

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-88654; File No. SR-OCC-2020-004)

April 15, 2020

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing of Proposed Rule Change to Modify the Sequence for Processing Options Transactions

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 April 6, 2020, 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

This proposed rule change by OCC would amend Interpretations and Policies .04 to Rule 801 and Interpretations and Policies .04 to Rule 805 to describe a proposed change to the sequence in which options transactions are processed, as described below. The proposed changes to OCC’s Rules are included in Exhibit 5 of the filing. 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.³

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ OCC’s By-Laws and Rules can be found on OCC’s public website: <http://optionsclearing.com/about/publications/bylaws.jsp>.

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

Background

OCC currently processes all securities and commodity futures options transactions in the following order:⁴

Options Processing Sequence for All Accounts

Opening Buys
Opening Sells
Closing Buys
Exercises
Closing Sells
Assignments

Based on discussions with Clearing Members, OCC is proposing to modify the sequence in which options transactions are processed at OCC for all account types to provide that

⁴ A “commodity future” is defined in Article I(c)(24) of By-Laws as “a futures contract within the exclusive jurisdiction of the Commodity Futures Trading Commission that is traded on, through the facilities of, or subject to the rules of a futures market.” Options on securities futures currently do not exist.

all sell transactions are processed before exercises (i.e., closing sells would be processed before exercises under the proposed change).⁵ For instance, for securities options transactions, this proposal would change the order in which such transactions are processed in “customers’ accounts,” “firm accounts,” and “Market-Maker accounts” such that all sell transactions are processed prior to exercises.⁶ OCC is proposing to amend Interpretations and Policies .04 to Rule 801 and Interpretations and Policies .04 to Rule 805 to reflect this change in the processing sequence for options transactions.

This proposed change is made possible by increased proficiency in Clearing Member position processing and is intended to help Clearing Members comply with certain exchange requirements that are described below.⁷ OCC’s current processing sequence was adopted at a time when trade processing was a far different process than it is today. OCC used to receive a batch file from each exchange at the end of the trading day showing the trades that had been executed on the exchange that day. OCC would then process those trades on a batch basis prior to the open of trading the following

⁵ Opening buys increase long positions and closing sells decrease long positions. Opening sells increase short positions and closing buys decrease short positions.

⁶ OCC Clearing Members hold omnibus accounts at OCC for customer positions (i.e., a “customers’ account” as defined in Article I, Section 1.C.(37) of the By-Laws) to the extent they conduct a customer business. They also hold omnibus accounts at OCC for non-customer positions (i.e., a “firm account” as defined in Article I, Section 1.F.(6) of the By-Laws) to the extent they conduct a proprietary business. To the extent they clear for Market-Makers, they also hold “Market-Maker accounts” as defined in Article I, Section 1.M.(1) of the By-Laws.

⁷ The proposed rule change also is designed to help facilitate the ability to run OCC’s current clearing system, known as ENCORE, in parallel with a new clearing system on which OCC is working, as the proposed processing sequence is the one expected to be used in the new clearing system. As OCC’s core clearing system, ENCORE processes trades received from OCC’s participant exchanges and settlements among OCC’s Clearing Members.

business day. Now, OCC receives, and Clearing Members can see, trades executed on an exchange on a near real-time basis.⁸ Clearing Members utilize this information as well as certain tools provided by OCC (described below) to balance exercise notices against existing long positions during the trading day.

Customers' and Firm Account Processing for Securities Options Transactions

As noted, OCC's current processing sequence has been in place for many years and was designed when options transactions were processed on a batch basis. It originally was designed to protect a Clearing Member against the risk that an erroneously coded transaction could result in the Clearing Member not exercising a customer's long position. In particular, because the vast majority of customer securities options positions are maintained on a gross basis at OCC, a miscoded sell transaction of one customer could close out a long position in the same series of another customer, thereby preventing that customer from exercising that option.⁹ For example, Customer A and Customer B use the same Clearing Member. Customer A wants to exercise a long position, and on the same day Customer B directs the Clearing Member to execute an opening sell. If the Customer B trade is erroneously marked as a closing sell, the long position that Customer A seeks to exercise could be closed out by that closing sell and thus be unavailable for exercise.

Processing exercises before closing sells ensured that all intended exercises would be processed irrespective of a mismarked customer transaction. OCC believes this is no longer necessary due to increased proficiency in Clearing Member position processing.

⁸ This functionality has been available in ENCORE since 2002.

⁹ There are a small subset of customer and firm sub-accounts that have elected to be held on a net basis. These accounts are discussed below.

