

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-67906; File No. SR-OCC-2012-14)

September 21, 2012

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing of Advance Notice Relating to the Clearance and Settlement of Over-the-Counter Options

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4(n)(1)(i),² notice is hereby given that on August 30, 2012, The Options Clearing Corporation (“OCC”) filed with the Securities and Exchange Commission (“Commission”) the advance notice 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 advance notice from interested persons.

I. Clearing Agency’s Statement of the Terms of Substance of the Advance Notice

The proposed changes contained in the advance notice will permit OCC to provide central clearing of index options on the S&P 500 that are negotiated bilaterally in the over-the-counter market and submitted to OCC for clearance.

II. Clearing Agency’s Statement of the Purpose of, and Statutory Basis for, the Advance Notice

In its filing with the Commission, OCC included statements concerning the purpose of and basis for the advance notice and discussed any comments it received on the advance notice. The text of these statements may be examined at the places specified in Item IV below. OCC

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4(n)(i).

has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of these statements.³

(A) Clearing Agency's Statement of the Purpose of, and Statutory Basis for, the Advance Notice

The purpose of this proposed rule change and advance notice is to allow OCC to provide central clearing of OTC index options on the S&P 500 Index. The proposed rule change replaces a previously proposed rule change which was withdrawn by OCC.⁴ OCC will clear the proposed OTC options in a manner that is highly similar to the manner in which it clears listed options, with only such modifications as are appropriate to reflect the unique characteristics of OTC options.

OTC Options

OCC has entered into a license agreement with Standard & Poor's Financial Services LLC ("S&P") that allows OCC to clear OTC options on three equity indices published by the S&P: the S&P 500 Index, the S&P MidCap 400 Index and the S&P Small Cap 600 Index. The initial OTC options to be cleared by OCC will consist of options on the S&P 500 Index. OCC may clear OTC options on other indices and on individual equity securities in the future, subject to Commission approval of one or more additional rule filings. The current rule filing defines "OTC option" and "OTC index option" generically in order to simplify future amendments to provide for additional underlying interests. OTC options will have predominantly common terms and characteristics, but also include unique terms negotiated by the parties. Transactions in OTC options will not be executed through the facilities of any exchange, but will instead be

³ The Commission has modified the text of the summaries prepared by OCC.

⁴ Securities Exchange Act Release No. 34-66090 (January 3, 2012), 77 FR 1107 (January 9, 2012) (SR-OCC-2011-19).

entered into bilaterally and submitted to OCC for clearance through one or more providers of trade affirmation services.⁵

OTC options will be similar to exchange-traded standardized equity index options called “FLEX Options” that are currently traded on certain options exchanges.⁶ FLEX Options are exchange-traded put and call options that allow for customization of certain terms. For example, FLEX index Options traded on the Chicago Board Options Exchange have six customizable terms: (1) underlying index, (2) put or call, (3) expiration date, (4) exercise price, (5) American or European exercise style, and (6) method of calculating settlement value. OCC is the issuer and guarantor of FLEX Options and clears FLEX Options traded on multiple exchanges.

Similar to FLEX Options, OTC options will allow for customization of a limited number of variable terms with a specified range of values that may be assigned to each as agreed between the buyer and seller. Parties submitting transactions in OTC options for clearing by OCC will be able to customize six discrete terms: (1) underlying index;⁷ (2) put or call; (3) exercise price; (4) expiration date; (5) American or European exercise style; and (6) method of

⁵ The initial provider of the trade affirmation services in connection with the OTC options will be MarkitSERV.

⁶ Note that FINRA Rule 2360(a)(16) refers to FLEX Options as “FLEX Equity Options,” which it defines as “any options contract issued, or subject to issuance by, The Options Clearing Corporation whereby the parties to the transaction have the ability to negotiate the terms of the contract consistent with the rules of the exchange on which the options contract is traded.” OCC does not believe this definition would capture OTC options as they are not traded on any exchange. Nevertheless, as discussed below, OCC is working with FINRA to amend certain of FINRA’s rules to clarify the proper application of such rules to OTC options.

⁷ Initially, however, the S&P 500 Index will be the only permitted underlying index.

calculating exercise settlement value on the expiration date.⁸ The variable terms and permitted values will be specified in the proposed Section 6 of Article XVII of the By-Laws. With respect to future OTC options accepted for clearing, OCC intends that such future OTC options will conform to the general variable terms and limits on the variable terms set forth in proposed Section 6 of the By-Laws, and will either amend the Interpretations and Policies thereunder to specify additional requirements for specific OTC options or publish such requirements on OCC's website.

