SECURITIES AND EXCHANGE COMMISSION
(Release No. 73961; File No. SR-OCC-2014-23)

December 30, 2014

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing of a Proposed Rule Change to Clarify that OCC would not Treat a Futures Transaction that is an Exchange-for-Physical or Block Trade as a Non-Competitively Executed Trade if the Exchange on Which Such Trade is Executed has Provided OCC with Representations That it Has Policies or Procedures Requiring That Such Trades be Executed at Reasonable Prices and That Such Price is Validated by the Exchange

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder,[2] notice is hereby given that on December 19, 2014, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II and III below, which Items have been prepared by OCC. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Clearing Agency's Statement of the Terms of Substance of the Proposed Rule Change

OCC proposes to amend its Rules to permit OCC to add an interpretation and policy clarifying that OCC would not treat a futures transaction that is an exchange-for-physical or block trade as a non-competitively executed trade, and therefore subject to delayed acceptance for clearing, if the exchange on which such trade is executed has provided OCC with representations satisfactory to OCC that it has policies and procedures requiring such trades to be executed at reasonable prices and that such prices are validated by the exchange.

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

2 17 CFR 240.19b-4.

II. Clearing Agency's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, OCC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. OCC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of these statements.

(A) Clearing Agency's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

OCC is proposing to modify its By-Laws to add an interpretation and policy to Section 7 of Article XII of the By-Laws to clarify that OCC would not treat a futures transaction that is an exchange-for-physical ("EFP")[3] or block trade[4] as a non-competitively executed trade, and therefore subject to delayed novation, if the exchange on which the futures EFP or block trade is executed has provided OCC with representations that it has rules, policies or procedures requiring that such trades be executed at reasonable prices and that such prices are validated by the exchange.

Background

Under OCC's By-Laws, the novation of confirmed trades (*i.e.*, transactions in options, futures, or other "cleared contracts" effected through an exchange and submitted

3 An EFP is a transaction between two parties in which a futures contract on a commodity or security is exchanged for the actual physical good.

4 A block trade is a trade involving a large number of shares being traded at an arranged price between parties, outside of the open markets, in order to lessen the impact of such a large trade being made public.

to OCC for clearing) occurs at the "commencement time" for such transactions.[5] The "commencement time" for most confirmed trades is when daily position reports are made available to clearing members.[6] However, transactions in certain cleared products and certain types of transactions, including non-competitively executed EFP and block trades, have delayed commencement times that are tailored to address risks specific to such products or transactions,[7] such as the risks presented by off-market transactions.

When OCC began clearing EFP and block transactions, it established that the commencement time for such transactions is expressly conditioned upon the receipt by OCC of variation payments due from purchasing and selling clearing members because EFP and block trades could be executed away from the market and be executed at other than market prices. These factors were viewed as creating heightened exposure to OCC if a clearing member defaults on a trade executed at an off-market price and, as a result, Article XII, Section 7 of OCC's By-Laws establishes that the commencement time for a futures transaction that is identified as an EFP or block trade is the time of the first variation payment after the trade is reported to OCC (typically 9:00 a.m. Central Time the

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5 Cleared Contracts and Commencement Time are defined terms set forth in Article 1, Section 1 of OCC's By-Laws.

6 *See* OCC's By-Laws Article VI, Section 5. In a practical sense, however, most trades are novated upon proper submission to OCC for clearing since OCC's By-Laws, with limited exception, do not permit OCC to reject any confirmed trade due to the failure of the purchasing clearing member to pay any amount due to OCC at or before the settlement time. *See also* Securities Exchange Act Release No. 65990 (December 16, 2011), 76 FR 79731 (December 22, 2011) (SR-OCC-2011-17).

7 *Id.*

following business day).[8] OCC delays its novation of these non-competitively executed futures trades because OCC is bound to pay the first variation settlement amount to the counterparty once novation has occurred, and if the agreed-upon price at which the trade is entered differs from the competitive market price, there is an increased likelihood that OCC may experience a loss if it is required to close out a defaulting purchaser's position. Accordingly, OCC does not novate, and thereby become a counterparty to, a non-competitively executed trade if OCC fails to receive the first variation payment when due.

