

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-89515; File No. SR-OCC-2020-805)

August 10, 2020

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing of Advance Notice Concerning Proposed Changes to Enhance OCC's Stock Loan Close-Out Process

Pursuant to Section 806(e)(1) of Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, entitled Payment, Clearing and Settlement Supervision Act of 2010 ("Clearing Supervision Act")¹ and Rule 19b-4(n)(1)(i)² under the Securities Exchange Act of 1934 ("Exchange Act"),³ notice is hereby given that on July 14, 2020, the Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") an advance notice 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 advance notice from interested persons.

I. Clearing Agency's Statement of the Terms of Substance of the Advance Notice

This advance notice is submitted in in connection with proposed changes to OCC Rules 2211 and 2211A, which concern the close-out of a defaulting Hedge Clearing Member's or Market Loan Clearing Member's (each a "defaulting Clearing Member") stock loan positions, respectively, to require Lending Clearing Members or Borrowing Clearing Members (each a "non-defaulting Clearing Member") whom OCC instructs to buy-in or sell-out securities to execute such transactions and provide OCC notice of such

¹ 12 U.S.C. 5465(e)(1).

² 17 CFR 240.19b-4(n)(1)(i).

³ 15 U.S.C. 78a et seq.

action by the settlement time for a Clearing Member's obligations to OCC on the business day after OCC gives the instruction.⁴ In addition, OCC proposes to amend Rules 2211 and 2211A to provide that if a non-defaulting Clearing Member so instructed does not execute the trades and provide notice by that time, OCC will terminate the Stock Loan and effect settlement based upon the Marking Price at the close of business on the day that OCC provided the instruction. OCC submitted the proposed amendments to OCC's Rules in Exhibit 5. Material proposed to be added to OCC's Rules as currently in effect is marked by underlining and material proposed to be deleted is marked with strikethrough text. All terms with initial capitalization that are not otherwise defined herein have the same meaning as set forth in the By-Laws and Rules.⁵

II. Clearing Agency's Statement of the Purpose of, and Statutory Basis for, the Advance Notice

In its filing with the Commission, OCC included statements concerning the purpose of and basis for the advance notice and discussed any comments it received on the advance notice. 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 and B below, of the most significant aspects of these statements.

(A) Clearing Agency's Statement on Comments on the Advance Notice Received from Members, Participants or Others

Written comments were not and are not intended to be solicited with respect to the

⁴ "Buy-in" refers to a non-defaulting lender purchasing replacement stock. "Sell-out" refers to a non-defaulting borrower selling the loaned securities in order to recoup its collateral.

⁵ OCC's By-Laws and Rules can be found on OCC's public website: <http://optionsclearing.com/about/publications/bylaws.jsp>.

advance notice and none have been received. OCC will notify the Commission of any written comments received by OCC.

(B) Advance Notices Filed Pursuant to Section 806(e) of the Payment, Clearing, and Settlement Supervision Act

Description of the Change

This advance notice concerns a change to OCC's operations to amend OCC Rules 2211 and 2211A to ensure that OCC has authority and operational capacity to take timely action to contain losses and liquidity demands and continue to meet its obligations in the event of a Clearing Member default by more closely aligning the close-out of stock loan positions through buy-in and sell-out transactions with the timing of an auction of a defaulting Clearing Member's other positions and to ensure that the close-out of a defaulting Clearing Member's stock loan positions by buy-in or sell-out transactions occurs within OCC's two-day liquidation assumption. The proposed amendments to the Rules are discussed in more detail below.

Background

OCC operates two programs in which it acts as a central counterparty for stock loan transactions: (1) the Stock Loan/Hedge Program and (2) Market Loan Program (collectively, the "Stock Loan Programs"). Stock Loan/Hedge Program transactions are initiated directly between Clearing Members on a bilateral basis (i.e., "broker-to-broker" model) and Market Loan Program transactions are initiated on either a broker-to-broker basis or anonymously through the matching of bids and offers (i.e., "market" model). Both programs rely on The Depository Trust Company ("DTC") to facilitate the settlement of equity securities and cash collateral between members.

