

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-73482; File No. SR-OCC-2014-803)

October 31, 2014

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of No Objection to Advance Notice Filing to Better Manage Risks Concentration and Other Risks Associated with Accepting Deposits of Common Stocks for Margin Purposes

On July 16, 2014, the Options Clearing Corporation (“OCC”) filed with the Securities and Exchange Commission (“Commission”) advance notice SR-OCC-2014-803 pursuant to Section 806(e)(1) of the Payment, Clearing, and Settlement Supervision Act of 2010 (“Payment, Clearing and Settlement Supervision Act”)¹ and Rule 19b-4(n)(1) under the Securities Exchange Act of 1934 (“Act”).² The advance notice was published for comment in the Federal Register on August 15, 2014.³ On September 8, 2014, pursuant to Section 806(e)(1)(D) of the Payment, Clearing and Settlement Supervision Act, the Commission required OCC to provide additional information concerning this

¹ 12 U.S.C. 5465(e)(1). The Financial Stability Oversight Council designated OCC a systemically important financial market utility on July 18, 2012. See Financial Stability Oversight Council 2012 Annual Report, Appendix A, <http://www.treasury.gov/initiatives/fsoc/Documents/2012%20Annual%20Report.pdf>. Therefore, OCC is required to comply with the Payment, Clearing and Settlement Supervision Act and file advance notices with the Commission. See 12 U.S.C. 5465(e).

² 17 CFR 240.19b-4(n)(1).

³ Securities Exchange Act Release No. 72803 (August 11, 2014), 79 FR 48285 (August 15, 2014) (SR-OCC-2014-803). OCC also filed the proposal contained in this advance notice as a proposed rule change under Section 19(b)(1) of the Act and Rule 19b-4 thereunder, which was published for comment in the Federal Register on August 5, 2014. 15 U.S.C. 78s(b)(1); 17 CFR 240.19b-4. See Securities Exchange Act Release No. 72717 (July 30, 2014), 79 FR 45523 (August 5, 2014) (SR-OCC-2014-14). The Commission did not receive any comments on the proposed rule change.

advance notice.⁴ The Commission did not receive any comments on the advance notice publication. This publication serves as a notice of no objection to the changes proposed in the advance notice.

I. Description of the Advance Notice

According to OCC, the purpose of this change is to permit OCC to better manage concentration risk and wrong-way risk associated with accepting deposits of common stock for margin purposes. In order to manage such risks, OCC is adding an Interpretation and Policy to Rule 604, which specifies the forms of margin assets accepted by OCC, that will provide OCC with discretion with respect to giving value to assets deposited by a single clearing member to satisfy its margin requirement(s). In addition, OCC is making clarifying amendments to an existing Interpretation and Policy under Rule 604 that gives OCC discretion to not give value to a particular type of margin collateral across all clearing members.

a. Background

OCC Rule 604 lists the types of assets that clearing members may deposit with OCC to satisfy their margin requirement(s) as well as sets forth eligibility criteria for such assets. According to OCC, common stocks, including Exchange Traded Funds (“ETFs”) and Exchange Traded Notes (“ETNs”), are the most common form of margin assets deposited by clearing members and currently comprise 68% of the \$60.6 billion in clearing member margin deposits held by OCC (not including deposits in lieu of margin).

⁴ 12 U.S.C. 5465(e)(1)(D). The Commission received a response with further information for consideration of the advance notice on September 19, 2014, at which time a 60 day review period began pursuant to Sections 806(e)(1)(E) and (G) of the Payment, Clearing and Settlement Supervision Act. See 12 U.S.C. 5465(e)(1)(E) and 12 U.S.C. 5465(e)(1)(G).

According to OCC, since 2009, OCC has used its System for Theoretical Analysis and Numerical Simulations (“STANS”), which is OCC’s daily automated Monte Carlo simulation-based margining methodology, to value common stocks deposited by clearing members as margin.⁵ The value given to margin deposits depends on factors that include the price volatility and the price correlation relationship of common stock collateral to the balance of the cleared portfolio. The approach used by STANS incentivizes clearing members who chose to meet their margin obligations with deposits of common stocks to choose common stocks that hedge their related open positions.