Clearing of OTC Options

OCC proposes to clear OTC options subject to the same basic rules and procedures used for the clearance of listed index options. The proposed rules require that the counterparties to the OTC options must be eligible contract participants ("ECPs"), as defined in Section 3a(65) of the Securities Exchange Act of 1934,⁹ as amended (the "Exchange Act") and Section 1a(18) of the Commodity Exchange Act,¹⁰ as amended (the "CEA"). Because an OTC option will be a "security" as defined in the Exchange Act, the proposed rules also require that the transactions be cleared through a clearing member of OCC that is registered with the Commission as a broker-dealer or one of the small number of clearing members that are "non-U.S. securities firms" as defined in OCC's By-Laws. OCC is not proposing to require clearing members to meet any

⁸ The expiration date of an OTC option must fall on a business day. The method of determining the exercise settlement value of an OTC option on its expiration date may be either the opening settlement value or the closing settlement value of the underlying index (calculated by S&P using the opening or closing price, as applicable, in the primary market of each component security of the underlying index on the specified expiration date), in each case as reported to OCC by CBOE.

⁹ 15 U.S.C. 78c(a)(65).

¹⁰ 7 U.S.C. 1a(18).

different financial standards for clearing OTC options. However, clearing members must be specifically approved by OCC to clear OTC options pursuant to new Interpretation and Policy .11 to Section 1 of Article V in order to assure the operational readiness of such clearing members to clear OTC options. Clearing members seeking to clear OTC options will be required to submit a business expansion request and complete an operational review. The operational review consists of an initial meeting with the clearing member's staff to evaluate the staff's experience, confirm the staff's familiarity with current OCC systems and procedures, complete an operational questionnaire, perform a high level review of the clearing member's systems and processing capabilities, and review other pertinent operational information. Successful testing of messaging capability between the clearing member, MarkitSERV and OCC is also necessary. These procedures will determine whether the firm is operationally ready to clear OTC Index Options.

Exercise of an OTC option will be settled by payment of cash by the assigned writer and to the exercising holder through OCC's cash settlement system on the business day following exercise in exactly the same manner as is the case with exercise settlement of listed index options. As in the case of listed index options, the exercise-settlement amount will be equal to the difference between the current value of the underlying interest and the exercise price of the OTC option, times the multiplier that determines the size of the OTC option. In the case of OTC index options on the S&P 500, the multiplier will be fixed at 1. The multipliers for additional OTC index options that OCC may in the future clear may be fixed at such value as OCC determines and provides for in its By-Laws and Rules.

OCC will calculate clearing margin for the OTC options using its STANS margin system on the same basis as for listed index options and will otherwise apply the same risk management

practices to both OTC options and listed index options, including new risk modeling enhancements for longer-tenor options discussed below under “Risk Management Enhancement for Longer-Tenor Options.” Because OCC currently clears listed options on all three of the underlying indexes on which OCC is currently licensed to clear OTC options, and because the customizable terms of these OTC options are relatively limited and the range of values that customizable terms may be given is limited, OCC does not believe that valuation and risk management for these OTC options present challenges that are different from those faced in the listed options market. Nevertheless, as discussed further below, OCC is proposing special OTC Options Auctions to be used in the unlikely event that OCC would be unable to close out positions in OTC options of a failed clearing member through other means.

OTC options may be carried in a clearing member’s firm account, in market-maker accounts or in its securities customers’ account, as applicable. Although customer positions in OTC options will be carried in the securities customers’ account (an omnibus account), OCC will use a “customer ID” to identify positions of individual customers based on information provided by clearing members.¹¹ However, positions are not presently intended to be carried in individual customer sub-accounts, and positions in OTC options will be margined at OCC in the omnibus customers’ account on the same basis as listed options. If a clearing member takes the other side of a transaction with its customer in an OTC option, the transaction will result in the creation of a long or short position (as applicable) in the clearing member’s customers’ account and the opposite short or long position in the clearing member’s firm account. The positions

¹¹ Such customer IDs are necessary in order to allow OCC to comply with certain terms of OCC’s license agreement with S&P. As described further below, customer IDs will be used for other purposes as well.

could also be includable in the internal cross-margining account, subject to any necessary regulatory approvals.

