be excluded by defining the minimum SWWR Equity Charge as zero. OCC stated that the purpose of the SWWR Equity Charge would be to provide protection from the risk of potential market exposure to products based on a Clearing Member Group’s own equity in a default or bankruptcy scenario.¹¹

2. SWWR ETN Charge

The SWWR ETN Charge would be designed to address the risk that the value of open

⁹ See e.g. Securities Exchange Act Release No. 86119 (Jun. 17, 2019), 84 Fed. Reg. 29267 (Jun. 21, 2019) (approving implementation of an add-on charge “to guard against potential shortfalls in margin requirements that may arise due to the costs of liquidating the portfolio of a defaulted Clearing Member.”)

¹⁰ Because the SWWR arising from equities issued by a Clearing Member or its affiliates would be fully covered as part of margins, OCC proposes to remove such positions from Clearing Fund calculations under OCC’s Clearing Fund methodology and would revise its Methodology Description accordingly.

¹¹ See Notice of Filing, 84 Fed. Reg. at 57892.

positions related to uncollateralized ETNs issued by a Clearing Member or its affiliates would be correlated with the Clearing Member's credit quality. Similar to the SWWR Equity Charge, the SWWR ETN Charge assumes that a degradation in the value of securities issued by a Clearing Member or its affiliates would occur concurrently with the Clearing Member's default. The SWWR ETN Charge, however, would not assume a complete loss of value for the relevant securities (i.e., ETNs issued by the Clearing Member or its affiliates). OCC states that such uncollateralized ETNs are generally equivalent to unsecured senior debt.¹² OCC, in turn, proposes to utilize an industry standard recovery rate assumption designed to reflect potential losses to ETN positions for the purpose of setting the SWWR ETN Charge component of the SWWR Add-on.

3. SWWR Residual

The SWWR Residual would ensure that implementation of the SWWR Add-on would not reduce a Clearing Member's overall margin requirements.¹³ To determine the SWWR Residual, OCC would first calculate a "base margin" under on OCC's current methodology (i.e., not assuming any specific degradation in the value of securities issued by a Clearing Member or its affiliates). Next, OCC would calculate a "residual margin," which would represent the Clearing Member's margin requirement for only those positions unaffected by the SWWR Equity Charge and SWWR ETN Charge. Finally, the SWWR Residual would be the difference between the residual margin and the base margin; however, OCC would adjust the value of the

¹² See Notice of Filing, 84 Fed. Reg. at 57892.

¹³ OCC noted that where a customer of a Clearing Member has net short positions referencing that Clearing Member's issued equities, such positions may actually present "right-way risk," whereby the position would result in a gain or margin credit for that account as the credit quality of the Clearing Member deteriorates. See Notice of Filing, 84 Fed. Reg. at 57893, n. 20.

SWWR Residual if the sum of the SWWR Equity Charge, SWWR ETN Charge, and SWWR Residual would otherwise reduce a Clearing Member's margin requirement.

B. SWWR Stress Test Scenarios

As noted above, the proposed SWWR ETN Charge would not assume a complete loss of value for ETNs issued by a Clearing Member or its affiliates. The SWWR Add-on, in turn, would not generate margin requirements designed to cover a scenario in which the recovery rate for such ETNs would be zero. To address such a scenario, OCC proposes to introduce new scenarios into the set of stress tests that OCC uses to test the sufficiency of its financial resources ("SWWR Sufficiency Scenarios"). To construct the SWWR Sufficiency Scenarios, OCC would revise certain of its existing stress test scenarios by assuming a value of zero for ETNs issued by a Clearing Member or its affiliates. OCC stated that the introduction of SWWR Sufficiency Scenarios would enable OCC to more accurately measure its credit risks as they relate to SWWR and better test the sufficiency of its overall financial resources as well as to call for additional resources as appropriate.¹⁴ OCC believes, therefore, it would have sufficient financial resources to cover the SWWR associated with SWWR ETN positions if such positions were to be liquidated for less than the assumed recovery rate.¹⁵