Under the Stock Loan Programs, OCC novates the transaction and becomes the

lender to the Borrowing Clearing Member and the borrower to the Lending Clearing Member upon receiving reports from DTC showing completed Stock Loans, provided that OCC has not rejected such transactions.⁶ As the principal counterparty to the Borrowing and Lending Clearing Members, OCC guarantees the return of the full value of cash collateral to a Borrowing Clearing Member and guarantees the return of the Loaned Stock (or value of that Loaned Stock) to the Lending Clearing Member.⁷ After novation, as part of the guaranty, OCC makes Mark-to-Market Payments for all cleared Stock Loans on a daily basis to collateralize all loans to the negotiated levels. Settlements generally are combined and netted against other OCC settlement obligations in a Clearing Member's account, including trade premiums and margin deficits. Clearing Member open positions in the Stock Loan Programs are factored into the Clearing Member's overall Margin⁸ and Clearing Fund contribution requirements.⁹

In the event a Clearing Member defaults, OCC closes the defaulting Clearing Member's positions, liquidates collateral, and deposits any proceeds into a Liquidating Settlement Account. The close-out of positions other than stock loan positions would typically be effected by an auction that would occur on the morning prior to market

⁶ See OCC Rules 2202(b) and 2202A(b). OCC receives DTC confirmation upon settlement of delivery versus payment. See generally DTC Settlement Services Guide, available at <http://www.dtcc.com/~media/Files/Downloads/legal/service-guides/Settlement.pdf> (discussing the operation of the "Option Exercise & Assignment Loan Program").

⁷ Under the Market Loan Program, OCC also provides a limited guaranty of dividend and rebate payments.

⁸ See OCC Rules 601 and 2203.

⁹ See OCC Rule 1001.

opening on the day after a default occurs.¹⁰ In contrast, OCC's Rules allow OCC to close stock loan positions by instructing the non-defaulting Clearing Members who are parties to the defaulting Clearing Member's loans to sell-out or buy-in securities as applicable.¹¹ A non-defaulting Clearing Member is required to provide OCC with evidence of the execution price at which each transaction occurred. This execution price is used as the settlement price to facilitate the final mark between the non-defaulting Clearing Member and the Liquidating Settlement Account. Currently, non-defaulting Clearing Members are required to buy-in or sell-out the relevant securities by the close of business on the stock loan business day after OCC's instruction.¹² If a non-defaulting Clearing Member fails to execute such buy-in or sell-out, OCC would terminate the stock loan position and mark the transaction based upon the Marking Price at close of business on the business day after OCC's instruction.¹³

The buy-in/sell-out process for stock loan positions has significant benefits as it distributes the liquidity demands across multiple counterparties, each of whom

¹⁰ While this timing describes the typical scenario, the timing of an auction is not set by regulation or OCC's By-Laws or Rules, which allows for an auction on an accelerated timeline, if needed. In addition, OCC's Rules also allow for the close-out of a defaulting Clearing Member's portfolio by open market transactions and hedging transactions to reduce the risks to OCC associated with holding open positions. See OCC Rule 1106.

¹¹ OCC may also effect the close-out of stock loan positions by re-matching Matched-Book Positions, an auction, or in such other manner as OCC determines to be the most orderly manner practicable under the circumstances. OCC Rules 2210(b) and 2210A(b).

¹² See OCC Rules 2211 (Suspension of Hedge Clearing Members – Buy-In and Sell-Out Procedures) and 2211A (Suspension of Market Loan Clearing Members – Buy-In and Sell-Out Procedures).

¹³ Id.

effectively act as independent liquidating agents. The buy-in/sell-out process also aligns the liquidity demands necessary to facilitate an unwind with the Clearing Member receiving proceeds from the origination of the loan and currently in possession of the collateral. However, the difference in timing between an auction and the buy-in/sell-out process presents credit and liquidity risks for OCC. Specifically, because OCC's portfolio-based margin methodology combines stock loan positions with options, futures, and margin collateral when determining margin requirements, the difference in timing could expose OCC to increased credit and liquidity risk should the price of the stock loan positions move unfavorably between the time of auction and determination of the final settlement price for remaining buy-in/sell-out transactions and should that price differential exceed the amount of margin on deposit for such positions.

