

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-94910; File No. SR-OCC-2022-003)

May 13, 2022

Self-Regulatory Organizations; The Options Clearing Corporation; Order Granting Approval of Proposed Rule Change by The Options Clearing Corporation Concerning Cash-Settled FLEX ETF Options

I. INTRODUCTION

On March 16, 2022, the Options Clearing Corporation (“OCC”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change SR-OCC-2022-003 (“Proposed Rule Change”) pursuant to Section 19(b) of the Securities Exchange Act of 1934 (“Exchange Act”)¹ and Rule 19b-4² thereunder to amend various provisions of the OCC By-Laws and Rules to accommodate the issuance, clearance and settlement of flexibly structured options on exchange-traded funds (“fund shares” or “ETFs”) that are cash-settled (“Cash-Settled Flex ETF Options”).³ The Proposed Rule Change was published for public comment in the Federal Register on April 4, 2022.⁴ The Commission received no comments regarding the substance of the Proposed Rule Change.⁵ This order approves the Proposed Rule Change.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Notice of Filing infra note 4, 87 Fed. Reg. at 19566.

⁴ Securities Exchange Act Release No. 94542 (Mar. 29, 2022), 87 Fed. Reg. 19566 (Apr. 4, 2022) (File No. SR-OCC-2022-003) (“Notice of Filing”).

⁵ The Commission received one comment letter that addressed market conduct generally; however, additional discussion is unnecessary because the comment letter does not bear on the purpose or legal basis of the Proposed Rule Change. The comment on the Proposed Rule Change is available at <https://www.sec.gov/comments/sr-occ-2022-003/srocc2022003.htm>.

II. BACKGROUND⁶

The NYSE American Exchange (“NYSE American”) received approval to list Cash-Settled Flex ETF Options as a variation of the currently-traded, physically-settled equity flex options.⁷ Cash-Settled Flex ETF Options generally have the same characteristics as physically-settled equity flex options, except Cash-Settled Flex ETF Options are cash-settled, not physically-settled, with a settlement amount based on the difference between the price of the underlying security on the date of exercise and the strike price of the exercised option.

OCC submitted the Proposed Rule Change because its rules do not allow for the settlement of equity options in cash, except in two specific circumstances: (i) the underlying security undergoes a corporate action resulting in the conversion of the option deliverable to only cash,⁸ or (ii) the underlying security is otherwise unavailable for delivery.⁹ Within the By-Laws and Rules, certain provisions apply to physically-settled options and certain provisions apply to cash-settled options. To accommodate the Cash-Settled Flex ETF Option product, OCC proposes to revise its By-Laws and Rules to do the following: (i) make distinctions between Cash-Settled Flex ETF Options and physically-settled options on the same underlying security; (ii) clarify that certain provisions that currently apply only to physically-settled options will also apply to Cash-Settled Flex ETF Options; and (iii) exclude application of certain provisions to Cash-Settled Flex ETF Options that otherwise would apply to all cash-settled options.

⁶ Capitalized terms used but not defined herein have the meanings specified in OCC’s Rules and By-Laws, available at <https://www.theocc.com/about/publications/bylaws.jsp>.

⁷ Securities Exchange Act Release No. 88131 (Feb. 5, 2020), 85 Fed. Reg. 7806 (Feb. 11, 2020) (File No. SR-NYSEAmer-2019-038).

⁸ See OCC By-Laws Article VI, Section 11A, Interpretations and Policies .05.

⁹ See OCC By-Laws Article VI, Section 19(c).

OCC proposes the following modifications to its By-Laws to distinguish physically-settled flexibly structured options from Cash-Settled Flex ETF Options:

- In Article I (Definitions), Section 1(F)(8), OCC proposes to revise the definition of “Flexibly Structured Option” to (i) allow such options to be physically-settled or cash-settled depending on the listing exchange’s rules, and (ii) state that Cash-Settled Flex ETF Options would not be fungible with physically-settled flexibly structured options and would not be consolidated with standard options listed after a flexibly-structured option with the same strike, expiration date, and underlying security, as is the case with a physically-settled flexibly structured option that is fungible.
- In Article I (Definitions), Section 1(S)(12), OCC proposes to revise the definition of “Series” to state that the options of the same series have the same settlement method.
- In Article I (Definitions), Section 1(V)(1), OCC proposes to revise the definition of “Variable Terms” to recognize that in addition to the variable terms itemized in the definition, flexibly-structured options on fund shares may be either physically- or cash-settled.
- In Article XVII (Index Options and Certain Other Cash-Settled Options), Introduction, OCC proposes to revise the introduction to add flexibly-structured options that cash-settle to the list of options for which Article XVII of the By-Laws applies.
- In Article XVII (Index Options and Certain Other Cash-Settled Options), Section 1(C)(4), OCC proposes to revise the definition of “Class of Options” to state that flexibly-structured options that cash-settle shall constitute a different class of options from physically-settled options on the same underlying interest.