According to OCC, notwithstanding the value STANS gives to deposits of common stocks, certain factors warrant OCC adjusting the value STANS gives to all clearing member margin deposits of a particular type of margin collateral. Such factors are set forth in Rule 604, Interpretation and Policy .14, and include the number of outstanding shares, number of outstanding shareholders and overall trading volume. OCC is proposing to add a new Interpretation and Policy to Rule 604 (the “Interpretation”) so that OCC has discretion to not give margin credit to a particular clearing member when such clearing member deposits a concentrated amount of any common stock and when a common stock, deposited as margin, presents “wrong-way risk” to OCC. In addition, the Interpretation will provide OCC discretion to grant margin credit to a clearing member when it deposits shares of common stock that serve as a

⁵ See Securities Exchange Act Release No. 58158 (July 15, 2008), 73 FR 42646 (July 22, 2008) (SR-OCC-2007-20).

hedge to the clearing member's related open positions and would otherwise be not be given margin credit.⁶

b. Concentrated Deposits of Common Stock

OCC has determined that in the event it is necessary to liquidate a clearing member's positions (including the clearing member's margin collateral), OCC may be exposed to risk arising from a large quantity of a particular common stock deposited as margin by a clearing member. Specifically, depending on the relationship between the average daily trading volume of a particular security and the number of outstanding shares of such security deposited by a clearing member as margin, it is possible that the listed equities markets may not be able to quickly absorb all of the common stock OCC seeks to sell, or OCC may not be able to auction such securities, without an appreciable negative price impact. This occurrence, referred to by OCC as "concentration risk," is greatest when the number of shares being sold is large and the average daily trading volume is low.

OCC's existing authority to not give value to otherwise eligible forms of margin only provides OCC with the discretion to not give value across all clearing member deposits of a particular common stock. However, concentration risk may be a clearing

⁶ According to OCC, consistent with the language contained in existing Interpretation & Policy .14, the Interpretation provides OCC with discretion in determining the amount of margin credit given to deposits of common stock by an individual clearing member as such determination would be based on positions held and common stock deposits made by such clearing member on a given business day. However, as discussed in the following two sections, OCC states that it also has developed certain automated processes as well as additional internal policies that describe how OCC presently intends to exercise such discretion. According to OCC, these additional internal policies are included in OCC's collateral risk management policy, which will not be implemented until approval of this rule change with changes thereto being subject to additional rule filings.

member and account-specific risk. In order to mitigate the concentration risk of a single clearing member, OCC plans to implement automated processes to monitor the composition of a clearing member's margin deposits. Such processes will identify concentration risk at both an account level and across all accounts of a clearing member. OCC is adding the Interpretation so that OCC has discretion to limit the margin credit granted to an individual clearing member that maintains a concentrated margin deposit of otherwise eligible common stock.

According to OCC, for reasons stated above, OCC considers a common stock's average daily trading volume and the number of shares a clearing member deposited as margin to be the two most significant factors when making a decision to limit margin credit due to concentration risk. Accordingly, OCC will not give margin credit to clearing member margin deposits of a particular common stock in respect of a particular account when the deposited amount of such common stock is in excess of two times the average daily trade volume of such common stock over the most recent three month period. OCC's systems will continually assess the composition of clearing member margin deposits for each account maintained by the clearing member, including intra-day collateral substitutions in such accounts, to determine if a clearing member has a margin deposit with a concentrated amount of common stock. With respect to a given account, OCC's systems will automatically set appropriate limits on the amount of a particular common stock for which a clearing member may be given margin credit for any one of a its tier accounts. In addition, and with respect to all of a clearing member's accounts, OCC will impose an add-on margin charge if, in aggregate, a clearing member deposits a concentrated amount of a particular common stock as margin across all of its accounts.

The add-on margin charge will operate to negate the margin credit given to the concentrated margin deposit, and will be collected, when applicable, as part of OCC's standard morning margin process. OCC will assess the add-on margin charge across all of a clearing member's accounts on a pro-rata basis (based on the amount of the particular common stock in each of a clearing member's accounts).⁷

According to OCC, OCC staff has been monitoring concentrated common stock positions, assessing the impact of the proposed change described in this filing and contacting clearing members affected by the proposed change. OCC believes that clearing members will be able to comply with the proposed change without making significant changes to their day-to-day business operations. In December 2013, an information memo was posted to inform all members of the upcoming change.

