SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-56069; File No. SR-OCC-2006-19)

July 13, 2007

Self-Regulatory Organizations; The Options Clearing Corporation; Order Granting Approval of a Proposed Rule Change Relating to Close-Out Netting Procedures

I. Introduction

On October 10, 2006, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") proposed rule change SR-OCC-2006-19 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act").[1] On May 15, 2007, OCC amended the proposed rule change. Notice of the proposal was published in the Federal Register on May 29, 2007.[2] On June 21, 2007, OCC again amended the proposed rule change.[3] Three comment letters were received.[4] For the reasons discussed below, the Commission is granting approval of the proposed rule change.

II. Description

Background

OCC was asked by several of its Clearing Members to consider adopting a rule that would allow for close-out netting of obligations running between OCC and Clearing Members in

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1 15 U.S.C. 78s(b)(1).

2 Securities Exchange Act Release No. 55788 (May 21, 2007), 72 FR 29569.

3 Although the proposed rule change was amended after it was noticed for comment in the Federal Register, republication of the notice was not necessary because the June 21, 2007, amendment made only a technical change regarding the application of a financial accounting interpretation.

4 Edward S. Grieb, Managing Director and Financial Controller, Lehman Brothers Holdings Inc. (June 19, 2007); Matthew Schroeder, Chairman, Dealer Accounting Committee, Securities Industry and Financial Markets Association (June 19, 2007); Gregory A. Sigrist, Managing Director, Morgan Stanley, New York, New York (June 19, 2007).

the event of an OCC default or insolvency. The reason was that such a rule could reduce applicable capital requirements for a Clearing Member's parent company where the parent is a U.S. or non-U.S. bank or part of a Consolidated Supervised Entity ("CSE"). The absence of a netting agreement that would apply in a default or insolvency of OCC could cause the minimum capital requirement applicable to such a parent company and its subsidiaries to be substantially larger on a consolidated basis than it would be otherwise. In the absence of a netting agreement, applicable banking regulations generally prohibit offsetting the Clearing Member's liabilities to OCC on short positions in options and on other obligations against the Clearing Member's credits from OCC with respect to long options positions and from other obligations of OCC. In addition, OCC believes that a close-out netting rule would clarify the accounting treatment of obligations between OCC and its Clearing Members.

The proposed rule change is designed to allow Clearing Members to comply with international standards under the Basel Capital Accord adopted by the Basel Committee on Banking Supervision relating to bilateral netting ("Basel Netting Standards").[5] It is OCC's understanding that the capital rules applicable to most banks following the Basel Netting Standards require that an enforceable netting agreement be in place in order for mutual obligations between a Clearing Member that is a bank affiliate and a counterparty such as OCC to be treated on a net basis. The policy behind this requirement is to ensure that obligations that are treated on a net basis for capital purposes can actually be offset against one another in the event of the failure of the counterparty. In the absence of an enforceable netting agreement,

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[5] For more information on the Basel Committee on Banking Supervision and the Basel Netting Standards, see the Bank for International Settlement's Web site at www.bis.org.

there is concern that the representative of the failed counterparty (i.e., OCC in this scenario) under applicable insolvency law might be able to "cherry pick" by assuming the benefit of contracts representing an asset to the bankruptcy estate while rejecting contracts representing a liability. This would force the non-defaulting counterparty (i.e., the Clearing Member in this scenario) to perform in full on its liabilities while sharing with other unsecured creditors in any amounts available for distribution from the bankruptcy estate to satisfy its claims. An enforceable netting agreement providing for "close-out netting" in the event of a default or insolvency of OCC would avoid this potential result.

Chapter XI of OCC's Rules, Suspension of a Clearing Member, provides in considerable detail for liquidation of the accounts of an insolvent Clearing Member including provisions for close-out netting of the Clearing Member's obligations against its assets to the extent permitted by customer protection rules under the Act and under the Commodity Exchange Act ("CEA"). However, OCC's rules do not presently contain any provisions that specifically provide for close-out netting in the event of a default or insolvency of OCC. Indeed, an OCC default or insolvency has always been considered so unlikely that OCC's rules do not contain any provisions whatever contemplating such events. OCC's management does not believe that an OCC default or insolvency has become any more likely. On the contrary, OCC's long history of safe operations and continually improved methods of risk management suggest that such an event is more remote than ever. Nevertheless, the Basel Netting Standards make it desirable for OCC to put in place such a netting provision in order to clarify the capital requirements applicable on a consolidated basis to parent companies of Clearing Members that are subject to the Basel Netting Standards.