¹⁴ See Notice of Filing, 84 Fed. Reg. at 57893. OCC's current rules authorize OCC to call for additional resources based on the results of stress scenarios used to test the sufficiency of OCC's financial resources. See Securities Exchange Act Release No. 83735 (Jul. 27, 2018), 83 Fed. Reg. 37855 (Aug. 2, 2018) (SR-OCC-2018-008). OCC's rules also authorize adjustments to OCC's monthly Clearing Fund sizing process based on the results of stress scenarios used to test the sufficiency of OCC's financial resources. OCC believes, however, that SWWR is more appropriately charged to the Clearing Member presenting the risk. See Notice of Filing, 84 Fed. Reg. at 57893. Based on that belief, OCC proposes to revise the CFM Policy such that the results of the SWWR Sufficiency Scenarios would not be used to adjust OCC's monthly Clearing Fund sizing.

¹⁵ See Notice of Filing, 84 Fed. Reg. at 57893.

C. Stock Lending Restrictions

Through its stock loan programs,¹⁶ OCC novates stock loan transactions and becomes the lender to each Borrowing Clearing Member and the borrower to each Lending Clearing Member. OCC is exposed to SWWR in such programs when a Clearing Member lends equity securities or ETNs issued by the Clearing Member or its affiliates. To mitigate such risks, OCC proposes prohibiting Clearing Members from lending equity securities or ETNs issued by the Clearing Member or its affiliates within OCC's stock loan programs. OCC does not believe that the proposed prohibition would have a material impact on Clearing Members because Clearing Members do not typically lend their own equity securities, and borrowers do not typically accept equity securities issued by their lending counterparty.¹⁷ Further, market participants are able to engage in, and would continue to be able to engage in, securities lending on an uncleared basis outside of OCC.¹⁸

OCC proposes to implement the prohibition on Clearing Members lending their own securities only on a going-forward basis. The proposal would not affect stock lending activity cleared by OCC before the implementation of the prohibition. Existing stock loan transactions would, however, be subject to the SWWR Add-on described above.

¹⁶ OCC operates programs for clearing stock loan transactions initiated either bilaterally between market participants or through anonymous matching by a Loan Market. See Notice of Filing, 84 Fed. Reg. at 57891.

¹⁷ See Notice of Filing, 84 Fed. Reg. at 57892.

¹⁸ The proposed restrictions on lending activity cleared by OCC would not prevent Clearing Members from lending equities or ETNs issued by the Clearing Member or any affiliate outside of OCC.

III. DISCUSSION AND COMMISSION FINDINGS

Section 19(b)(2)(C) of the Exchange Act directs the Commission to approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to such organization.¹⁹ After carefully considering the Proposed Rule Change, the Commission finds that the proposal is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to OCC. More specifically, the Commission finds that the proposal is consistent with Section 17A(b)(3)(F) of the Exchange Act²⁰ and Rules 17Ad-22(e)(4) and (6) thereunder.²¹

A. Consistency with Section 17A(b)(3)(F) of the Exchange Act

Section 17A(b)(3)(F) of the Exchange Act requires, among other things, that the rules of a clearing agency be designed to (i) promote the prompt and accurate clearance and settlement of securities transactions, and to the extent applicable, derivatives agreements, contracts, and transactions; and (ii) assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible.²² Based on its review of the record, the Commission believes that the proposed changes are designed to promote prompt and accurate clearance and settlement as well as assure the safeguarding of securities and funds which are in OCC's custody or control for the reasons set forth below.

First, the Commission believes that the adoption of the SWWR Add-on would be

¹⁹ 15 U.S.C. 78s(b)(2)(C).

²⁰ 15 U.S.C. 78q-1(b)(3)(F).

²¹ 17 CFR 240.17Ad-22(e)(4) and 17 CFR 240.17Ad-22(e)(6).