OCC also proposes the following modifications to its By-Laws and Rules to require the application of certain provisions to Cash-Settled Flex ETF Options that otherwise would apply only to physically-settled options, and to exclude Cash-Settled Flex ETF Options from certain provisions that otherwise would apply to all cash-settled options:

- In Article I (Definitions), Section 1(C)(15), OCC proposes to revise the definition of “Clearing Member” to state that a Clearing Member is not an “Index Clearing Member” solely by virtue of being approved to clear Cash-Settled Flex ETF Options.
- In Article I (Definitions), Section 1(R)(5), OCC currently defines “Reporting Authority” when used with respect of any cash-settled contract to mean the source that OCC uses as the official source for the current price or value of the underlying interest. OCC proposes to revise this definition to state that the reporting for Cash-Settled Flex ETF Options will be the same source used by OCC for physically-settled equity options with the same underlying interest. According to OCC, this change is designed to facilitate the use of the same closing price for automatic exercise determinations on both physically- and cash-settled options with the same underlying security, thereby ensuring that expiration processing for a Cash-Settled Flex ETF Option will align with expiration processing for a physically-settled product on the same underlying security.¹⁰
- In Article XVII (Index Options and Certain Other Cash-Settled Options), Section 1(R)(3), defines “Reporting Authority” specifically in the context of index options and certain other cash-settled options. OCC proposes to revise this definition to

¹⁰ See Notice of Filing, supra note 4, at 19567.

explicitly exclude Cash-Settled Flex ETF Options and to state that the reporting authority for Cash-Settled Flex ETF Options is the same source used by OCC for physically-settled equity options.

- Article XVII (Index Options and Certain Other Cash-Settled Options), Sections 3(a) and 3(h) currently state that the adjustment provisions of Article VI, Section 11A do not apply to cash-settled equity contracts. To ensure that adjustment decisions for Cash-Settled Flex ETF Options and physically-settled options on the same underlying are the same, OCC is proposing to add language to this section to state that Article VI, Section 11A of the By-Laws applies to Cash-Settled Flex ETF Options.
- Article XVII (Index Options and Certain Other Cash-Settled Options), Section 4(a)(2) states the method by which the exercise settlement amount for exercised contracts of an affected series is fixed for index options and certain other cash-settled options. OCC proposes to amend this provision to state that the exercise settlement amount for Cash-Settled Flex ETF Options shall be determined by using the last reported sale price for the underlying security during regular trading hours, which is consistent with the expiration closing price determination for physically-settled options under OCC's Rule 805(j).
- Chapter VI (Margins), Rule 610 (Deposits in Lieu of Margin) allows Clearing Members to use specific deposits of the underlying security as collateral to cover short customer positions on call options. Specific deposits fully cover a short call position because the Clearing Member pledges the security, in the appropriate amount, that must be delivered if the call option writer is assigned. OCC proposes to modify Rule 610 to disallow specific deposits for Cash-Settled Flex ETF Options

because such options do not require delivery of the underlying security upon assignment.¹¹

- Chapter VIII (Exercise and Assignment), Rule 805(j) (Expiration Exercise Procedure) states that the “closing price” used for any underlying security in Rule 805 is the last reported sale price for the underlying security during regular trading hours (as determined by OCC) on the trading day immediately preceding the expiration date, or on the expiration date if the expiration date is a trading day, on such national securities exchange or other domestic securities market as OCC shall determine. OCC proposes to revise Rule 805(j) to state explicitly that the same definition of “closing price” applies to underlying securities for Cash-Settled Flex ETF Options.
- Chapter XVIII (Index Options and Certain Other Cash Settled Options), Rule 1804(a) (Expiration Exercise Procedure for Cash-Settled Options) generally provides for the expiration exercise procedure for cash-settled options. OCC is proposing to add an interpretation and policy to Rule 1804 to clarify that, notwithstanding its general application to cash-settled options, the determination of the closing price for an underlying security of a flexibly-structured cash-settled equity option is the same as the determination of the closing price per Rule 805(j).
- In Chapter XVIII (Index Options and Certain Other Cash Settled Options), Rule 1804 (Expiration Exercise Procedure for Cash Settled Options), OCC proposes to revise Rule 1804(a) and Rule 1804(b) to state that Cash-Settled Flex ETF Options will be deemed exercised on expiration if the strike price is \$0.01 or more in-the-money in

¹¹ OCC would, however, allow escrow deposits to be made for Cash-Settled Flex ETF Options.

accordance with the provisions of Rule 805(d). The change would set the threshold for automatic exercise of Cash-Settled Flex ETF Options at the threshold established for physically-settled equity options rather than the \$1.00 per contract threshold established in Rule 1804.

