

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-88989; File No. SR-OCC-2020-004)

June 2, 2020

Self-Regulatory Organizations; The Options Clearing Corporation; Order Approving Proposed Rule Change to Modify the Sequence for Processing Options Transactions

I. INTRODUCTION

On April 6, 2020, the Options Clearing Corporation (“OCC”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change SR-OCC-2020-004 (“Proposed Rule Change”) pursuant to Section 19(b) of the Securities Exchange Act of 1934 (“Exchange Act”)¹ and Rule 19b-4² thereunder to describe a change to the sequence in which options transactions are processed.³ The Proposed Rule Change was published for public comment in the Federal Register on April 21, 2020.⁴ The Commission has received no comments regarding the Proposed Rule Change. This order approves the Proposed Rule Change.

II. BACKGROUND

Currently, OCC processes all securities and commodity futures options transactions in the following sequence:⁵ (1) Opening Buys; (2) Opening Sells; (3) Closing Buys; (4) Exercises; (5)

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Notice of Filing infra note 4, 85 Fed. Reg. at 22197.

⁴ Securities Exchange Act Release No. 88654 (Apr. 15, 2020), 85 Fed. Reg. 22197 (Apr. 21, 2020) (File No. SR-OCC-2020-004) (“Notice of Filing”).

⁵ 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. See https://www.theocc.com/components/docs/legal/rules_and_bylaws/occ_bylaws.pdf.

Closing Sells; and (6) Assignments. As discussed below, OCC's Clearing Members indicated that the current processing sequence could raise issues related to compliance with exchange rules requiring that firms exercise only "outstanding" net long positions.⁶ OCC proposes to change the order in which it processes such transactions by moving "Closing Sells" ahead of "Exercises," which would result in the following sequence: (1) Opening Buys; (2) Opening Sells; (3) Closing Buys; (4) *Closing Sells*; (5) *Exercises*; and (6) Assignments. The current processing sequence was designed to protect Clearing Members against certain errors; however, OCC believes that operational changes as well as increased Clearing Member proficiency in trade processing warrants a change to the processing sequence to reflect the tools OCC offers its Clearing Members as well as increased Clearing Member proficiency.⁷

Current Processing Sequence

The current processing sequence was designed to protect against the risk that an erroneously coded transaction could prevent a Clearing Member from appropriately exercising a long position. 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, which would prevent the latter from exercising the long position. Processing closing sell transactions after exercises avoids the prevention of exercises by erroneously coded sell transactions.

Market-Maker and Other Net Accounts: The current processing sequence applies to firm, customer, and Market-Maker accounts. The processing sequence for Market-Maker accounts,

⁶ See Notice of Filing, 85 Fed. Reg. at 22198.

⁷ See id.

however, includes one additional step because Market-Maker accounts are held on a net basis.⁸

At the end of each trading day, OCC nets offsetting positions in the same options series in each Market-Maker account. OCC nets offsetting positions before processing the exercise of long positions.⁹ From a systems perspective, this means that the current processing sequence for Market-Maker accounts is as follows: (1) Opening Buys; (2) Opening Sells; (3) Closing Buys; (4) *Position Netting*; (5) Exercises; (6) Closing Sells; and (7) Assignments.

Clearing Members have visibility into the trade information that OCC receives, which is now available in near real-time.¹⁰ OCC provides for visibility through a screen in ENCORE and an On Demand Position file provided to Clearing Members, both of which allow Clearing Members to evaluate the availability of long positions to cover exercises notices. OCC also

⁸ As noted above, the vast majority of customer accounts are maintained on a gross basis. 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 available at https://www.theocc.com/components/docs/legal/rules_and_bylaws/occ_bylaws.pdf.

⁹ OCC represented that netting before exercise is designed to address operational risk concerns related to the processing of dividend play transactions by Market-Makers. See Notice of Filing, 85 Fed. Reg. at 22198. 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.

¹⁰ When the current processing sequence was adopted, OCC received trades in a batch file from each exchange at the end of the trading day. OCC would then process trades on a batch basis prior to the opening of trading the following business day. In contrast, OCC now receives trade information on a near real-time basis. The functionality to receive trades on a near real-time basis has been available through OCC's ENCORE clearing system since 2002. See id.

permits Clearing Members to adjust positions for the purpose of correcting the miscoding errors as described above. Specifically, Clearing Members may correct such errors by entering a position adjustment in ENCORE prior to exercises being processed.¹¹

Additionally, OCC's Clearing Members have indicated that the current processing sequence could raise issues related to compliance with exchange rules requiring that firms exercise only "outstanding" net long positions.¹² Clearing Members have indicated that a customer position could be subject to conflicting closing sale and exercise instructions. Under OCC's current processing sequence, such instructions could lead to a position that was intended to be closed out being exercised instead.

Proposed 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.¹³ OCC proposes to change the order in which it processes such transactions by

¹¹ OCC allows Clearing Members to make such position adjustment only for non-critical aspects of a trade. For example, a Clearing Member would not be permitted to change the price or symbol of a trade.