EFP and Block Trades Subject to Price Checks

In the time since OCC adopted Article XII, Section 7 of its By-Laws, the Commodity Futures Trading Commission ("CFTC") has adopted Regulation 1.73, which requires clearing futures commission merchants ("FCMs") to establish certain risk controls, including risk based limits for bilaterally executed transactions and for block trades.[9] In light of this requirement and other proposed regulatory developments that may affect EFP and block trades in futures,[10] certain exchanges that permit such

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8 *See* Securities Exchange Act Release No. 44727 (August 20, 2001), 66 FR 45351 (August 28, 2001) (SR-OCC-2001-07).

9 *See* 17 CFR 1.73. Specifically, Regulation 1.73 requires FCMs to: 1) establish risk-based limits in the proprietary account and in each customer account based on position size, order size, margin requirements, or similar factors; 2) screen orders for compliance with the risk-based limits; and 3) monitor for adherence to the risk based limits intra-day and overnight.

10 Specifically, the CFTC has proposed regulations requiring Designated Contract Markets (i.e., futures exchanges) to determine whether or not the price of a block trade is fair and reasonable considering: 1) the size of the block trade, 2) the price and size of other block trades in any relevant markets at the applicable time, and 3) the circumstances of the market or the parties to the block trade. *See* proposed CFTC Regulation 38.503. 75 FR 80572, 80592. *See also* proposed Appendix B of part 38 of the CFTC's proposed regulations concerning Core Principle 9. 75

transactions have requested that OCC review its By-Laws regarding delayed novation of futures EFP and block trades (hereinafter, “Block Trades”). Specifically, such exchanges have implemented rules, supported by policies and procedures, which require their market participants to execute Block Trades at reasonable prices that are verified by the exchange. These rules, policies and procedures leverage risk controls implemented by FCMs, as applicable. These exchanges have inquired as to whether Block Trades continue to present the same risk to OCC as they did before such rules, policies or procedures were in place. OCC reviewed its practices with respect to delayed novation of Block Trades and determined that it will novate Block Trades when daily position reports are made available provided that the exchange that submitted such Block Trades to OCC represents to OCC that the exchange has in place rules, policies and procedures to verify the reasonableness of the price of Block Trades it submits to OCC for clearance and settlement, and that such price is validated by the exchange.

OCC has determined that Block Trades that are subject to price reasonability checks do not present the same settlement risks discussed above in relation to non-competitively executed Block Trades. Specifically, should a clearing member that executed a reasonably priced Block Trades fail to pay its first variation payment to OCC in respect such trade, OCC expects to liquidate the futures positions at the prevailing market price and likely obtain sufficient funds, or have sufficient funds in its clearing fund, to pay, or reimburse itself for, the first variation settlement to the counterparty to the trade. This is the same risk management methodology OCC uses for all other

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FR 80572, 80630. The CFTC has also proposed to adopt similar regulations concerning EFP trades. *See* proposed CFTC Regulation 38.505. 75 FR 80572, 80593.

competitively executed trades in cleared contracts that OCC accepts for clearance and settlement on a daily basis. Accordingly, OCC proposes to exclude Block Trades from the delayed novation provisions of Article XII, Section 7 by adding an interpretation and policy thereto that provides for the treatment of Block Trades as competitively executed trades provided that the Block Trades are reported by an exchange that represents to OCC that it performs a price reasonableness check on the trade, and that such price is validated by the exchange.

Verification of Exchange Rules, Policies and Procedures Related to Price Reasonableness

Before permitting an exchange to submit Block Trades that will not be subject to delayed novation, OCC will require an exchange to provide OCC with a certification that the exchange has rules, policies or procedures as they relate to verifying the reasonableness of the price of the Block Trade. Specifically, OCC will require an exchange to certify that its rules, policies or procedures provide that the price at which a Block Trade is executed must be fair and reasonable in light of: (i) the size of the Block Trade; (ii) the prices and sizes of other transactions in the same contract at the relevant time; and (iii) the prices and sizes of transactions in other relevant markets, including, without limitation, the underlying cash market or related futures markets, at the relevant time.[11] An exchange will also have to certify that its rules, policies or procedures require one or both parties to a Block Trade to report the trade details of the Block Trade to the exchange within a reasonable period of time (i.e., within 10 minutes of the time of