According to OCC, since January 2014, OCC staff has been in contact with any clearing member that would be affected by the proposed change. On a weekly basis, any clearing member that would see a reduction of 10% or more of its collateral value is contacted and provided an explanation of the policy and a list of concentrated positions observed in this analysis. On a monthly basis, all clearing members exhibiting any concentration risk are contacted to provide an explanation of the proposed policy and a list of concentrated positions. In both cases, clearing members are encouraged to proactively reduce

⁷ According to OCC, since a 2-day limit is first checked at each account, it is possible that a clearing member with multiple accounts may have more than 2-days of a given common stock on deposit in aggregate. To control this condition, a final check is done on the aggregate amount of shares held by a clearing member across all of its accounts. For example, if a particular clearing member has three accounts each holding 2-days volume of a specific common stock, the clearing member check would identify that the member was holding six days of volume in aggregate. To mitigate this risk, an add-on charge equal to the market value of four days of volume would be applied to all accounts holding that security on a pro-rata basis.

concentrated positions to conform to the proposed policy. As of June 2014, twenty-five members would be affected. Implementation of the Interpretation would result in disallowing \$1.2 billion in collateral value and result in margin calls for six members totaling \$710 million. Moreover, in July 2014, OCC made an automated report concerning concentrated margin deposits of common stock available to all clearing members.

c. Wrong-Way Risk

OCC also will use the Interpretation to address the risk that the common stock a clearing member has deposited as margin and which is issued by the clearing member itself or an affiliate of the clearing member will lose value in the event the clearing member providing such margin defaults, which is known as “wrong-way risk.”

According to OCC, wrong-way risk occurs when a clearing member makes a deposit of common stock issued by it or an affiliate and, in the event the clearing member defaults, the clearing member’s common stock margin deposit will also be losing value at the same time because there is likely to be a strong correlation between the clearing member’s creditworthiness and the value of such common stock. In order to address wrong-way risk, the Interpretation will implement automated systems that will not give margin credit to a clearing member that deposits common stock issued by such clearing member or an affiliate as margin collateral. OCC will define “affiliate” broadly in the Interpretation to include any entity with direct or indirect equity ownership of 10% of the clearing member, or any entity for which the clearing member holds 10% of the direct or indirect equity ownership.⁸

⁸ This standard is based on the provisions of OCC Rule 215(a)(5).

OCC has addressed the impact of the change designed to address wrong-way risk. As of June 2014, there were 73 clearing members whose parent or an affiliate has issued securities trading on U.S. exchanges. As of June 2014, there are six clearing members that would be affected by virtue of having made margin deposits of their own or an affiliate's common stock. In total, these shares equaled \$132 million and accounted for less than one half of one percent of the total market value of valued securities pledged as margin at OCC. In July 2014, OCC made information available to each clearing member that indicates which of its deposits of common stock would not receive margin credit under the proposed change due to wrong-way risk considerations, as described above.⁹

d. Deposits That Hedge Open Positions

In addition to the above, OCC also will include language in the Interpretation so that it has discretion to give margin credit to common stock deposited as margin that would otherwise not be given margin credit in circumstances when such common stock acts as a hedge (i.e., the member holds an equivalent short position in cleared contracts on the same underlying security). This condition will be checked in both the account and clearing member level. For example, if a clearing member deposits the common stock of an affiliate as margin collateral, which, pursuant to the above, would ordinarily not be given value for the purposes of granting margin credit, OCC may nevertheless give value to such common stock for the purposes of granting margin credit to the extent such common stock acts as a hedge against open positions of the clearing member. In this case, a decline in the value of the margin deposit would be wholly or partially offset by

⁹ OCC believes that by providing such information clearing members will be better able to adjust their margin deposits at OCC to conform to the proposed change if it is approved.

an increase in the value in the open position. Moreover, in such a situation, OCC will systematically limit the margin credit granted to the lesser of a multiple of the daily trading volume or the “delta equivalent position”¹⁰ for the particular common stock, taking into account the hedging position.¹¹ OCC believes that this policy will further encourage clearing members to deposit margin collateral that hedges their related open positions and is in line with the valuation methods within STANS. This policy will also facilitate OCC’s management of its and its participants’ credit exposure as well as the liquidation of a clearing member’s portfolio should the need arise.