The trade data for an OTC option trade will be entered into the system of MarkitSERV or another trade confirmation/affirmation vendor approved by OCC for this purpose (the “OTC Trade Source”).¹² While MarkitSERV will be the only OTC Trade Source at launch, OCC will permit additional OTC Trade Sources in the future in response to sufficient market demand from OCC’s clearing members and subject to the ability of any such OTC Trade Source to meet OCC’s requirements for operational readiness and interoperability with OCC’s systems, as well as requirements with respect to relevant business experience and reputation, adequate personnel and expertise, financial qualification and such other factors as OCC deems relevant. OCC will receive confirmed trades from the OTC Trade Source. It will be permissible for parties to submit trades for clearance that were entered into bilaterally at any time in the past, provided that the eligibility for clearance will be determined as of the date the trade is submitted to OCC for clearance.¹³ The OTC Trade Source will process the trade and submit it as a confirmed trade to OCC for clearing. If the trade meets OCC’s validation requirements, OCC will so notify the

¹² MarkitSERV, LLC is owned by Markit Group Limited, Markit Group Holdings Limited and The Depository Trust & Clearing Corporation. MarkitSERV Limited is a wholly-owned U.K. subsidiary of MarkitSERV, LLC. MarkitSERV, LLC and MarkitSERV Limited (collectively, “MarkitSERV”) provide derivatives transaction processing, electronic confirmation, portfolio reconciliation services, and other related services for firms that conduct business in the over-the-counter derivatives markets through a variety of electronic systems, including the MarkitWire system. MarkitWire, owned by MarkitSERV Limited, is an OTC derivatives electronic confirmation/affirmation service offered by MarkitSERV as part of its post-trade processing suite of products. The role of MarkitSERV and MarkitWire in OCC’s clearing of OTC options is described in further detail below.

¹³ OCC’s license agreement with S&P imposes certain requirements relating to minimum time remaining to expiration of an OTC option.

OTC Trade Source, which will notify the submitting parties. Customers of clearing members may have direct access to the OTC Trade Source for purposes of entering or affirming trade data and receiving communications regarding the status of transactions, in which case mechanisms will be put in place for a clearing member to authorize a customer to enter a trade for the clearing member's customers' account or for the clearing member to affirm a trade once entered.

In order for a clearing member to be approved for clearing OTC options, the clearing member must enter into a standard agreement with MarkitSERV (or another OTC Trade Source with which the clearing member intends to enter trade data, if and when OCC enters into arrangements with other OTC Trade Sources). At launch, OTC options will not be subject to the same clearing member trade assignment rules and procedures through which exchange-traded options can be cleared by a clearing member other than the executing clearing member. This functionality may be added at a later date. OCC and MarkitSERV will adopt procedures to permit a customer that has an account with Clearing Member A ("CM A") to enter into an OTC option transaction with Clearing Member B ("CM B") and have the position included in its account at CM A and cleared in CM A's customers' account at OCC.

OTC options will be fungible with each other to the extent that there are OTC options in the system with identical terms. However, OCC will not treat OTC options as fungible with index options listed on any exchange, even if an OTC option has terms identical to the terms of the exchange-listed option.

Clearing members that carry customer positions in cleared OTC options will be subject to all OCC rules governing OCC-cleared options generally, as well as all applicable rules of the Commission and of any self-regulatory organization, including the Financial Industry Regulatory Authority ("FINRA"), of which they are a member. Section 8 of Article III of

OCC's By-Laws provides that, subject to the By-Laws and Rules, "the Board of Directors may suspend Clearing Members and may prescribe and impose penalties for the violation of the By-Laws or the Rules of the Corporation, and it may, by Rule or otherwise, establish all disciplinary procedures applicable to Clearing Members and their partners, officers, directors and employees." As a condition to admission, Section 3(c) of Article V of the By-Laws provides that a clearing member must agree, among other things, to "pay such fines as may be imposed on it in accordance with the By-Laws and Rules." Rule 305 permits OCC to impose restrictions on the clearing activities of a clearing member if it finds that the financial or operational condition of the clearing member makes it necessary or advisable to do so for the protection of OCC, other clearing members, or the general public. Rule 1201(a) provides that OCC "may censure, suspend, expel or limit the activities, functions or operations of any Clearing Member for any violation of the By-Laws and Rules or its agreements with the Corporation." In addition to, or in lieu of, such actions, OCC is permitted under the same paragraph to impose fines. Rule 1202(b) establishes procedures for taking any such disciplinary actions. The foregoing provisions are sufficient to permit OCC to fine or otherwise discipline a clearing member that fails to abide by OCC's By-Laws and Rules applicable to OTC options, or to prohibit such clearing member from continuing to clear such options.