The Basel Netting Standards are not directly applicable to the determination of net capital requirements for broker-dealers under Commission Rule 15c3-1.[6] However, some Clearing Members are subsidiaries of banks or bank holding companies that are subject to the Basel Netting Standards when computing capital requirements on a consolidated basis. In addition, several of OCC's largest Clearing Members have volunteered to participate in the Commission's CSE program. Finally, as noted below, OCC believes that a close-out netting rule would also clarify the accounting treatment of obligations between OCC and a Clearing Member under FIN 39.[7]

The Basel Netting Standards and FIN 39 (collectively "Netting Standards") are stated in general terms and do not contain detailed requirements. OCC's proposed close-out netting procedures would clearly permit Clearing Members to treat their obligations to OCC on a net basis to the fullest extent consistent with the Commission's customer protection rules in the event of an OCC default or insolvency. The proposed rule change is also intended to protect the clearing system from being thrown out of balance or forced into a disorderly liquidation by a single Clearing Member's exercise of netting rights. Unlike typical, purely bilateral OTC derivatives relationships, OCC's contractual rights and obligations, while bilateral between OCC and any individual Clearing Member, represent a balanced structure in which every obligation owed by OCC to a Clearing Member is in turn matched by a corresponding obligation of a Clearing Member to OCC. The creation of individually exercisable netting rights that could be

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[6] 17 CFR 240.15c3-1.

[7] Financial Account Standards Board ("FASB") Interpretation No. 39, Offsetting of Amounts Related to Certain Contracts. FIN 39 specifies the circumstances in which assets and liabilities may be treated as offsetting in financial statements.

exercised independently by each Clearing Member in the event of an OCC default or insolvency could result in unfairness and disruption if no coordination is imposed.

The Basel Netting Standards

The Basel Netting Standards are contained in Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version (June 2006) ("Basel II Accord"). The Basel Netting Standards provide that a bank[8] may net transactions subject to any legally valid form of bilateral netting, including netting of bilateral obligations arising from novation, if the bank satisfies its national supervisor that it has a netting contract with the counterparty "which creates a single legal obligation, covering all included transactions, such that the bank would have either a claim to receive or obligation to pay only the net sum of the positive and negative mark-to-market values of included individual transactions in the event a counterparty fails to perform due to any . . . default, bankruptcy, liquidation or similar circumstances."[9]

The Basel Netting Standards also require that the bank have certain "written and reasoned legal opinions that, in the event of a legal challenge, the relevant courts and administrative authorities would find the bank's exposure to be the net amount." The national supervisor must be satisfied that the netting is enforceable under the laws of each relevant jurisdiction. The proposed close-out netting procedures are intended to support such an opinion.

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[8] These same standards are also applied to bank holding companies.

[9] Basel Committee on Banking Supervision, Basel Capital Accord: Treatment of Potential Exposure for Off-Balance Sheet Items (April 1995) at Annex, p.4. The relevant bilateral netting standards under this 1995 publication were not overridden by the Basel II Accord. Basel II Accord at p.213. Basel II also allows cross-product netting.

The Basel Netting Standards have been incorporated in applicable bank regulatory laws or regulations in various jurisdictions. For example, the substance of this standard appears in Article 12f of the Swiss Banking Ordinance. It has also been incorporated into the capital guidelines for various U.S. financial institutions.[10]

FDICIA and Bankruptcy Code

The proposed close-out netting procedures are designed to take advantage of the netting provisions of Title IV of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") and of the applicable provisions of the United States Bankruptcy Code. Section 404 of FDICIA generally validates netting contracts among members of clearing organizations notwithstanding any other provision of law.[11] In order to qualify for this benefit, the "netting contract" must be between "members" of a "clearing organization," as each of these terms is defined in FDICIA. OCC meets the definition of "clearing organization" under FDICIA, and both it and its Clearing Members meet the definition of "members." Under FDICIA, the rules of a clearing organization are expressly included within the definition of "netting contract." Accordingly, under Section 404 of FDICIA, the netting provisions of OCC's By-Laws and Rules, including the proposed revised netting procedures, will be given effect in the event of OCC's default or insolvency.