¹⁰ According to OCC, the “delta equivalent position” is the equivalent number of underlying shares represented by the aggregation of cleared products on that same underlying instrument. This value is calculated using the “delta” of the option or futures contract, which is the ratio between the theoretical change in the price of the options or futures contract to the corresponding change in the price of an underlying asset. Thus, delta measures the sensitivity of an options or futures contract price to changes in the price of the underlying asset. For example, a delta of +0.7 means that for every \$1 increase in the price of the underlying stock, the price of a call option will increase by \$0.70. Delta for an option or future can be expressed in shares of the underlying asset. For example, a standard put option with a delta of -.45 would have a delta of -45 shares, because the unit of trading is 100 shares.

¹¹ Assume, for example, an average daily trade volume of 250 shares, a threshold of 2 times the average daily trade volume, and a delta of -300 shares for the options on a particular security in a particular account. A position of 700 shares that did not hedge any short options or futures would receive credit for only 500 shares (i.e., 2 times the average daily trade volume). If the net long position in the account, when combined with the delta of short option and futures position, were only 400, credit would be given for the entire 700 shares since the delta equivalent position is below the 500 share threshold. However, if the option delta were +300, the net long position would be 1000, and credit would only be given for 500 shares because the delta equivalent position would exceed the 500 share threshold.

e. Other Proposed Changes

OCC also will make certain clarifying changes in order to accommodate the adoption of the Interpretation into its Rules. Primarily, OCC is adding language to OCC Rule 604, Interpretation and Policy .14, to clarify that such Interpretation and Policy concerns OCC’s authority to not give value to certain margin deposits for all clearing members (whereas the Interpretation applies to particular clearing member(s)). In addition, OCC is removing language from OCC Rule 604, Interpretation and Policy .14, to improve readability as well as to remove “factors” concerning number of shares and affiliates since OCC’s authority with respect to such factors will be more clearly described in the Interpretation. Finally, OCC is renumbering the Interpretations and Policies of Rule 604 in order to accommodate the adoption of the Interpretation.

II. Discussion and Commission Findings

Although the Payment, Clearing and Settlement Supervision Act does not specify a standard of review for an advance notice, the Commission believes its stated purpose is instructive.¹² The stated purpose is to mitigate systemic risk in the financial system and promote financial stability by, among other things, promoting uniform risk management standards for systemically-important financial market utilities (“FMU”) and strengthening the liquidity of systemically important FMUs.¹³

Section 805(a)(2) of the Payment, Clearing and Settlement Supervision Act¹⁴ authorizes the Commission to prescribe risk management standards for the payment,

¹² See 12 U.S.C. 5461(b).

¹³ Id.

¹⁴ 12 U.S.C. 5464(a)(2).

clearing, and settlement activities of designated clearing entities and financial institutions engaged in designated activities for which it is the supervisory agency or the appropriate financial regulator. Section 805(b) of the Payment, Clearing and Settlement Supervision Act¹⁵ states that the objectives and principles for the risk management standards prescribed under Section 805(a) shall be to:

- promote robust risk management;
- promote safety and soundness;
- reduce systemic risks; and
- support the stability of the broader financial system.

The Commission has adopted risk management standards under Section 805(a)(2) of the Payment, Clearing and Settlement Supervision Act¹⁶ and the Act (“Clearing Agency Standards”).¹⁷ The Clearing Agency Standards became effective on January 2, 2013 and establish, among other things, minimum requirements regarding how registered clearing agencies must maintain effective risk management procedures and controls.¹⁸ Therefore, it is appropriate for the Commission to review advance notices against these Clearing Agency Standards and the objectives and principles of these risk management standards

¹⁵ 12 U.S.C. 5464(b).

¹⁶ 12 U.S.C. 5464(a)(2).

¹⁷ See Rule 17Ad-22 of the Act. 17 CFR 240.17Ad-22. Securities Exchange Act Release No. 68080 (October 22, 2012), 77 FR 66220 (November 2, 2012) (S7-08-11).