Regulatory Status of the OTC Options

An OTC option will be a "security" as defined in both the Securities Act of 1933, as amended (the "Securities Act") and, as noted above, the Exchange Act. OCC will be the "issuer" of the OTC options. The OTC options will be neither "swaps" nor "security-based

swaps” for purposes of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).¹⁴

Most of OCC’s clearing members are members of FINRA and subject to FINRA’s rules, which have different provisions for “listed” and “OTC options” and contain various definitions distinguishing between the two. In some cases, OTC options would fall into neither category under FINRA’s definitions and in other cases, they would fall within what OCC perceives to be the wrong category. FINRA and OCC are working together to implement appropriate amendments to FINRA rules to clarify the proper application of such rules to cleared OTC options.

MarkitSERV Trade Submission Mechanics

MarkitSERV provides an interface to OCC that allows OCC to receive messages containing details of transactions in OTC options submitted for clearing by clearing members with access to MarketWire and also allows OCC to transmit messages to MarkitWire participants identifying the status of submitted transactions. MarkitWire applications use product-specific templates to simplify deal entry and negotiations. The templates specify the data required for a given product and also the business validation rules for each field. MarkitSERV has included OCC’s validation requirements for OTC options in its trade templates.

¹⁴ Section 1a(47)(A)(i) of CEA, 7 U.S.C. 1a(47)(A)(i), as added by Section 721(a)(21) of Dodd-Frank, defines “swaps” broadly to include options on indices. However, Section 1a(47)(B)(iii) of the CEA, 7 U.S.C. 1a(47)(B)(iii), excludes from the “swap” definition any option on any index of securities that is subject to the Securities Act and the Exchange Act. A contract that is excluded from the definition of a “swap” under Section 1a(47)(B) of the CEA, 7 U.S.C. 1a(47)(B) (other than Section 1a(47)(B)(x), 7 U.S.C. 1a(47)(B)(x)) is not a “security-based swap” for purposes of Section 3a(68) of the Exchange Act, 15 U.S.C. 78c(a)(68).

The trade data for each OTC option transaction must be entered into MarkitWire. MarkitSERV will use a “confirmation/affirmation” procedure in which one party to the trade enters the trade data to the MarkitWire platform, which issues a confirmation to the counterparty to be affirmed, rejected or requested to be revised. If the trade details are confirmed, the trade will then be submitted to OCC for clearance and MarkitSERV will affirm such submission to both parties. OCC then validates the trade information for compliance with applicable requirements, such as the identification of an account of an eligible clearing member in which each side of the trade will be cleared, that the variable terms are within permissible ranges, and that minimum size requirements under OCC’s license agreement with S&P are met. This validation will be completed by OCC immediately upon submission. OCC’s clearing system will automatically accept the trade if it passes the validation process and will otherwise reject it.¹⁵ A trade that is rejected by OCC may be corrected and submitted as a new transaction. Clearing members and customers with access to MarkitSERV will be able to determine whether a trade has been accepted or rejected both through MarkitSERV and, in the case of clearing members, through their interface with OCC’s clearing system.

MarkitSERV’s Regulatory Status¹⁶

MarkitSERV is not registered as a clearing agency under the Exchange Act, and the Commission staff has asked OCC to consider whether MarkitSERV would be required to so

¹⁵ Once accepted, a trade is guaranteed by OCC. Note, however, that OTC options for which the premium payment date communicated by MarkitSERV to OCC is prior to the business day on which the OTC option is submitted to OCC for clearing (referred to as a “Backloaded OTC Option”) will not be accepted and guaranteed until the selling clearing member has met its initial morning cash settlement obligations to OCC on the following business day.

¹⁶ MarkitSERV offers different services in different markets, and this discussion is addressed only to the “confirmation/affirmation” procedure to be used in submitting trades to OCC.

register in order to provide the proposed services to the OTC options market. OCC believes that no such registration is necessary based upon relevant interpretive guidance issued by the Commission.