¹² See Notice of Filing, 85 Fed. Reg. at 22198. The rules of one exchange provide 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]." NYSE Arca Rule 6.24-O(a). See also FINRA Rule 2360 (b)(23) and NYSE American Options Rule 980(a). An "outstanding" contract is "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." NYSE Arca Rule 6.1-O(b)(26). See also FINRA Rule 2360 (a)(26).

¹³ OCC currently uses the same processing sequence for options on commodity futures; however, OCC understands that futures customers and Clearing Members are indifferent to the processing sequence for futures transactions. See Notice of Filing, 85 Fed. Reg. at 22199. Futures firms submit very few trades marked as closing transactions, and as a result, submit nightly adjustments to correct their open interest, which, in turn reduces the

moving “Closing Sells” ahead of “Exercises,” which would result in the following sequence: (1) Opening Buys; (2) Opening Sells; (3) Closing Buys; (4) *Closing Sells*; (5) *Exercises*; and (6) Assignments. For Market-Maker and other accounts held on a net basis, OCC proposes to net offsetting positions after closing sells but before exercises.

OCC discussed the current processing sequence and the Proposed Rule Change with its Clearing Members at the OCC Roundtable, an OCC-sponsored advisory group comprised of representatives from OCC’s participant.¹⁴ Based upon those 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.¹⁵ Further, OCC represented that Clearing Members believe the Proposed Rule Change would help them comply with certain Exchange rules that require customers to exercise only “outstanding” net long positions.¹⁶ As noted, Clearing Members now have visibility into near real-time trade data and the ability to adjust positions prior to exercise to correct errors in the coding of non-critical aspects of a trade, which was not available when the current processing sequence was established.

potential of an exercise error since the firms verify their long positions on a daily basis. Id.

¹⁴ The OCC Roundtable is made up of Exchanges, a cross-section of OCC Clearing Members, and OCC staff who hold regular monthly operations update calls.

¹⁵ See Notice of Filing, 85 Fed. Reg. at 22199.

¹⁶ See Notice of Filing, 85 Fed. Reg. at 22199. By processing all buys and sells prior to exercises, Clearing Members believe that the proposed processing sequence 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. Id.

III. DISCUSSION AND COMMISSION FINDINGS

Section 19(b)(2)(C) of the Exchange Act directs the Commission to approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to such organization.¹⁷ After carefully considering the Proposed Rule Change, the Commission finds that the proposal is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to OCC. More specifically, the Commission finds that the proposal is consistent with Section 17A(b)(3)(F) of the Exchange Act.¹⁸

A. Consistency with Section 17A(b)(3)(F) of the Exchange Act

Section 17A(b)(3)(F) of the Exchange Act requires, among other things, that the rules of a clearing agency be designed to promote the prompt and accurate clearance and settlement of securities transactions.¹⁹ Based on its review of the record, the Commission believes that modifying OCC's processing sequence for all securities and futures options transactions as described above is consistent with the promotion of prompt and accurate clearance and settlement of securities transactions for the reasons described below.

Clearing Members have raised concerns regarding their ability to comply with exchange rules given OCC's current processing sequence. Specifically, exchanges require market participants to exercise only outstanding net long positions. Processing exercises after buys and sells could 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

¹⁷ 15 U.S.C. 78s(b)(2)(C).

¹⁸ 15 U.S.C. 78q-1(b)(3)(F).

¹⁹ 15 U.S.C. 78q-1(b)(3)(F).

closed out.

The current processing sequence was designed to ensure that a market participant would be able to exercise its long positions even if a trade has been miscoded. The need for such protections, however, arose at a time when trades were received and processed in a batch at the end of the day. Visibility into the near real-time trade information provided to OCC allows Clearing Members to better understand the long positions available for exercise and to correct coding errors through position adjustments.

Further, as noted above, OCC's determination to propose a change to its current processing sequence was supported by discussions with Clearing Members at the OCC Roundtable and during regular monthly operations update calls with Clearing Members and exchanges. Given the position adjustment tools available to Clearing Members to address miscoded transactions, the Commission believes that revising OCC's processing sequence to facilitate compliance with exchange rules would promote the prompt and accurate clearance and settlement of securities transactions. The Commission believes, therefore, that the proposed processing sequence is consistent with the requirements of Section 17A(b)(3)(F) of the Exchange Act.²⁰

²⁰ 15 U.S.C. 78q-1(b)(3)(D).

IV. CONCLUSION

On the basis of the foregoing, the Commission finds that the Proposed Rule Change is consistent with the requirements of the Exchange Act, and in particular, the requirements of Section 17A of the Exchange Act²¹ and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Exchange Act,²² that the Proposed Rule Change (SR-OCC-2020-004) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²³

J. Matthew DeLesDernier
Assistant Secretary

²¹ In approving this Proposed Rule Change, the Commission has considered the proposed rules' impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

²² 15 U.S.C. 78s(b)(2).

²³ 17 CFR 200.30-3(a)(12).