

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-72717; File No. SR-OCC-2014-14)

July 30, 2014

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing of Proposed Rule Change to Better Manage Risks Concentration and Other Risks Associated with Accepting Deposits of Common Stocks for Margin Purposes

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 July 15, 2014, The Options Clearing Corporation (“OCC”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I and II below, which Items have been prepared by the clearing agency.³ 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 better manage concentration and other risks (i.e., wrong-way risk) associated with accepting deposits of common stock for margin purposes. In order to manage such risks, OCC proposes to add an proposed Interpretation and Policy that will provide OCC with discretion with respect to giving value to margin collateral deposited by a single clearing member.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ OCC also filed the proposed rule change as an advance notice under Section 806(e)(1) of Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act entitled the Payment, Clearing, and Settlement Supervision Act of 2010. 12 U.S.C. 5465(e)(1). *See* SR-OCC-2014-803.

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

The purpose of this proposed rule change is to permit OCC to better manage concentration risk and other risks (i.e., wrong-way risk) associated with accepting deposits of common stock for margin purposes.⁴ Accordingly, in order to manage such risks, OCC proposes to add 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 proposes to make 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.

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. Common stocks, including Exchange Traded Funds ("ETFs") and Exchange

⁴ This proposed rule change has also been filed as an advance notice filing (SR-OCC-2014-803).

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). Since 2009, OCC has used STANS, its 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.

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

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

shares of common stock that serve as a hedge to the clearing member's related open positions and would otherwise be not be given margin credit.⁶

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 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 is broad in its application since such authority only provides OCC with the discretion to not give value across all clearing member deposits of a particular common stock.

⁶ 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 also has developed certain automated processes as well as additional internal policies that describe how OCC presently intends to exercise such discretion. 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.

However, concentration risk may be a clearing 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 proposes to add 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.

For the 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.⁷ 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.⁸ 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).

OCC staff has been monitoring concentrated common stock positions, assessing the impact of the proposed rule change described in this filing and contacting clearing members affected by the proposed rule change. OCC believes that clearing members will be able to comply with the proposed rule 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. Since January 2014, staff has been in contact with any clearing member that would be affected by the proposed rule 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

⁷ OCC believes that this policy is consistent with proposed Rule 17Ad-22(e)(5), which requires covered clearing agencies to set and enforce concentration limits to manage its or its participant's credit exposure. *See* 79 FR 16866, 16972 (March 26, 2014).

⁸ Since the 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.

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 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.

Wrong-Way Risk

OCC is also proposing to 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.” 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 proposes to 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.⁹

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. 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 due to wrong-way risk considerations, as described above.¹⁰

Deposits That Hedge Open Positions

In addition to the above, OCC also proposes to 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

⁹ This standard is based on the provisions of OCC Rule 215(a)(5).

¹⁰ 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 rule change once it is approved.

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 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”¹¹ for the particular common stock, taking into account the hedging position.¹² 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

¹¹ 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.

¹² 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.

policy will also facilitate OCC's management of its and its participants' credit exposure¹³ as well as the liquidation of a clearing member's portfolio should the need arise.

Other Proposed Changes

OCC is also proposing to make certain clarifying changes in order to accommodate the adoption of the Interpretation into its Rules. Primarily, OCC proposes to add 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 proposes to remove 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 proposes to renumber the Interpretations and Policies of Rule 604 in order to accommodate the adoption of the Interpretation.

2. Statutory Basis

OCC believes that the proposed rule change is consistent with Section 17A(b)(3)(F) of the Act¹⁴ because it will assure the safeguarding of securities and funds which are in the custody and control of OCC. In addition, the proposed rule change will promote the prompt and accurate clearance and settlement of securities transactions for which it is responsible. OCC believes that the proposed changes to its margin policy, as

¹³ OCC also believes that this policy is consistent with proposed Rule 17Ad-22(e)(5). *See* Fn.6, *supra*.

¹⁴ 15 U.S.C. 78q-1(b)(3)(F).

described above, will 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. For the same reasons, the proposed rule change will promote confidence that OCC will be able to timely meet its settlement obligations because the proposed rule change will diminish the likelihood a large percentage of a defaulting clearing member's margin assets would not be available to OCC in the event of a clearing member default. The proposed rule change is not inconsistent with any existing OCC By-Laws or Rules, including those proposed to be amended.

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

OCC believes that the proposed rule change would impose a burden on competition, and that such burden is appropriate in furtherance of the purposes of the Act.¹⁵ As state [sic] above, the proposed rule change will affect the composition of certain clearing members' margin deposits. Clearing members may be required to modify their business practices and potentially incur costs in doing so. However, the proposed rule change will not place a significant burden on clearing members, will better assure the safeguarding of securities and funds in OCC's custody and control and promote the prompt and accurate clearance and settlement of securities transactions for which it is responsible. By implementing the proposed rule change, it is less likely OCC will experience negative consequences due to exposure to a concentrated position of common stock deposited as margin by any clearing member as well as due to any wrong-way risk presented by a clearing member default. Accordingly, the proposed rule change

¹⁵ 15 U.S.C. 78q-1(b)(3)(I).

contributes to the goal of OCC's financial stability in the event of clearing member default.

Moreover, and after implementation of the proposed rule change, OCC will still accept a large variety of common stocks as margin collateral, and no clearing member has indicated to OCC that it will have difficulty satisfying its margin requirement(s) once OCC implements the proposed rule change. Therefore, OCC believes that any burden on competition imposed by the proposed rule change is appropriate in furtherance of the purposes of the Act.

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

The proposal shall not take effect until all regulatory actions required with respect to the proposal are completed.¹⁶

¹⁶ OCC also filed the proposed rule change as an advance notice under Section 806(e)(1) of Title VIII of the Dodd-Frank Wall Street Reform and Consumer

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-2014-14 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-2014-14. 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,

Protection Act entitled the Payment, Clearing, and Settlement Supervision Act of 2010. See supra note 3.

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

(http://www.theocc.com/components/docs/legal/rules_and_bylaws/sr_occ_14_14.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-2014-14 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.¹⁷

Kevin M. O'Neill
Deputy Secretary

¹⁷ 17 CFR 200.30-3(a)(12).