²² 15 U.S.C. 78q-1(b)(3)(F).

consistent with assuring the safeguarding of securities and funds. To the extent that the value of a Clearing Member's positions is positively correlated with the creditworthiness of the Clearing Member, OCC faces SWWR. OCC's current margin methodology does not incorporate a specific component designed to address SWWR for cleared positions. As described above, the proposed SWWR Add-on would address SWWR arising out of equities and ETNs issued by the relevant Clearing Member or its affiliates underlying a Clearing Member's cleared positions. Further, the SWWR Add-on would be designed to avoid any unintended reduction in margin requirements resulting from "right-way risk" in a Clearing Member's accounts.²³ The Commission believes that the proposal would provide for more comprehensive management of the potential risks posed by the default of a Clearing Member because OCC would adopt an add-on charge to address a risk not captured elsewhere in its margin methodology. Management of such risks through the collection of margin collateral could, in turn, help reduce the amount of credit losses that would potentially be charged to the Clearing Fund contributions of surviving Clearing Members. The Commission believes, therefore, that the proposed SWWR charge would be consistent with assuring the safeguarding of securities and funds posted by surviving Clearing Members as collateral.

Second, the Commission believes that introduction of the SWWR Sufficiency Scenarios and the proposed prohibition of certain stock lending activity as described above would be consistent with the promotion prompt and accurate clearance and settlement. As an initial matter, OCC is the only clearing agency for standardized U.S. securities options listed on

²³ See supra at note 13.

Commission-registered national securities exchanges (“listed options”).²⁴ The ETN component of the SWWR Add-on would not address the exposures presented by a complete loss of value for ETNs issued by the Clearing Member or its affiliates. To address the potential credit exposure represented by the value of such ETNs going to zero, OCC proposes to introduce the new SWWR Sufficiency Scenarios described above. OCC would use the SWWR Sufficiency Scenarios to test its total financial resources. The proposed introduction of new scenarios to test the sufficiency of OCC’s financial resources in the Clearing Fund would address assumptions underlying OCC’s proposed margin methodology (i.e., a non-zero ETN recovery rate). OCC relies on the resources in its Clearing Fund to manage the risk of losses arising out of the default of a Clearing Member under extreme but plausible market conditions. Additionally, prohibiting certain stock loan activity that could generate losses in the event of a Clearing Member default would avoid those potential losses all together. Strengthening the methodology that OCC uses to manage its financial resources or avoiding the risk of loss all together, strengthens OCC’s ability to manage Clearing Member defaults, which, in turn, facilitates the clearance and settlement of listed options.

The Commission believes, therefore, that the Proposed Rule Change is consistent with the requirements of Section 17A(b)(3)(F) of the Exchange Act.²⁵

B. Consistency with Rule 17Ad-22(e)(4) under the Exchange Act

Rule 17Ad-22(e)(4) under the Exchange Act requires, in part, that a covered clearing agency establish, implement, maintain, and enforce written policies and procedures reasonably

²⁴ See Securities Exchange Act Release No. 85121 (Feb. 13, 2019), 84 Fed. Reg. 5157 (Feb. 20, 2019) (File No. SR-OCC-2015-02).

²⁵ 15 U.S.C. 78q-1(b)(3)(F).

designed to effectively identify, measure, monitor, and manage its credit exposures to participants and those arising from its payment, clearing, and settlement processes.²⁶

As described above, OCC proposes to prohibit each Clearing Member submitting for clearing any stock loan activity involving the lending of equity securities or ETNs issued by such a Clearing Member or its affiliates going forward. Under the proposal, OCC would identify those stock loan transactions presenting SWWR and avoid any potential exposures arising out of such transactions through the proposed prohibition. Further, for those transactions that would not be affected by the prohibition (i.e., existing transactions), OCC proposes to measure, monitor, and manage its exposures through the use of the SWWR Add-on described above and discussed below. Accordingly, the Commission believes that OCC's proposal in the Proposed Rule Change to prohibit certain stock loan transactions is consistent with Rule 17Ad-22(e)(4) under the Exchange Act.²⁷

Rules 17Ad-22(e)(4)(i) and (iii) under the Exchange Act require that a covered clearing agency's policies and procedures meet the requirements of Rule 17Ad-22(e)(4) by maintaining financial resources at the minimum to enable OCC to cover a wide range of foreseeable stress scenarios that include, but are not limited to, the default of the participant family that would potentially cause the largest aggregate credit exposure for OCC in extreme but plausible market conditions.²⁸ Further, Rule 17Ad-22(e)(4)(vi) under the Exchange Act requires that a covered clearing agency's policies and procedures meet the requirements of Rule 17Ad-22(e)(4) by

²⁶ 17 CFR 240.17Ad-22(e)(4).