Enhancement to Stock Loan Programs Close-Out Rules

In response to these concerns, OCC proposes to amend OCC Rules 2211 and 2211A to require buy-in or sell-out transactions to be complete by the settlement time for a Clearing Member's obligations to OCC, defined in Article I of the By-Laws,¹⁴ on the stock loan business day after OCC gives non-defaulting Clearing Members the buy-in/sell-out instruction. If a non-defaulting Clearing Member does not execute the trades and provide notice by that time, OCC would terminate the Stock Loan and effect settlement based upon the Marking Price at the close of business the previous business day (i.e., the day that OCC provided the instruction). This Marking Price (i.e., closing price) would be the last settlement price captured in OCC's systems prior to the time by

¹⁴ By-Law Article I, Section 1.S.(16) defines "settlement time" with respect of a Clearing Member's obligations to OCC to mean 9:00 A.M. Central Time.

which the non-defaulting Clearing Member was supposed to have taken such actions.

This proposed enhancement is designed to mitigate the risks associated with the difference in timing between close-out of stock loan positions and an auction for the remainder of defaulting Clearing Member's portfolio. In the typical case, an auction to close positions for other products would occur on the morning prior to market opening on the day after a default event occurs. Accelerating the deadline for buy-in or sell-out transactions to that morning—rather than the end of the stock loan business day—would reduce credit and liquidity risks by aligning liquidation timing across products more closely.

The proposed enhancement also is designed to ensure that the close-out process for the Stock Loan Programs would occur in a manner consistent with OCC's two-day liquidation assumption (which is applicable to all products without differentiation). At the earliest, a defaulting Clearing Member would have made its last margin payment at the settlement time on the business day prior to default. When that Clearing Member fails to make its margin or mark-to-market payments the next morning, OCC would suspend it and typically would issue the buy-in/sell-out instruction to non-defaulting Clearing Members. The proposed requirement that non-defaulting Clearing Members execute buy-in and sell-out transactions by the settlement time on the business day after default ensures that close-out occurs in a manner consistent with the two-day liquidation assumption.

OCC considered requiring non-defaulting Clearing Members to execute buy-in or sell-out transactions by the end of the business day on the same day as OCC's instruction but believes extending the process to the following morning is the better option. In

discussion with several Clearing Members, they expressed a preference for setting the deadline at 9:00 a.m. Central Time the following business day because doing so would allow a non-defaulting Clearing Member the opportunity to trade at market opening. OCC believes allowing non-defaulting Clearing Members to trade at market opening the following morning would provide additional time to execute the buy-in and sell-out method in a manner consistent with OCC's two-day liquidation assumption.¹⁵ OCC also presented the proposed change at a meeting of its Financial Risk Advisory Council ("FRAC"), a working group comprised of exchanges, Clearing Members and other market participants.¹⁶ No participant objected to OCC's proposal to accelerate the close-out timing. While questions were raised about the proposal to use the Marking Price at the close of business the day prior in the event a Clearing Member fails to act by the settlement time the next day, OCC believes using the last Marking Price available in its system prior to the time by which a Clearing Member is obligated to take action is superior because OCC's automated systems are designed to determine the Marking Price based on closing securities prices. The manual processes that OCC would need to institute to pull pricing information other than closing prices would make the stock loan close-out process more susceptible to delay and errors.

Implementation Timeframe

OCC expects to implement the proposed changes within thirty (30) days after the

¹⁵ OCC is considering a proposal to move its settlement time from 9:00 A.M. settlement time earlier in the day, in which case the deadline for a non-defaulting Clearing Member instructed to buy-in or sell-out would change to the new settlement time.

¹⁶ OCC submitted the relevant portions of the presentation provided at the April 16, 2019 FRAC meeting in confidential Exhibit 3.

date that OCC receives all necessary regulatory approvals for the proposed changes. OCC will announce the implementation date of the proposed change by an Information Memorandum posted to its public website at least one (1) weeks prior to implementation.

Anticipated Effect On and Management of Risk

OCC believes that the proposed changes would reduce the nature and level of risk presented by OCC because they would enhance the overall resilience of OCC's Stock Loan Programs by enhancing the default management processes for the Stock Loan Programs to mitigate the risks associated with the buy-in/sell-out described above.

