

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-94938; File No. SR-OCC-2022-005)

May 18, 2022

Self-Regulatory Organizations; The Options Clearing Corporation; Order Granting Approval of Proposed Rule Change by The Options Clearing Corporation Concerning Revisions to OCC's Partial Tear-Up Rules

I. INTRODUCTION

On March 22, 2022, the Options Clearing Corporation (“OCC”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change SR-OCC-2022-005 (“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 OCC’s rules regarding OCC’s payment obligations and the allocation of losses related to the use of Partial Tear-Up (defined below) as a recovery tool.³ The Proposed Rule Change was published for public comment in the Federal Register on April 7, 2022.⁴ The Commission received one comment regarding 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 20495.

⁴ Securities Exchange Act Release No. 94583 (Apr. 1, 2022), 87 Fed. Reg. 20495 (Apr. 7, 2022) (File No. SR-OCC-2022-005) (“Notice of Filing”).

⁵ The comment on the Proposed Rule Change is available at <https://www.sec.gov/comments/sr-occ-2022-005/srocc2022005.htm>.

II. BACKGROUND⁶

As a covered clearing agency, OCC is required to establish policies and procedures reasonably designed to manage its credit exposures and liquidity risk.⁷ However, a Clearing Member default may result in losses or shortfalls that exceed OCC's routine risk management tools. To address such credit losses or liquidity shortfalls, OCC has established tools to re-establish a matched book and to allocate uncovered losses following the default of a Clearing Member.⁸ One such tool, "Partial Tear-Up," is a process designed to return OCC to a matched book by extinguishing positions that remain open after OCC has attempted one or more auctions.⁹ OCC Rule 1111(e) sets forth the process for determining and terminating Partial Tear-Up positions.

When it initially proposed Rule 1111(e) in 2018, OCC noted that the Partial Tear-Up process would be initiated only if OCC determined that potential losses from remaining positions of the defaulting member would exceed OCC's financial resources.¹⁰ OCC further stated that, in order for OCC to maintain its ability to meet obligations to non-defaulting members, the process was designed to be initiated in advance of exhausting OCC's financial resources.¹¹ OCC also acknowledged that the process may be used to allocate losses if OCC's resources are insufficient

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 See generally, 17 CFR 240.17Ad-22(e)(4) and (e)(7).

⁸ Securities Exchange Act Release No. 83916 (Aug. 23, 2018), 83 Fed. Reg. 44076 (Aug. 29, 2018) (File No. SR-OCC-2017-020).

⁹ See supra note 8, 83 Fed. Reg. at 44079.

¹⁰ Securities Exchange Act Release No. 82351 (Dec. 19, 2017), 82 Fed. Reg. 61107, 61111 (Dec. 26, 2017) (File No. SR-OCC-2017-020).

¹¹ Id.

to pay the Partial Tear-Up Price.¹² Rule 1111(e)(iii) currently provides that when the Partial Tear-Up process is used to allocate losses, each Clearing Member will receive a pro rata payment based on OCC's remaining resources and an unsecured claim against OCC for the difference between the pro rata amount received and the Partial Tear-Up Price.

An unsecured claim issued pursuant to Rule 1111(e) provides a mechanism for OCC to compensate Clearing Members that receive a pro rata payment, when warranted by particular circumstances (e.g., when funds are subsequently recovered from a defaulted Clearing Member or the estate of the defaulted Clearing Member). However, OCC Rules do not currently describe a specific payment obligation for these claims. OCC states that the Proposed Rule Change is intended to provide clarity regarding the nature of the claim issued following a Partial Tear-Up. More specifically, the revisions to Rule 1111(e) would add the following details about the claim: (i) a Clearing Member receiving a pro rata payment following a Partial Tear-Up will have a claim for the value of the difference between the pro rata amount received and the Partial Tear-Up Price; and (ii) such a claim shall be an unsecured claim on any recovery from a suspended or defaulted Clearing Member (or from the estate of a suspended or defaulted Clearing Member). OCC believes that clarifying the nature of the claim arising out of Rule 1111(e) would, in turn, clarify that such claims would not provide a basis for Clearing Members to trigger the close-out netting process under Article VI, Section 27 of OCC's By-Laws.¹³

¹² Id.

