

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-89393; File No. SR-OCC-2020-008)

July 24, 2020

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

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on July 14, 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 primarily 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

The proposed rule change would amend 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 action by the settlement time for a Clearing Member's obligations to OCC on the business day after OCC gives the

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

instruction.<sup>3</sup> 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.<sup>4</sup>

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

OCC proposes amendments to OCC Rules 2211 and 2211A designed to ensure that OCC has authority and operational capacity to take timely action to contain losses

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<sup>3</sup> "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.

<sup>4</sup> OCC's By-Laws and Rules can be found on OCC's public website: <http://optionsclearing.com/about/publications/bylaws.jsp>.

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.<sup>5</sup> As the principal counterparty to the

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<sup>5</sup> 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").

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.<sup>6</sup> 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 Margin<sup>7</sup> and Clearing Fund contribution requirements.<sup>8</sup>

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 opening on the day after a default occurs.<sup>9</sup> 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.<sup>10</sup>

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<sup>6</sup> Under the Market Loan Program, OCC also provides a limited guaranty of dividend and rebate payments.

<sup>7</sup> See OCC Rules 601 and 2203.

<sup>8</sup> See OCC Rule 1001.

<sup>9</sup> 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.

<sup>10</sup> 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

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.<sup>11</sup> 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.<sup>12</sup>

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 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

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to be the most orderly manner practicable under the circumstances. OCC Rules 2210(b) and 2210A(b).

<sup>11</sup> 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).

<sup>12</sup> Id.

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,<sup>13</sup> 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 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

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<sup>13</sup> 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.

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.<sup>14</sup> 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.<sup>15</sup> 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 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.

#### (2) Statutory Basis

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<sup>14</sup> 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.

<sup>15</sup> OCC submitted the relevant portions of the presentation provided at the April 16, 2019 FRAC meeting in confidential Exhibit 3.



OCC believes the proposed rule change is consistent with Section 17A of the Exchange Act and the rules and regulations thereunder. In particular OCC believes that the proposed rule change is consistent with Section 17A(b)(3)(F)<sup>16</sup> of the Exchange Act and Rule 17Ad-22(e)(13)<sup>17</sup> and (e)(23)<sup>18</sup> thereunder for the reasons described below.

Section 17A(b)(3)(F) of the Exchange Act,<sup>19</sup> requires, among other things, that the rules of a clearing agency be designed to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible. The proposed rule change would help mitigate the potential credit and liquidity risks associated with the difference in timing between the close-out of a defaulting Clearing Member's stock loan positions by buy-in or sell-out transactions and the close-out of the remainder of its portfolio by auction. Furthermore, the proposed rule change would ensure that the close-out of stock loan positions is consistent with the two-day liquidation assumption upon which OCC's margin calculations rely. Therefore, OCC believes that the proposed rule change is consistent Section 17A(b)(3)(F) because it helps safeguard against the possibility that OCC would need to charge the Clearing Fund contributions of non-defaulting Clearing Members to meet settlement obligations in the event of a member default.

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

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<sup>16</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>17</sup> 17 CFR 240.17Ad-22(e)(13)

<sup>18</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>19</sup> 15 U.S.C. 78q-1(b)(3)(F).

timely action to contain losses and liquidity demands and continue to meet its obligations in the event of a Clearing Member default.<sup>20</sup> 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 change would give OCC the authority and operational capacity to take timely action to contain credit losses by authorizing OCC to cash-settle positions within OCC's two-day liquidation time horizon should a non-defaulting Clearing Member fail to report buy-in or sell-out transactions as instructed. Hence, OCC believes the proposed rule change is 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.

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.<sup>21</sup> The proposed rule 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-defaulting

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<sup>20</sup> 17 CFR 240.17Ad-22(e)(13).

<sup>21</sup> 17 CFR 240.17Ad-22(e)(23).

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.

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

Section 17A(b)(3)(I) of the Exchange Act requires that the rules of a clearing agency not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.<sup>22</sup> OCC does not believe that the proposed rule change would have any impact or impose any burden on competition. The proposed rules are generally designed to align the timeframe for buy-in or sell-out of stock loan positions more closely with the close-out of the defaulting Clearing Member's other positions by auction and to ensure the close-out of stock loan positions is consistent with OCC's two-day liquidation assumption. The new deadline for buy-in and sell-out transactions, as well as the rules governing the determination of the Marking Price when a Clearing Member fails to buy-in or sell-out as directed, would be equally applicable to all Clearing Members in OCC's Stock Loan Programs. Accordingly, OCC does not believe that the proposed rule change would have any impact or impose a burden on competition.

(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

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<sup>22</sup> 15 U.S.C. 78q-1(b)(3)(I).

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

(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 Exchange 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](mailto:rule-comments@sec.gov). Please include File Number SR-OCC-2020-008 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-2020-008. 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-2020-008 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.<sup>23</sup>

J. Matthew DeLesDernier  
Assistant Secretary

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<sup>23</sup> 17 CFR 200.30-3(a)(12).