OCC proposes to amend OCC Rules 2211 and 2211A to require buy-in or sell-out transactions to be complete by the settlement time for a Clearing Member's obligations to OCC, defined in Article I of the By-Laws,¹⁷ on the stock loan business day after OCC gives non-defaulting Clearing Members the buy-in/sell-out instruction. If a non-defaulting Clearing Member does not execute the trades and provide notice by that time, OCC would terminate the Stock Loan and effect settlement based upon the Marking Price at the close of business the previous business day (i.e., the day that OCC provided the instruction).

OCC believes the proposed changes help to mitigate the risks associated with the difference in timing between close-out of stock loan positions and an auction for the remainder of defaulting Clearing Member's portfolio. In the typical case, an auction to close positions for other products would occur on the morning prior to market opening on the day after a default event occurs. Accelerating the deadline for buy-in or sell-out

¹⁷ By-Law Article I, Section 1.S.(16) defines "settlement time" with respect of a Clearing Member's obligations to OCC to mean 9:00 A.M. Central Time.

transactions to that morning—rather than the end of the stock loan business day—would reduce credit and liquidity risks by aligning liquidation timing across products more closely. OCC also believes the proposed changes helps to mitigate credit risks by ensuring that the close-out process for the Stock Loan Programs would occur in a manner consistent with OCC’s two-day liquidation assumption (which is applicable to all products without differentiation). In addition, OCC believes using the last Marking Price available in its system prior to the time by which a Clearing Member is obligated to take action helps manage risk in situations where a Clearing Member fails to take action because OCC’s automated systems are designed to determine the Marking Price based on closing securities prices. The manual processes that OCC would need to institute to pull pricing information other than closing prices would make the stock loan close-out process more susceptible to delay and errors.

Consistency with the Clearing Supervision Act

The stated purpose of the Clearing Supervision Act 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 and strengthening the liquidity of systemically important financial market utilities.¹⁸ Section 805(a)(2) of the Clearing Supervision Act¹⁹ also authorizes the Commission to prescribe risk management standards for the payment, clearing and settlement activities of designated clearing entities, like OCC, for which the Commission is the supervisory

¹⁸ 12 U.S.C. 5461(b).

¹⁹ 12 U.S.C. 5464(a)(2).

agency. Section 805(b) of the Clearing Supervision Act²⁰ states that the objectives and principles for 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 Clearing Supervision Act and the Exchange Act in furtherance of these objectives and principles.²¹ Rule 17Ad-22 requires registered clearing agencies, like OCC, to establish, implement, maintain, and enforce written policies and procedures that are reasonably designed to meet certain minimum requirements for their operations and risk management practices on an ongoing basis.²² Therefore, the Commission has stated²³ that it believes it is appropriate to review changes proposed in advance notices against Rule 17Ad-22 and the objectives and principles of these risk management standards as described in Section 805(b) of the Clearing Supervision Act.²⁴

OCC believes the proposed changes are consistent with the objectives and

²⁰ 12 U.S.C. 5464(b).

²¹ 17 CFR 240.17Ad-22. See Exchange Act Release Nos. 68080 (October 22, 2012), 77 FR 66220 (November 2, 2012) (S7-08-11) (“Clearing Agency Standards”); 78961 (September 28, 2016), 81 FR 70786 (October 13, 2016) (S7-03-14) (“Standards for Covered Clearing Agencies”).

²² 17 CFR 240.17Ad-22.

²³ See, e.g., Exchange Act Release No. 86182 (June 24, 2019), 84 FR 31128, 31129 (June 28, 2019) (SR-OCC-2019-803).

²⁴ 12 U.S.C. 5464(b).

principles of Section 805(b) of the Clearing Supervision Act.²⁵ The proposed changes are generally designed to enhance OCC's overall framework for managing member defaults by mitigating credit and liquidity risks associated with the difference in timing between the close-out of a defaulting Clearing Member's stock loan positions with the auction of the remainder of its positions and ensuring that the close-out occurs within OCC's two-day liquidation time horizon. These proposed changes would help OCC avoid credit losses or liquidity shortfalls that could disrupt OCC's operations. In this way, OCC believes that the proposed enhancements to its overall framework for managing liquidity risk would improve OCC's resilience as a systemically important market utility by promoting robust risk management; promoting safety and soundness; reducing systemic risks; and supporting the stability of the broader financial system.