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[10] See e.g., Regulations of the Office of the Comptroller of the Currency applicable to national banks set forth at 12 CFR Appendix A to Part 3 Section (3)(b)(5)(ii)(B) (adopted July 1, 2002).

[11] 12 U.S.C. 4403.

Section 362(b) of the United States Bankruptcy Code[12] exempts from the automatic stay provisions of the Bankruptcy Code the setoff by, among other parties, stockbrokers, commodity brokers, or clearing agencies of mutual debts or claims under commodity or securities contracts. This section preserves OCC's ability to net obligations between OCC and a suspended Clearing Member and similarly would protect the ability of Clearing Members to net obligations under the proposed netting procedures in the event of OCC's default or insolvency. In addition, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA")[13] added to the Bankruptcy Code new subsection 362(o) which provides that the right of setoff and other relevant rights may not be stayed by any order of a court or administrative agency in any proceeding under the Bankruptcy Code.[14] This addition was a significant expansion of the protections for financial contracts under the Bankruptcy Code.

Prior Netting Filing and Clearing Member Comments

OCC previously submitted and subsequently withdrew a proposed rule change with respect to close-out netting ("Prior Netting Filing").[15] After reviewing the Prior Netting Filing, some Clearing Members questioned whether the netting procedures set forth in that filing satisfied the Netting Standards. Specifically, Clearing Members questioned whether:

1. the definition of insolvency in the Prior Netting Filing, which covered only voluntary or involuntary cases under Chapter 7, needed to be expanded to include

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12 11 U.S.C. 362(b).

13 Public Law 109-8, 119 Stat. 23 (2005).

14 11 U.S.C. 362(o).

15 File No. SR-OCC-2005-17.

other types of bankruptcies, particularly Chapter 11 cases, and non-bankruptcy defaults;

2. the procedures set forth in the Prior Netting Filing complied with the Netting Standards in light of the inability of the Clearing Members as the non-defaulting parties to initiate the netting process; and

3. the proposed procedures gave Clearing Members the ability to promptly net and to close-out positions as required to comply with the Netting Standards given the degree of control that OCC reserved to itself in the process.

After considering the Clearing Members' comments, OCC withdrew the Prior Netting Filing and made modifications to the proposed netting provisions which are reflected in the current filing. The primary differences between the currently-proposed close-out netting procedures and those contained in the Prior Netting Filing are that the currently-proposed procedures:

1. significantly expand the definition of insolvency to include non-bankruptcy defaults, specifically any failure by OCC to comply with an undisputed obligation to deliver money or property to a Clearing Member for a period of thirty days after the obligation becomes due, and to include bankruptcy or insolvency proceedings under statutory provisions other than Chapter 11 of the U.S. Bankruptcy Code;

2. provide that upon the occurrence of an event of default or insolvency, any Clearing Member that is neither suspended nor in default with regard to an obligation to OCC may provide a notice to OCC of its intention to terminate all cleared contracts and stock loan and borrow positions in all of its accounts; and

3. establish a fixed termination time for all cleared contracts and stock loan and borrow positions, which would be the close of business on the third business day

after OCC's receipt of the prescribed notice from a Clearing Member unless a different time is mandated by the Bankruptcy Code, and provide that the liquidation settlement date will occur as promptly as practicable after the termination time (the original provisions granted OCC the discretion to establish the termination time and provided that the liquidation settlement date would occur no earlier than the business day following the termination date).

OCC believes that the above modifications address the Clearing Members' concerns while still permitting the liquidation process to proceed in an orderly manner and the clearance system to remain in balance.

Overview of Proposed Rule Change

The proposed rule change consists of a single new Section 27, Close-Out Netting, of Article VI of OCC's By-Laws, Clearance of Exchange Transactions. Consistent with the requirements of the Basel Netting Standards, the netting provision is applicable in the event that OCC fails to perform its obligations with respect to cleared contracts as the result of defaults by OCC in performing its obligations under its rules or as the result of bankruptcy, a liquidation of OCC, or similar circumstances. The close-out netting procedures are drafted in such a way that they would only be triggered by an event of default, as defined in new Section 27(a). The procedures would not be triggered by any delay in performance that is permitted under OCC's By-Laws or Rules. For example, Section 19 of Article VI of OCC's By-Laws permits OCC to take specified actions, including suspension of settlement obligations, in the event of a shortage of underlying securities. These delays would not be considered an event of default under Section 27 and therefore would not allow a Clearing Member to initiate the close-out netting procedures.