Section 3(a)(23)(A) of the Exchange Act¹⁷ defines a “clearing agency” broadly. The definition includes, in relevant part, “any person who . . . provides facilities for comparison of data respecting the terms of settlement of securities transactions[.]” In 1998, the Commission issued a release entitled “Confirmation and Affirmation of Securities Trades; Matching” (the “Matching Release”).¹⁸ In the Matching Release, the Commission published “its interpretation that a ‘matching’ service that compares securities trade information from a broker-dealer and the broker-dealer’s customer is a clearing agency function.” The Matching Release distinguishes between such a matching service and a “confirmation/affirmation service” where the “vendor intermediary will only transmit information between the parties to a trade, and the parties will confirm and affirm the accuracy of the information.” The Commission noted that “matching” constitutes the “comparison of data respecting the terms of settlement of securities transactions” and that such services therefore trigger status as a clearing agency, while confirmation/affirmation services would not, by themselves, constitute such a data comparison. The Commission concluded in the Matching Release that “an intermediary that captures trade information from a buyer and a seller of securities and performs an independent reconciliation or matching of that information is providing facilities for the comparison of data within the scope of Exchange Act Section 3(a)(23).” The Commission stated that “matching” is “so closely tied to

¹⁷ 15 U.S.C. 78c(a)(23)(A).

¹⁸ Securities Exchange Act Release No. 34-39829 (April 13, 1998), 63 FR 17943 (April 13, 1998).

the clearance and settlement process that it is different not only in degree but also different in kind from the . . . confirmation and affirmation process.” The Matching Release goes on to state: “a vendor that provides confirmation/affirmation services only will exchange messages between a broker-dealer and its institutional customer. The broker-dealer and its institutional customer will compare the trade information contained in those messages, and the institution itself will issue the affirmed confirmation.” This is precisely what occurs when a counterparty to a trade affirms the trade data through MarkitSERV and requests submission to OCC for clearance. MarkitSERV transmits messages only; it does not “compare” or “match” trade data submitted by two parties.

The “confirmation/affirmation” functionality (as described above) to be provided by MarkitSERV (through MarkitWire) with respect to OTC options is functionally identical to the confirmation/affirmation service described in the Matching Release and OCC believes such service would not be a “matching” service within the meaning of the release. OCC believes that MarkitSERV will not be a “clearing agency” with respect to the services to be provided in connection with OTC options. The confirmation/affirmation service described in the Matching Release referred “to the transmission of messages among broker-dealers, institutional investors, and custodian banks regarding the terms of a trade executed for the institutional investor.” MarkitWire’s confirmation/affirmation process will allow for the transmission of messages among OCC’s clearing members (most of which are registered broker-dealers), their customers (all of whom will be ECPs and will therefore be large and financially sophisticated market participants) and OCC, which is itself registered and subject to the Commission’s oversight as a clearing agency.

By contrast, the “matching” services contemplated in the Matching Release would involve “the process whereby an intermediary compares the broker dealer’s trade data submission . . . with the institution’s allocation instructions . . . to determine whether the two descriptions of the trade agree.” MarkitWire performs no such comparison. Under the confirmation/affirmation procedure, trade data is entered into MarkitWire by one party and such data is made available to the counterparty to be affirmed, rejected or requested to be revised. MarkitWire merely facilitates the transfer of information between the parties sufficient to allow the comparison to be made. A binding transaction (*i.e.*, an “affirmed confirmation” in the language of the Matching Release) is not produced through any action of MarkitSERV, but is instead created by the completion, by the counterparty, of an affirmation of the trade data entered by the first party. MarkitWire provides no “independent reconciliation or matching” of trade data. Rather MarkitWire is providing essentially a messaging service among OCC and the parties to trades in OTC Options. The Matching Release is clear as to the distinction between a matching service and a confirmation/affirmation service, and OCC believes that there is no ambiguity that the services to be provided by MarkitWire with respect to OTC options fall into the latter, rather than the former, category.

Risk Management Enhancements for Longer-Tenor Options

Although OCC’s license agreement with S&P allows OCC to clear OTC options with tenors of up to fifteen years, OCC has elected at this time to clear only OTC options on the S&P 500 index with tenors of up to five years. However, OCC currently clears FLEX Options on the S&P 500 with tenors of up to 15 years. While OCC believes that its current risk management practices are adequate for current clearing activity, OCC is in the process of implementing risk modeling enhancements with respect to longer-tenor options, including OTC options. The

enhancements are part of OCC's ongoing efforts to test and improve its risk management operations with respect to all longer-tenor options that OCC currently clears. These procedures will be submitted for review in a separate "advance notice" filing and OCC will not commence clearing of OTC options until such procedures have been approved and implemented.