- In Chapter VIII (Exercise and Assignment), Rule 805 (Expiration Exercise Procedure), Interpretation and Policy .03 states that the exercise procedures set forth in Rule 805 apply to flexibly-structured equity options. OCC proposes to add language excepting from application of Rule 805(d) American-style Cash-Settled Flex ETF Options subject to delayed settlement for any deliverable component. Similarly, in Chapter XVIII (Index Options and Certain Other Cash Settled Options), Rule 1804 (Expiration Exercise Procedure for Cash Settled Options), OCC is proposing to add language to Rule 1804(a) to state explicitly that Rule 805(d) does not apply to American-style Cash-Settled Flex ETF Options that have a deliverable component subject to delayed settlement. OCC states that the changes are necessary because any such option with a pended delivery component on its expiration date should not be automatically exercised, as the total value of the option deliverable can only be estimated.¹² OCC anticipates this outcome would be rare, and likely the result of a contract adjustment that involves cash in lieu of fractional shares that have yet to be finalized on an option's expiration date.

¹² See Notice of Filing, supra note 4, at 19568.

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.¹³ 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 Proposed Rule Change is consistent with Section 17A(b)(3)(F) of the Exchange Act¹⁴ as described in detail below.

Section 17A(b)(3)(F) of the Exchange Act requires, among other things, that a clearing agency's rules are designed to promote the prompt and accurate clearance and settlement of securities transactions and, to the extent applicable, derivative agreements, contracts, and transactions.¹⁵ Based on its review of the record, and for the reasons described below, the Commission believes that the proposed changes to its By-Laws and Rules are reasonably designed to be consistent with the prompt and accurate clearance and settlement of securities transactions and derivative agreements, contracts, and transactions for which OCC is responsible.

The Proposed Rule Change would amend the By-Laws and Rules to maintain consistency between OCC's By-Laws and Rules and NYSE American's rules as applied to the clearance and settlement of Cash-Settled Flex ETF Options. To maintain consistency with NYSE American's rules, the Proposed Rule Change ensures that OCC is able to provide two different types of

¹³ 15 U.S.C. 78s(b)(2)(C).

¹⁴ 15 U.S.C. 78q-1(b)(3)(F).

¹⁵ Id.

settlement methods for flexibly-structured ETF options, in order to accommodate the clearance and settlement of Cash-Settled Flex ETF Options in addition to physically-settled options.

Maintaining this congruence between OCC and NYSE American's rules provides assurance to market participants that the two self-regulatory organizations are treating the clearance and settlement processes of the Cash-Settled Flex ETF Option product in the same manner. This is consistent with facilitating the prompt and accurate clearance and settlement of these products.

OCC proposes numerous By-Law and Rule changes to distinguish between physically-settled flexibly structured options and Cash-Settled Flex ETF Options. The Commission believes that these changes will make clear to market participants that, despite certain similarities, these two products are entirely distinct and should be treated as such for clearance and settlement purposes. In particular, the Proposed Rule Change states that Cash-Settled Flex ETF Options are not fungible with physically-settled flexibly structured options, and that the two products are not to be consolidated even if they have the same strike, expiration date, and underlying security. As such, the proposed changes provide unambiguous requirements for clearing and settling such transactions, and the Commission believes that the resulting clarity may facilitate prompt and accurate clearance and settlement by avoiding confusion or errors.

Additionally, OCC proposes numerous By-Law and Rule changes to state that certain provisions that currently apply only to physically-settled options will also apply to Cash-Settled Flex ETF Options, while other provisions that currently apply to all cash-settled options will not apply to Cash-Settled Flex ETF Options. The proposed changes are designed to treat the Cash-Settled Flex ETF Options like all other Flex ETF options instead of as cash-settled options generally, given the difference in the form of settlement and the lack of fungibility. Accordingly,

the changes to OCC's By-Laws and Rules facilitate the prompt and accurate clearance and settlement of these transactions.

The Commission believes, therefore, that the proposal to revise OCC's By-Laws and Rules to accommodate the clearance and settlement of Cash-Settled Flex ETF Options is consistent with the requirements of Section 17A(b)(3)(F) under the Exchange Act.¹⁶

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 Act¹⁷ and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Exchange Act,¹⁸ that the Proposed Rule Change (SR-OCC-2022-003) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁹

J. Matthew DeLesDernier
Assistant Secretary

¹⁶ 15 U.S.C. 78q-1(b)(3)(F).

¹⁷ 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).

¹⁸ 15 U.S.C. 78s(b)(2).

¹⁹ 17 CFR 200.30-3(a)(12).