Under the proposed close-out netting procedures, in the event of a default or insolvency by OCC, OCC would be required to provide notice of the default or insolvency to the Commission, the CFTC, all Clearing Members, any clearing organizations with which OCC has cross-margining or cross-guarantee agreements, and all markets for which OCC clears transactions. The proposed procedures further provide that in the event of an OCC default, any Clearing Member, so long as it is not suspended or in default, may provide a written notice to OCC of its intent to initiate the liquidation process with regard to its own contracts and stock loan and borrow positions. This notice would, however, trigger a liquidation of cleared contracts and positions of all Clearing Members. This procedure is necessary because liquidating contracts and positions of less than all Clearing Members would result in an imbalance of the clearing system and therefore would be unworkable. The proposed procedures establish the close of business on the third business day after OCC's receipt of the liquidation notice from a Clearing Member as the termination time unless the Bankruptcy Code prescribes a different time.

The proposed close-out netting procedures provide that when a triggering event occurs, rights and obligations within and between accounts of each Clearing Member will be netted to the same extent as if the Clearing Member had been suspended and its accounts were being liquidated under Chapter XI of the Rules. This is appropriate in that those rules generally provide for the netting of assets against liabilities to the extent permitted under applicable law, including the customer protection rules referred to above. Assets remaining after all legally permissible offsets would be returned to the Clearing Member entitled to them. The Clearing

Member would remain obligated to OCC only to the extent of any remaining net liabilities following such permitted offsets.

If close-out netting were ever required because of the default or insolvency of OCC, it seems likely that there would be no market available in which to liquidate positions in cleared contracts through market transactions. Accordingly, the proposed procedures contain a provision for valuation of open cleared contracts based upon market values of underlying interests and provide a reasonable means for OCC to fix all necessary values of assets and liabilities for purposes of the netting. Under the procedures, OCC is to provide valuations as promptly as practicable but in any event within thirty days of the termination time. Valuations would be based upon available market information.

FIN 39: Offsetting of Amounts Related to Certain Contracts

In addition to the potential benefit of the proposed close-out netting procedures with respect to capital requirements applicable to certain Clearing Members and their affiliates on a consolidated basis under the Basel Netting Standards, OCC believes that the proposed close-out netting procedures should also clarify the accounting treatment of mutual obligations running between OCC and its Clearing Members. OCC's Clearing Members most commonly prepare their financial statements using United States Generally Accepted Accounting Principles ("US GAAP"). FIN 39 responds to certain questions relating to the circumstances in which assets and liabilities may be treated as offsetting in financial statements. FIN 39 is an interpretation of Accounting Principles Board ("APB") Opinion No. 10, which states that "it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists." FIN 39 provides a definition of a right of setoff and a statement

of the conditions under which a right of setoff exists. FIN 39 states, "A right of setoff is a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor." FIN 39 sets forth the following four conditions which must be met for there to exist a right of setoff:

(1) Each of two parties owes the other determinable amounts.

(2) The reporting party has the right to set off the amount owed with the amount owed by the other party.

(3) The reporting party intends to set off.

(4) The right of setoff is enforceable at law.

It is the obligation of each Clearing Members to determine its proper application of US GAAP but OCC believes that proposed new Section 27 will enable Clearing Members to conclude that conditions (1), (2), and (4) have been met. (Condition (3) deals with intent, which is a factual question.)

Discussion of Specific Provisions of Section 27

The text of proposed new Section 27 of Article VI of the By-Laws is largely self-explanatory in light of the foregoing discussion of its purpose. A few comments may nevertheless be helpful.

Under proposed Sections 27(a) and (b), if OCC should ever give notice of its default or insolvency and a Clearing Member in turn provide a notice of termination, the termination time

may be later than the time at which a Clearing Member's liquidation notice is given.[16] This leaves open at least the theoretical possibility that, if there are trading days or hours left between the time the notice is given and the termination time, market participants could attempt to engage in closing transactions at prices determined in the market to avoid being subject to a forced liquidation at prices fixed by OCC. [17]