The proposed enhancements are as follows:

- First, OCC will introduce indicative over-the-counter quotations into the daily dataset of prices used to risk manage OCC-cleared products. These quotations will be obtained from a service provider that will collect OTC dealer polling information on a daily basis and provide such data to OCC.
- Second, OCC will introduce variations in the implied volatilities used in the modeling of all cleared options whose residual tenors are at least three years. To date, OCC's margin methodology has assumed that implied volatilities of option contracts are static over the two-day risk horizon. While OCC's backtesting has identified few exceedances related to implied volatility shocks, such shocks could occur and taking them into account in OCC's margin model will allow more robust risk management. OCC proposes to achieve this result by incorporating into the risk factors included in OCC's models time series of proportional changes in implied volatilities for a range of representative volatilities.
- Third, OCC will introduce a valuation adjustment into its calculation of portfolio net asset value. This adjustment will be based on the aggregate sensitivity of the longer-tenor options in a portfolio to the overall level of implied volatilities at three and five years, and to the implied volatility skew.

A review of individual S&P 500 Index put and call options positions that are in the money by varying amounts and have expiration dates between four and nine years out indicates that the inclusion of modeled implied volatilities tends to result in less margin being held against short call positions and more being held against short put positions. These results are consistent with what would be expected given the strong negative correlation that exists between changes in implied volatility and market returns. On average, OCC observed a decrease in the margin requirement of approximately 24% on the nine call options tested and a 63% increase associated with the nine put options.

Proposed By-Law and Rule Changes

The specific proposed changes to OCC's By-Laws and Rules to provide for the clearing of OTC options relate primarily to: (i) specification of customizable terms; (ii) procedures for submission and acceptance of trades for clearance; and (iii) specification of criteria for eligibility of clearing members to clear transactions in OTC options and limitation of the types of customers for whom clearing members may effect transactions in OTC options. Otherwise, the currently proposed OTC options will be cleared and settled under the same provisions applicable to clearance of listed index options. Many of the proposed amendments are self-explanatory, and OCC has therefore attempted to confine the following discussion to a broad overview with specific explanation only where the reasons for the change may be less obvious.

Article I of the By-Laws contains defined terms used throughout the By-Laws and Rules. OCC proposes to modify certain existing definitions and include certain new definitions in order to incorporate OTC options into existing rules and facilitate the creation of new provisions unique to OTC options. Throughout the By-Laws and Rules, OCC proposes to replace the term "Exchange transaction," which is currently defined in Article I, in relevant part, as "a transaction

on or through the facilities of an Exchange for the purchase, writing or sale of a cleared contract” with the term “confirmed trade” so as to make the relevant portions of the By-Laws and Rules applicable to transactions in OTC options as well as listed options, without causing confusion about the role of the OTC Trade Source in OCC’s clearing of OTC options. “Confirmed trade” is proposed to be defined in Article I to include transactions “effected on or through the facilities of an exchange” or “affirmed through the facilities of an OTC Trade Source” in order to include transactions in both listed options and OTC options. The current definition of “confirmed trade” in Rule 101 is proposed to be deleted as unnecessary given the new definition. Much of the length of this rule filing is attributable to the fact that the term “Exchange transaction” is used so many places in the rules. OCC has entered into agreements in the past which reference the term “Exchange transaction” or “exchange transaction.” OCC is also proposing to add an Interpretation and Policy to the new definition of “confirmed trade” in order to avoid any ambiguity concerning how such terms should be interpreted in any such agreement.

OCC proposes to add a new Interpretation and Policy .11 to Section 1 of Article V of the By-Laws, providing the additional criteria that must be met by a clearing member in order to clear OTC index options. Among these new criteria are that clearing members seeking to clear OTC index options on underlying indices published by Standard & Poor’s Financial Services LLC (“S&P”) must execute and maintain in effect a short-form license agreement in such form as specified from time to time by S&P. The current form of S&P short-form index license agreement is attached hereto as Exhibit 3.

The Interpretations and Policies under Section 1, Article VI allow clearing members to adjust their positions with OCC for certain enumerated reasons. OCC proposes to amend the Interpretations and Policies to clarify that adjustment of positions in OTC options will be

effected through a manual process (as opposed to the electronic process available to post-trade adjustments in listed options), to the extent permitted by OCC. For the same reason, OCC is proposing to amend Rule 403 to prohibit clearing member trade assignment (“CMTA”) transactions in OTC options. Trade “give-ups” that are effected through the CMTA process in the case of listed options will, in the case of OTC options, be effected through MarkitSERV before the trades are submitted to OCC for clearing.