In particular, Clearing Members now have the ability to use certain functions provided by OCC to confirm that submitted exercises have sufficient long positions. These functions include a screen in OCC's ENCORE clearing system called the Exercise screen that shows Clearing Members during a trading day whether they have "Insufficient Longs" (i.e., insufficient long positions) for the exercise notices they have received during that trading day.¹⁰ These functions also include OCC's On Demand Position file ("ODP") that allows Clearing Members during a trading day to balance long positions versus exercises that are received during that trading day to ensure that the Clearing Members have sufficient long positions for those exercises. In addition, they have the ability to correct open/close errors by entering a position adjustment in ENCORE prior to exercises being processed. In the example above, where Customer B's trade is erroneously marked as a closing sell, Customer A's long position could be closed out by that closing sell and thus be unavailable for exercise. Position Adjustments allow a firm to correct open/close errors associated with a trade. This correction functionality can only be used for non-critical aspects of a trade and cannot be used, for instance, to change the price, symbol or other critical aspects of a trade.

Clearing Members have indicated that they believe this change will help them comply with certain exchange rules that require customers to only exercise "outstanding" net long positions. As an example, BATS Rule 23.1(a) provides that, "an outstanding options contract may be exercised during the time period specified in the Rules of [OCC] by the tender to [OCC] of an exercise notice in accordance with the Rules of [OCC]."¹¹

¹⁰ See supra note 7.

¹¹ See also FINRA Rule 2360 (b)(23), NYSE American Options Rule 980(a), and NYSE Arca Rule 6.24-O(a).

BATS Rule 16.1(a)(43) defines “outstanding” as “an options contract which has been issued by [OCC] and has neither been the subject of a closing writing transaction nor has reached its expiration date.” Clearing Members have indicated that issues could arise under the rule in situations where a customer position is subject to conflicting closing sale and exercise instructions, which could lead to a position being exercised that was intended to be closed out under OCC’s current processing sequence.

Market Maker and Other Net Account Processing for Securities Options Transactions

The processing sequence set forth above for customer and firm accounts also applies to Market-Maker accounts held by Clearing Members. Market-Maker accounts, however, are held on a net basis. This means that at the end of each trading day, OCC nets offsetting positions in the same options series in each Market-Maker account.¹² Prior to 2014, this netting occurred at the end of the processing sequence immediately before assignments.

In response to operational risk concerns related to the processing of dividend play transactions by Market-Makers, a modification to OCC’s systems was approved by OCC’s Board of Directors to insert a step in the processing sequence that would limit

¹² A few Clearing Members have established the functionality to designate sub-accounts within their omnibus customer and firm accounts held at OCC. These sub-accounts are established for a specific customer or joint back office account and the account holders can elect to hold these accounts on a net basis to assist with the position reconciliation process. When the account holders elect to hold the accounts in this manner, they are subject to the same netting process to which Market-Maker accounts are subject. See Interpretation and Policy .04 to Article VI, Section 3 of OCC’s By-Laws.

Market-Maker exercises to net long positions.¹³ From a systems perspective, this change was implemented by moving up the netting in the processing sequence such that it occurred before exercises, as set forth below.

Options Processing Sequence for Market Maker and Other Net Accounts

Opening Buys
Opening Sells
Closing Buys
Net Positions in Net Accounts (location after 2014 change)
Exercises
Closing Sells
~~Net Positions in Net Accounts~~ (location prior to 2014 change)
Assignments

From a Rules perspective, this change was implemented by adopting Interpretations and Policies .04 to Rule 801 and Interpretations and Policies .04 to Rule 805.¹⁴ In relevant part, these provisions provide that, “[w]ith respect to any Market-Maker account, the Corporation shall process sell transactions in respect of option contracts prior to exercises in respect of such contracts.” Despite this rule text, as indicated in the net processing sequence list immediately above, closing sells continued to be processed after exercises for Market-Maker and other net accounts after the 2014 change. As described below, the proposed change to the options processing sequence that is the subject of this rule filing would modify the sequence for all accounts, including Market-Maker and other net accounts, such that closing sells would be processed before exercises.

¹³ A dividend play is a trading strategy that historically was primarily engaged in by Market-Makers and involved buying and selling an equal number of call options right before a dividend date on the underlying equity and exercising the long call options with the goal of capturing the dividend on the underlying equity.

¹⁴ See Exchange Act Release No. 73438 (October 27, 2014), 79 FR 64843 (October 31, 2014) (SR-OCC-2014-15).

Customer and House Account Processing for Options on Commodity Futures

While OCC currently uses the same processing sequence for options on commodity futures, OCC understands that futures customers and Clearing Members are indifferent to the processing sequence for futures transactions. Futures firms submit very few trades marked as closing transactions, and as a result, are accustomed to submitting nightly adjustments to correct their open interest. This process reduces the potential of an exercise error since the firms verify their long positions on a daily basis.