OCC also believes that the proposed changes are consistent with the risk management standards adopted by the Commission under Section 805(a)(2) of the Clearing Supervision Act;²⁶ specifically, Rule 17Ad-22(e)(13)²⁷ and Rule 17Ad-22(e)(23).²⁸ Rule 17Ad-22(e)(13) requires covered clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to, in part, ensure the covered clearing agency has the authority and operational capacity to take timely action to contain losses and liquidity demands and continue to meet its

²⁵ Id.

²⁶ 12 U.S.C. 5464(a)(2).

²⁷ 17 CFR 240.17Ad-22(e)(13).

²⁸ 17 CFR 240.17Ad-22(e)(23)

obligations in the event of a Clearing Member default.²⁹ By more closely aligning the close-out of stock loan positions with the close-out of other positions, these proposed changes to OCC's default management processes would help mitigate credit and liquidity risks should the price of the stock loan positions move unfavorably between the time of auction and determination of the final settlement price for remaining buy-in/sell-out transactions and should that price differential exceed the amount of margin on deposit for such positions. In addition, the proposed changes would give OCC the authority and operational capacity to take timely action to contain credit losses by authorizing OCC to cash settle positions by the close of OCC's two-day liquidation time horizon should a non-defaulting Clearing Member fail to report buy-in or sell-out transactions as instructed. For these reasons, OCC believes the proposed changes are reasonably designed to ensure that OCC's default management processes contain losses and liquidity demands and continue to meet settlement demands in the event of a Clearing Member default.

In addition, Rule 17Ad-22(e)(23) requires covered clearing agencies to maintain written policies and procedures reasonably designed to, among other things, provide for publicly disclosing all relevant rules and material procedures, including key aspects of its default rules and procedures.³⁰ The proposed changes would amend OCC's Rules, which are available on OCC's websites, to provide for the new deadline for non-defaulting Clearing Members to buy-in or sell-out if so instructed by OCC in the event of a Clearing Member default, as well as how OCC would close out a stock loan position if a non-

²⁹ 17 CFR 240.17Ad-22(e)(13).

³⁰ 17 CFR 240.17Ad-22(e)(23).

defaulting Clearing Member failed to do so. Therefore, OCC believes the proposed changes would disclose default rules and procedures to the public and to Clearing Members so that they can understand their obligations in the event of a Clearing Member default.

For the foregoing reasons, OCC believes that the proposed changes are consistent with Section 805(b) of the Clearing Supervision Act³¹ and Rules 17Ad-22(e)(13)³² and (e)(23)³³ under the Exchange Act.

III. Date of Effectiveness of the Advance Notice and Timing for Commission Action

The proposed change may be implemented if the Commission does not object to the proposed change within 60 days of the later of (i) the date the proposed change was filed with the Commission or (ii) the date any additional information requested by the Commission is received. OCC shall not implement the proposed change if the Commission has any objection to the proposed change.

The Commission may extend the period for review by an additional 60 days if the proposed change raises novel or complex issues, subject to the Commission providing the clearing agency with prompt written notice of the extension. A proposed change may be implemented in less than 60 days from the date the advance notice is filed, or the date further information requested by the Commission is received, if the Commission notifies the clearing agency in writing that it does not object to the proposed change and authorizes the clearing agency to implement the proposed change on an earlier date,

³¹ 12 U.S.C. 5464(b).

³² 17 CFR 240.17Ad-22(e)(7).

³³ 17 CFR 240.17Ad-22(e)(23).

subject to any conditions imposed by the Commission.

OCC shall post notice on its website of proposed changes that are implemented. The proposal shall not take effect until all regulatory actions required with respect to the proposal are completed.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the advance notice is consistent with the Clearing Supervision 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-2020-805 on the subject line.

Paper Comments:

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

All submissions should refer to File Number SR- OCC-2020-805. 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 advance notice that are filed with

the Commission, and all written communications relating to the advance notice 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 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the self-regulatory organization.

All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly.

All submissions should refer to File Number SR- OCC-2020-805 and should be submitted on or before [insert date 15 days from publication in the Federal Register].

By the Commission.

J. Matthew DeLesDernier
Assistant Secretary