¹³ OCC By-Laws Art. VI, Section 27(a)(i), regarding default or insolvency of OCC, requires OCC to notify various stakeholders if OCC fails to comply with an undisputed obligation to pay money or deliver property to a Clearing Member for a period of thirty days from the date that OCC receives notice from the Clearing Member of the past due obligation. See Notice of Filing supra note 4, 87 Fed. Reg. at 20495.

In proposing to adopt Partial Tear-Up as a recovery tool, OCC proposed a mechanism for re-allocating losses for non-defaulting Clearing Members arising out of Partial Tear-Up.¹⁴ OCC Rule 1111(g) currently provides OCC’s Board of Directors (the “Board”) with discretionary authority to levy a special charge against remaining non-defaulting Clearing Members for the purpose of re-allocating the losses, costs, and fees imposed on holders of torn-up positions. Currently, Rule 1111 does not impose any ex ante limit on the amount of any discretionary special charge that could be levied by the Board. Following the adoption of OCC Rule 1111, OCC received a letter from the Futures Industry Association (“FIA”) requesting that OCC limit the amount of the Rule 1111(g) Board-levied special charge to the amount of a Clearing Member’s required contribution to the Clearing Fund.¹⁵ Upon consideration of this request, OCC proposes to amend Rule 1111(g) to cap the amount of the special charge levied under the rule to the amount of the Clearing Member’s required contribution to the Clearing Fund at the time of the special charge. According to OCC, the purpose of this change is to provide Clearing Members with a firm ex ante limit that would improve their ability to measure, monitor and manage their potential exposure to OCC.¹⁶

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

¹⁴ Securities Exchange Act Release No. 82351 (Dec. 19, 2017), 82 Fed. Reg. 61107, 61112 (Dec. 26, 2017) (File No. SR-OCC-2017-020).

¹⁵ The letter OCC received from the FIA has been provided as Exhibit 3A to File No. SR-OCC-2022-005.

¹⁶ See Notice of Filing supra note 4, 87 Fed. Reg. at 20495.

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 Act¹⁸ as described in detail below.

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 a clearing agency's rules are designed, in general, to protect investors and the public interest.¹⁹ Based on its review of the record, and for the reasons described below, the Commission believes that the proposed changes to Rule 1111(e) and (g) are consistent with being organized to protect investors and the public interest.

With the proposed revisions to Rule 1111(e), OCC codifies critical details about the nature of a Clearing Member's claim resulting from the Partial Tear-Up process, including the specific value of the claim (e.g., the value of the difference between the pro rata amount received and the Partial Tear-Up Price) and the source of funds that the claim would draw upon (e.g., an unsecured claim on any recovery from a suspended or defaulted Clearing Member, or from the estate of a suspended or defaulted Clearing Member). These details provide Clearing Members with material information regarding their potential claims, and provide greater visibility to Clearing Members on how open claims from the partial tear-up process would be honored. In

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).

particular, the revisions remove any ambiguity that could cause Clearing Members to believe that OCC would default if it fails to pay an unsecured claim issued by a Clearing Member as a result of the Partial Tear-Up process, because revised Rule 1111(e) would place appropriate responsibility for the unsecured claim on the suspended or defaulted Clearing Member. As such, the Commission believes that these revisions to Rule 1111(e) are consistent with being organized to protect investors and the public interest.