¹⁸ See Securities Exchange Act Release No. 68080 (October 22, 2012), 77 FR 66220 (November 2, 2012) (S7-08-11).

as described in Section 805(b) of the Payment, Clearing and Settlement Supervision Act.¹⁹

The proposal in this advance notice is consistent with Clearing Agency Standards, Rule 17Ad-22(b)(2) of the Act.²⁰ Rule 17Ad-22(b)(2) of the Act²¹ requires a registered clearing agency that performs central counterparty services to, among other things, establish, implement, maintain and enforce written policies and procedures reasonably designed to use margin requirements to limit its credit exposures to participants under normal market conditions. This proposal is consistent with this rule because it is reasonably designed to permit OCC to use margin requirements to limit its credit exposures to clearing members under normal market conditions in two ways. First, it is reasonably designed to limit OCC's credit exposures to clearing members whose collateral portfolios could present concentration risk. Specifically, it addresses concentration risk by particular clearing member and by particular account by giving OCC discretion to disapprove as margin collateral certain securities, based on the number of shares deposited, by particular clearing member and by particular account, while also considering deposits that hedge open positions. It also clarifies that OCC's existing authority to not give value to certain margin deposits applies to all clearing members, as opposed to particular clearing members.²² Second, it is reasonably designed to limit

¹⁹ 12 U.S.C. 5464(b).

²⁰ 17 CFR 240.17Ad-22(b)(2).

²¹ Id.

²² See Rule 604, Interpretation and Policy .15 (providing OCC discretion to disapprove as margin collateral securities that meet certain factors, including trading volume, number of outstanding shareholder, number of outstanding shares, volatility and liquidity).

OCC's credit exposures to clearing members whose collateral portfolios could present wrong-way risk. Specifically, it addresses wrong-way risk presented by clearing members who deposit as margin securities that are issued by the clearing member itself or by an affiliate of the clearing member. It addresses this type of wrong-way risk by giving OCC discretion to disapprove as margin collateral, with respect to a particular clearing member, any security issued by such clearing member or by an affiliate of such clearing member, while also considering deposits that hedge open positions.

Rule 17Ad-22(b)(2) of the Act²³ also requires a registered clearing agency that performs central counterparty services to, among other things, establish, implement, maintain and enforce written policies and procedures reasonably designed to use risk-based models and parameters to set margin requirements. This proposal is consistent with this rule because it permits OCC to use risk-based models and parameters to set margin requirements in a way that takes into account concentration risk and wrong-way risk, as described above.

The proposal in this advance notice meets the objectives and principles described in Section 805(b) of the Payment, Clearing and Settlement Supervision Act.²⁴ The changes to OCC's margin policy, as described above, are designed to reduce the risk that clearing member margin assets would be insufficient should OCC need to use such assets to close-out positions of a defaulted clearing member. The changes are also designed to facilitate OCC to timely meet its settlement obligations because the change will diminish the likelihood that a large percentage of the value of a defaulting clearing member's

²³ 17 CFR 240.17Ad-22(b)(2).

²⁴ 12 U.S.C 5464(b); See also 12 U.S.C. 5464(a).

margin assets would not be available to OCC to cover losses in the event of a clearing member default. Therefore, the proposal (i) promotes robust risk management (including risk management of concentration risk and wrong-way risk), (ii) promotes safety and soundness, (iii) reduces systemic risks (including those caused by concentration risk and wrong-way risk), and (iv) supports the stability of the broader financial system.

III. Conclusion

IT IS THEREFORE NOTICED, pursuant to Section 806(e)(1)(I) of the Payment, Clearing and Settlement Supervision Act,²⁵ that the Commission DOES NOT OBJECT to the proposal in OCC's advance notice (SR-OCC-2014-803) and OCC is AUTHORIZED to implement the proposal as of the date of this notice or the date of an order by the Commission approving a proposed rule change that reflects rule changes that are consistent with the proposal in this advance notice (SR-OCC-2014-14), whichever is later.

By the Commission.

Kevin O'Neill
Deputy Secretary

²⁵ 12 U.S.C. 5465(e)(1)(I).