Article XVII of the By-Laws governs index options in general and OCC is proposing amendments to Article XVII in order to set forth the terms applicable to the initial OTC options proposed to be cleared by OCC — options on the S&P 500 Index — and to differentiate OTC index options from other index options cleared by OCC. For example, certain amendments to the definitions are necessary because OTC options will be permitted to have a much wider range of expiration dates than exchange-traded options (other than FLEX Options). Additional definitional amendments ensure that OTC index options will constitute a separate class of options from other cash-settled index options even if both index options have the same terms and cover the same underlying interest.

Section 3 of Article XVII provides for adjustment of the terms of outstanding index options as necessary to reflect possible changes in the underlying index — such as those creating a discontinuity in the level of the index — that could theoretically make an adjustment necessary to protect the legitimate expectations of holders and writers of options on the index. Pursuant to paragraph (g) of Section 3, most but not all such adjustments would be made, in the case of listed index options, by an adjustment panel consisting of representatives of the exchanges on which the options are traded. In the case of OTC options, any such adjustments will be made by OCC in its sole discretion. However, in exercising that discretion, OCC may take into consideration

adjustment made by the adjustment panel with respect to exchange-traded options covering the same underlying index.¹⁹

OCC proposes to add a new Section 6 to Article XVII to set forth certain provisions unique to OTC index options, including the variable terms allowed for OTC index options and the general limitations on such variable terms. In general, all OTC index options must conform to the terms and limitations set forth in Section 6, and additional specific requirements applicable to specific OTC index options will either be set forth in the Interpretations and Policies under Section 6 or published separately on OCC's website. Section 6 also makes clear that although OTC index options are not fungible with exchange-traded index options, OTC index options of the same series (*i.e.*, options having identical terms) will be fungible with each other. In addition to the terms and limitations applicable to OTC index options, Section 6 will establish that clearing members will be deemed to have made a number of representations and warranties in connection with their activities in OTC options each time they affirm a confirmed trade entered into an OTC Trade Source.

OCC has submitted a rulemaking petition to the Commission²⁰ seeking an amendment to Commission Rule 238²¹ that would exempt the OTC Options from most provisions of the Securities Act. Unless another exemption from the registration requirements of the Securities

¹⁹Because index options, unlike options on individual stocks, rarely, if ever, require adjustments, allocation of the adjustment authority may have little practical significance.

²⁰ See SEC File No. 4-644 (Submitted January 13, 2012), *available at* <http://www.sec.gov/rules/petitions/2012/petn4-644.pdf>.

²¹ 17 CFR 230.238.

Act is available, OCC intends to rely upon Rule 506 of Regulation D²² under the Securities Act, which is a safe harbor under the Securities Act exemption in Section 4(a)(2)²³ for offerings by an issuer not involving a public offering. OCC intends to satisfy the conditions of Rule 506 of Regulation D as in effect at the time OCC relies upon the safe harbor. Participants in the existing markets for OTC equity options offered and sold in the United States commonly rely on the private offering exemption under these provisions and such reliance is therefore consistent with existing practice. OTC Options will be available for purchase only by highly sophisticated investors that are both “eligible contract participants,” as defined in Section 3a(65) of the Exchange Act,²⁴ and “accredited investors,” as defined in Rule 501(a) under Regulation D.²⁵ Section 6(f) of Article XVII includes representations of clearing members necessary to ensure that there is no general solicitation or general advertising in connection with the offer or sale of the OTC Options until such time as OCC notifies clearing members that such restriction no longer applies.

Chapter IV of the Rules sets forth the requirements for reporting of confirmed trades to OCC, and Rule 401 thereunder governs reporting of transactions in listed options by participant Exchanges. OCC is proposing to add new Rule 404 to govern the details of reporting of confirmed trades in OTC options by an OTC Trade Source.

²² 17 CFR 230.506.

²³ 15 U.S.C. 77d(a)(2).

²⁴ 15 U.S.C. 77c(a)(65).

²⁵ 17 CFR 230.501.