With the proposed revisions to Rule 1111(g), OCC codifies a specific limit to the amount of special charge that the Board would potentially levy on each non-defaulting Clearing Member. This revision indicates to non-defaulting Clearing Members that such special charges are not unlimited in nature, and provides non-defaulting Clearing Members with the assurance to manage and monitor their potential exposures to OCC with fewer concerns on whether or not they could cover their exposures successfully. As such, the Commission believes that these revisions to Rule 1111(e) are also consistent with the protection of investors and the public interest.

In response to the Notice of Filing,²⁰ the Commission received a comment opposing the proposal on the basis that it would increase investor risk by shifting the responsibility of covering default-related liability from OCC to individual investors.²¹ The Commission disagrees with this assertion, as the Proposed Rule Change provides further information to Clearing Members on the nature and amount of Partial Tear-Up claims. In particular, the Proposed Rule Change indicates that unsecured claims issued by a Clearing Member as a result of the Partial

²⁰ See Notice of Filing supra note 4, 87 Fed. Reg. at 20495.

²¹ The comment on the Proposed Rule Change is available at <https://www.sec.gov/comments/sr-occ-2022-005/srocc2022005.htm>.

Tear-Up process are the responsibility of the defaulted or suspended Clearing Member, thus removing the risk of an unintended OCC wind-down due to Clearing Members initiating a close-out netting under Article XI, Section 27 of OCC's By-Laws. The Proposed Rule Change also provides further information to non-defaulting Clearing Members on the nature and amount of Board-levied special charges. As such, the revisions would in fact support the goals of the Partial Tear-Up process, which are to account for the exposures of non-defaulting Clearing Members and place responsibility on suspended or defaulted Clearing Members where due—the opposite of what the comment is asserting.

The Commission believes, therefore, that the proposal to revise Rule 1111(e) and (g) is consistent with the requirements of Section 17A(b)(3)(F) of the Exchange Act.²²

B. Consistency with Rule 17Ad-22(e)(23) under the Exchange Act

Rule 17Ad-22(e)(23)(ii) under the Exchange Act requires that a clearing agency must establish, implement, maintain and enforce written policies and procedures reasonably designed to provide sufficient information to enable participants to identify and evaluate the risks, fees, and other material costs they incur by participating in the covered clearing agency.²³ Based on its review of the record, and for the reasons described below, the Commission believes that the proposed changes to Rule 1111(e) and (g) are consistent with the requirements of Rule 17Ad-22(e)(23)(ii).

By revising Rule 1111(e) to codify critical details on the nature of a Clearing Member's claim resulting from the Partial Tear-Up process, including the specific value of the claim (e.g., the value of the difference between the pro rata amount received and the Partial Tear-Up Price)

²² 15 U.S.C. 78q-1(b)(3)(F).

²³ 17 CFR 240.17Ad-22(e)(23)(ii).

and the source of funds that the claim would be against (e.g., an unsecured claim on any recovery from a suspended or defaulted Clearing Member, or from the estate of a suspended or defaulted Clearing Member), OCC provides critical information that Clearing Members may use to better evaluate the nature and amount of their claims resulting from the Partial Tear-Up process. Similarly, the 1111(g) revisions codify a specific limit to the amount of special charge that the Board would potentially levy on each non-defaulting Clearing Member. Non-defaulting Clearing Members may use this additional information to better evaluate the nature and amount of the special charges. As such, the Commission believes that the Rule 1111(e) and (g) revisions are consistent with providing sufficient information to enable participants to identify and evaluate the risks, fees, and other material costs incurred with participation in the covered clearing agency.

The Commission believes, therefore, that the proposal to revise Rule 1111(e) and (g) is consistent with the requirements of Rule 17Ad-22(e)(23)(ii) under the Exchange Act.²⁴

²⁴

Id.

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 Act²⁵ and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Exchange Act,²⁶ that the Proposed Rule Change (SR-OCC-2022-005) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁷

J. Matthew DeLesDernier
Assistant Secretary

²⁵ 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).

²⁶ 15 U.S.C. 78s(b)(2).

²⁷ 17 CFR 200.30-3(a)(12).