Proposed Section 27(b) provides that in the event of a default or insolvency and the requisite notice by a Clearing Member, positions of all Clearing Members will be liquidated to the maximum extent permitted by law and the By-Laws and Rules. The limitations on netting under OCC's By-Laws and Rules are in general those mandated by applicable law, such as the Commission's Rule 15c3-3. For example, where a Clearing Member carries both proprietary and customer accounts netting across accounts could cause the Clearing Member to be in violation of Rule 15c3-3 and other customer protection rules. Accordingly, Section 27 generally provides for netting within and not across different accounts with specific exceptions set forth in Section 27(d). In addition, CEA segregation rules require separate segregation of customer funds of futures customers. Accordingly, netting across futures segregated funds accounts and other accounts is also generally prohibited. Otherwise, the provisions of Section 27(d) are intended to maximize netting where consistent with customer protection rules. While securities

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[16] Under proposed Section 27(b), the termination time would be the close of business on the third business day following a Clearing Member's liquidation notice unless the Bankruptcy Code prescribes a different time. Under Section 502(b) of the Bankruptcy Code, claims against a debtor are valued as of the date of the filing of the bankruptcy petition. Accordingly, in the event of a bankruptcy the termination time would be on the date of the filing of the petition.

[17] Such activity of market participants could start at the time of OCC's default notice rather than the time of the liquidation notice although as a practical matter a liquidation notice would likely closely follow the default notice.

market makers and specialists are generally not customers within the meaning of Rule 15c3-3, they are ordinarily "customers" within the meaning of the Commission's hypothecation rules.[18] OCC has historically not permitted setoff between market-maker accounts and customer accounts in which positions of other securities customers are carried. This separation has been preserved in Section 27(d)(3).

III. Comments

The Commission received three comment letters to the proposed rule change.[19] All three comment letters support the proposed rule change. Two of the comment letters, one from the Dealer Accounting Committee of the Securities Industry and Financial Markets Association and one from Lehman Brothers Holdings, Inc., state that the commenters support the proposed rule change because it is designed to allow OCC's members to comply with the Basel Capital Accord standards relating to bilateral netting and because it will clarify the accounting treatment of obligations between OCC and its clearing members. The third comment letter, from Morgan Stanley, states that Morgan Stanley believes the proposed rule change would result in significant improvement in financial reporting, would better align financial reporting with risk management practices, and would result in presenting the net credit risk exposure related to derivative instruments cleared through the OCC.

IV. Discussion

Section 17A(b)(3)(F) of the Act requires, among other things, that the rules of a clearing agency be designed to remove impediments to and perfect the mechanism of a national system

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[18] 17 CFR 240.8c-1 and 240.15c2-1.

[19] Supra note 4.

for the prompt and accurate clearance and settlement of securities transactions.[20] The proposed rule change should help to reduce uncertainty by establishing the procedures OCC and its Clearing Members must follow in the event of an OCC default or insolvency. Accordingly, because the proposed rule change establishes procedures that should reduce uncertainty and streamline the final clearance and settlement process in the event OCC defaults on it obligations to its members or otherwise becomes insolvent, we find that the proposed rule change is designed to remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions.

Although the proposed rule change applies in the event of the default or insolvency of OCC, OCC considers such an event to be unlikely. OCC's purpose in making the rule change is to allow its Clearing Members and certain affiliates of its Clearing Members to obtain better treatment under regulatory and financial standards where such better treatment requires that close-out netting procedures are in place. The close-out netting procedures are intended to allow Clearing Members to (1) reduce the applicable capital requirements for the Clearing Member's parent company where the parent is a U.S. or non-U.S. bank or part of a CSE under the Basel Netting Standards; (2) take advantage of the netting provisions of FDICIA and the applicable provisions of the United States Bankruptcy Code; and (3) clarify the accounting treatment of obligations between OCC and each Clearing Member under FIN 39. While the Commission believes that these intended benefits of the proposed rule change are not inconsistent with our finding above that the proposed rule change is designed to remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of

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[20] 15 U.S.C. 78q-1(b)(3)(F).

securities transactions under Section 17A the Act, we note that this order relates only to OCC's obligations under Section 17A of the Act and neither makes any findings nor expresses any opinion with respect to OCC's representations and interpretations regarding the application of the Basel Netting Standards, FDCIA, Bankruptcy Code, or FIN 39.

V. Conclusion

On the basis of the foregoing, the Commission finds that the proposed rule change is consistent with the requirements of the Act and in particular Section 17A of the Act and the rules and regulations thereunder.[21]

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (File No. SR-OCC-2006-19) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.[22]

Florence E. Harmon
Deputy Secretary

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21 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).

22 17 CFR 200.30-3(a)(12).