Proposed Change to Processing Sequence

OCC proposes to modify the processing sequence for all securities and futures options transactions for all account types to process all **closing sell** transactions prior to all **exercise** transactions. The proposed processing sequence is set forth below.

Proposed Options Processing Sequence for All Accounts

Opening Buys
Opening Sells
Closing Buys
Closing Sells
Exercises
Assignments

For Market-Maker and other accounts held on a net basis, OCC proposes to net offsetting positions after closing sells but before exercises. Each Market-Maker account is held individually (i.e., on a Market-Maker by Market-Maker basis) at a Clearing Member on a net basis, unlike customer accounts. Holding each Market-Maker account in this manner helps with the position reconciliation process at Market-Makers and allows them to see a single net position in each options series for risk management purposes.

OCC has discussed the proposed change with its Clearing Members at the OCC Roundtable, which is an OCC-sponsored advisory group comprised of representatives

from OCC's participant exchanges, a cross-section of OCC Clearing Members, and OCC staff, and during regular monthly operations update calls with Clearing Members and exchanges.¹⁵ OCC also issued Information Memos on its public website to inform Clearing Members of the proposed change.¹⁶ Based upon the feedback from these discussions, OCC believes that its current processing sequence for options transactions no longer needs to be designed to protect Clearing Members from errors in customers' accounts that would result in closing out a position that was intended to be exercised. As noted, Clearing Members have increased their position processing proficiency and can now use OCC tools to confirm that submitted exercises have sufficient long positions. They also have the ability to correct any errors prior to exercises being processed. Clearing Members also have indicated that they believe this change will help them comply with certain exchange rules that require customers to exercise only "outstanding" net long positions. By processing all buys and sells prior to exercises, they believe that the proposed change would help address situations in which a customer position is subject to conflicting closing sale and exercise instructions, which could lead to a position being exercised that was intended to be closed out under the current processing sequence.

¹⁵ OCC provided supplemental materials to its Clearing Members after the August 2019 Monthly Operations Update meeting to help illustrate the proposed change in the processing sequence. OCC provided these materials as Exhibit 3A to File No. SR-OCC-2020-004.

¹⁶ See OCC Information Memo #45781, dated October 9, 2019, and Information Memo #46129, dated December 10, 2019. OCC provided these Information Memos as Exhibits 3B and 3C to File No. SR-OCC-2020-004.

(2) Statutory Basis

Section 17A(b)(3)(F) of the Act¹⁷ requires, among other things, that the rules of a clearing agency be designed to promote the prompt and accurate clearance and settlement of securities and derivatives transactions. OCC believes that the proposed rule change will promote the prompt and accurate clearance and settlement of securities transactions. In this regard, the proposed rule change would provide for the processing of closing sell transactions prior to exercises, which OCC's Clearing Members have indicated would help promote compliance with exchange rules noted above that require that only outstanding options positions be exercised. As indicated above, OCC's system no longer needs to be designed to protect Clearing Members from customer transaction marking errors in which a sell transaction is miscoded as a closing sell transaction. The near real-time processing of options transactions by OCC and OCC tools have helped Clearing Members increase their position processing proficiency. The proposed change to the position processing sequence would result in OCC's system allowing only net long positions to be exercised in all accounts, including individual customer accounts. This result is designed to promote compliance with exchange rules and further the goal of promoting the prompt and accurate clearance and settlement of securities transactions.

In addition, the proposed rule change is not inconsistent with the existing By-Laws and Rules of OCC, including any rules proposed to be amended

¹⁷ 15 U.S.C. 78q-1(b)(3)(F).

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

Section 17A(b)(3)(I) of the Act¹⁸ requires that the rules of a clearing agency not impose any burden on competition not necessary or appropriate in furtherance of the Act. OCC does not believe that the proposed rule change would impact or impose any burden on competition. The proposed rule change would not affect the competitive dynamics between Clearing Members in that it would apply to all Clearing Members equally. The proposed rule change also would not inhibit access to OCC's services or disadvantage or favor any particular user in relationship to another. In this regard, as described above, the proposed rule change is designed to further facilitate the prompt and accurate clearance and settlement of securities transactions. It would change the processing sequence so that closing sells are processed before exercises, which would ensure from a systematic perspective that only net long positions can be exercised.

(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 the proposed rule change, or

¹⁸ 15 U.S.C. 78q-1(b)(3)(I).

(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-2020-004 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-2020-004. 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 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of OCC and on OCC's website at

<https://www.theocc.com/about/publications/bylaws.jsp>.

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-2020-004 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.¹⁹

J. Matthew DeLesDernier
Assistant Secretary

¹⁹ 17 CFR 200.30-3(a)(12).