[11] For example, OneChicago LLC (“OCX”) Rule 417 governs Block Trades executed on OCX and provides that such trades be executed on a designated trading platform that will automatically verify that Block Trades were executed at competitive prices by price verification software for price reasonableness.

execution or, if the Block Trade is executed outside of regular trading hours, within 15 minutes of the commencement of trading on the next business day). OCC believes that it is appropriate to rely on price reasonableness checks performed by exchanges trading futures because they are self-regulatory organizations subject to regulatory oversight, including routine examinations. Moreover, OCC will presume that all Block Trades submitted by an exchange that represents that it has price reasonableness rules, policies or procedures in place will submit to OCC Block Trades that have undergone a price reasonableness check.

In addition to exchanges implementing rules, policies or procedures regarding the price reasonableness checks for Block Trades, exchanges are able to use existing authority to notify OCC to disregard, pursuant to Article VI, Section 7(c) of OCC's By-Laws, any Block Trade submitted to OCC that was executed at an unreasonable price, since such a trade could not be properly cleared under the proposed interpretation but instead would fall within the non-competitively executed category and therefore be subject to delayed novation. Such a notification would be delivered to OCC along with other trades "busted" by an exchange and in accordance with an operational process that currently occurs every day before daily position reports are distributed. OCC believes that this measure appropriately protects OCC in the event OCC receives a Block Trade at an unreasonable price. Moreover, OCC and the exchanges maintain an informal ongoing dialogue about operational matters, which OCC will use to confirm the continued application of price reasonableness controls.

2. Statutory Basis

OCC believes that the proposed rule change is consistent with Section 17A(b)(3)(F) of the Act,[12] because the proposed rule change will ensure that the rules of OCC are designed to promote the prompt and accurate clearance and settlement of securities transactions as well as remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions. As described above, the proposed rule change implements an Interpretation and Policy that sets forth the specific criteria that must be met by a futures exchange before OCC would consider a Block Trade submitted to OCC by such exchange to not be subject to the delayed novation time set forth in Article XII, Section 7 of OCC's By-Laws. The proposed rule change therefore ensures that OCC's rules explain the time at which OCC would novate Block Trades and thereby promotes the prompt and accurate clearance and settlement of securities transactions. In addition, as a result of OCC novating certain Block Trades at commencement time, the proposed rule change removes impediments to and perfects the mechanisms of a national system for the prompt and accurate clearance and settlement of securities transactions because the time at which OCC novates trades submitted by exchanges for clearance and settlement will be more uniform across different product types. The proposed rule change is not inconsistent with the existing rules of OCC, including any other rules proposed to be amended.

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[12] 15 U.S.C. 78q-1(b)(3)(F).

(B) Clearing Agency's Statement on Burden on Competition

OCC does not believe that the proposed rule change would impose any burden on competition.[13] The proposed rule change will provide that Block Trades executed at reasonable prices will not be subject to delayed novation by OCC. The proposed rule change would not unfairly inhibit access to OCC's services or disadvantage or favor any particular user in relationship to another user because the proposed rule change would be applied uniformly to all Block Trade transactions, regardless of the identity of the clearing member for whose account the trade was reported and the exchange through which the trade is reported to OCC. Moreover, the proposed interpretation to Article XII, Section 7 will apply uniformly to all futures exchanges that submit trades to OCC for clearance and settlement.

For the foregoing reasons, OCC believes that the proposed rule change is in the public interest, would be consistent with the requirements of the Act applicable to clearing agencies, and would not impose a burden on competition.

(C) Clearing Agency's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments on the proposed rule change were not and are not intended to be solicited with respect to the proposed rule change and none have been received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period up to 90 days (i) as the Commission may designate if it finds

13 15 U.S.C. 78q-1(b)(3)(I).

such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove the proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-OCC-2014-23 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-OCC-2014-23. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/sro.shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549 on official business days between the hours of 10:00 am and 3:00 pm. Copies of the filing also will be available for inspection and copying at the principal office of OCC and on OCC's website at http://www.theocc.com/components/docs/legal/rules_and_bylaws/sr_occ_14_23.pdf. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-OCC-2014-23 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[14]

Brent J. Fields
Secretary

[14] 17 CFR 200.30-3(a)(12).