²⁷ 17 CFR 240.17Ad-22(e)(4).

²⁸ 17 CFR 240.17Ad-22(e)(4)(i) and 17 CFR 240.17Ad-22(e)(4)(iii).

testing the sufficiency of a covered clearing agency's total financial resources available to meet the minimum financial resource requirements under Rules 17Ad-22(e)(4)(i) through (iii).²⁹

As described above and discussed below, the proposed SWWR Add-on is designed to measure and manage OCC's credit exposures to Clearing Members to the extent those exposures arise out of SWWR related to cleared positions. One component of the SWWR Add-on – the SWWR ETN Charge – would not, however, fully cover OCC's potential exposure through margin because it would not assume a complete loss of value for ETNs issued by the Clearing Member or its affiliates. To address the potential credit exposure represented by the value of ETNs issued by the Clearing Member or its affiliates going to zero, OCC proposes to introduce the new SWWR Sufficiency Scenarios described above. OCC would use the SWWR Sufficiency Scenarios to test its total financial resources and to call for additional resources as necessary to ensure the resources it holds would be sufficient to enable OCC to cover exposures arising under the relevant stress scenarios. Accordingly, and for the reasons stated above, the Commission believes the changes proposed in the Proposed Rule Change are consistent with Rule 17Ad-22(e)(4)(i), (iii), and (vi) under the Exchange Act.³⁰

C. Consistency with Rule 17Ad-22(e)(6) under the Exchange Act

Rule 17Ad-22(e)(6)(i) under the Exchange Act requires that a covered clearing agency establish, implement, maintain, and enforce written policies and procedures reasonably designed to cover, if the covered clearing agency provides central counterparty services, its credit exposure to participants by establishing a risk-based margin system that, at a minimum,

²⁹ 17 CFR 240.17Ad-22(e)(4)(vi).

³⁰ 17 CFR 240.17Ad-22(e)(4)(i); 17 CFR 240.17Ad-22(e)(4)(ii); 17 CFR 240.17Ad-22(e)(4)(vi).

considers, and produces margin levels commensurate with, the risks and particular attributes of each relevant product, portfolio, and market.³¹

As noted above, OCC faces SWWR to the extent that the value of a Clearing Member's positions is positively correlated with the creditworthiness of the Clearing Member. OCC proposes to cover its exposure to such SWWR posted by its Clearing Members through the introduction of the SWWR Add-on. The SWWR Add-on consists of three components. Two of those components – the SWWR Equity Charge and SWWR ETN Charge – are designed to produce margin levels commensurate with the particular attributes of certain products that OCC clears in terms of the likely recovery available in the event of a default by the issuing Clearing Member. Further, the SWWR Residual would ensure that the introduction of the SWWR Add-on could not inadvertently weaken OCC's current margin methodology due to the potential existence of "right-way risk" in a Clearing Member's accounts.³² Accordingly, and for the reasons stated above, the Commission believes the adoption of a margin add-on charge designed to cover exposures arising out of SWWR is consistent with Rule 17Ad-22(e)(6)(i) under the Exchange Act.³³

³¹ 17 CFR 240.17Ad-22(e)(6)(i).

³² See supra at note 13.

³³ 17 CFR 240.17Ad-22(e)(6)(i).

IV. CONCLUSION

On the basis of the foregoing, the Commission finds that the Proposed Rule Change is consistent with the requirements of the Exchange Act, and in particular, the requirements of Section 17A of the Exchange Act³⁴ and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Exchange Act,³⁵ that the Proposed Rule Change (SR-OCC-2019-010) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³⁶

J. Matthew DeLesDernier
Assistant Secretary

³⁴ In approving this Proposed Rule Change, the Commission has considered the proposed rules' impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

³⁵ 15 U.S.C. 78s(b)(2).

³⁶ 17 CFR 200.30-3(a)(12).