As discussed above, positions in OTC options will generally be margined in the same manner as positions in listed options using STANS and pursuant to Chapter VI of the Rules. However, OCC proposes to amend Rule 611 to establish different procedures for the segregation of long positions in OTC options for margining purposes. Long positions in listed options are held in a clearing member's customers' account or firm non-lien account and by default are deemed to be "segregated," meaning that they are not subject to OCC's lien and are given no collateral value when determining the margin requirement in the account. Such positions may be unsegregated only when a clearing member instructs OCC to unsegregate a long position and represents to OCC that the long position is part of a spread transaction carried for a single customer whose margin requirement on the corresponding short position has been reduced in recognition of the spread. OCC will then unsegregate the long position and so reduce OCC's margin requirement. However, in case of long positions in OTC options that are carried in a clearing member's customers' account and for which OCC has received a customer ID, OCC proposes that it will automatically unsegregate such long positions if OCC identifies a qualifying short position in OTC options carried under the same customer ID. Clearing members will not be required to give an affirmative instruction to OCC to unsegregate a long position in OTC options or make a separate representation regarding the spread transaction. Instead, by carrying a qualifying spread position in a customer account, clearing members are deemed to have represented to OCC that the customer's margin has been reduced in recognition of the spread. Based on discussion with the clearing members, it is OCC's understanding that, in practice, broker-dealers reduce customers' margin requirements to reflect spread positions. Therefore, OCC believes that automatic recognition of such spreads by OCC together with the deemed representation will greatly increase operational efficiency while providing equal assurance that

long positions in OTC options will be unsegregated only if an identified customer will receive the benefit of the reduced margin required for spread transactions.

Rule 1001 sets forth the amount of the contribution that each clearing member is required to make to the clearing fund. OCC proposes to amend Rule 1001(c) so that, for purposes of calculating the daily average number of cleared contracts held by a clearing member in open positions with OCC during a calendar month (which number is used in turn to determine the clearing member's contribution to the clearing fund), open positions in OTC options will be adjusted as needed to account for any differences between the multiplier or unit of trading with respect to OTC options relative to non-OTC options covering the same underlying index or interest so that OTC options and non-OTC options are given comparable weight in the computation.²⁶

In general, the rules in Chapter XI governing the suspension of a clearing member will apply equally to clearing members that transact in OTC options. Rule 1104 provides broad authority for OCC to liquidate a suspended clearing member's margin and clearing fund deposits "in the most orderly manner practicable." Rule 1106 provides similarly worded authority to close out open positions in options and certain other cleared contracts carried by a suspended clearing member. In 2011, the Commission approved an OCC rule change providing OCC the express authority to use a private auction as one of the means by which OCC may close out open positions and liquidate margin and clearing fund deposits of a suspended clearing member.²⁷

²⁶ For example, the index multiplier applicable to OTC index options on the S&P 500 Index will be fixed at 1. In comparison, the index multiplier applicable to listed index options is 100.

²⁷ See Securities Exchange Act Release No. 34-65654 (October 28, 2011), 76 FR 68238 (November 3, 2011) (SR-OCC-2011-08). OCC subsequently filed a rule change, currently pending Commission approval, providing detailed procedures for the conduct of such an auction.

OCC anticipates it will use this auction process for OTC options as well. As an additional tool to ensure its ability to close out positions in OTC options promptly, OCC is proposing to amend Rule 1106 to provide for an alternative auction procedure specifically applicable only to OTC index options and related positions hedging, or hedged by, OTC index options (an “OTC Options Auction”). An OTC Options Auction would be used only in unusual circumstances where OCC determines it is not feasible to close out open positions in OTC index options through the other means provided for in OCC’s Rules and By-Laws.²⁸ The amendments to Rule 1106 summarize the OTC Options Auction procedures and incorporate by reference the detailed procedures contained in a document entitled “OTC Options Auction Procedures,” which will be posted on the Corporation’s website and otherwise made available to clearing members upon request of OCC. A copy of the OTC Options Auction Procedures was attached to the filing as Exhibit 5.

Rule 1106(e)(2)(C) clarifies that, in the event that the liquidation of a clearing member results in a deficiency that would otherwise result in a proportionate charge against the clearing fund contributions of other clearing members, each OTC Index Option Member (as defined below) that failed to purchase or assume its share of an auction portfolio will be the first to absorb the deficiency, through a “Priority Charge” against such clearing members’ clearing fund contributions. The Priority Charge is a “first loss” mechanism, and is not intended to increase a clearing member’s total maximum exposure to OCC.

See Securities Exchange Act Release No. 34-67443 (July 16, 2012), 77 FR 42784 (July 20, 2012) (SR-OCC-2012-11).

²⁸ OCC anticipates that these procedures would be applicable to other OTC derivatives that may be cleared by OCC in the future. However, OCC has limited the currently proposed rule to OTC index options, and will amend it as and if appropriate to apply to other over-the-counter products that OCC may propose to clear in the future.

Under the OTC Options Auction procedures, all clearing members authorized to clear transactions in OTC index options (“OTC Index Option Members”), other than the defaulting clearing member, will be required to participate in the OTC Options Auction by submitting competitive bids for all or a portion of the defaulting clearing member’s OTC index option portfolio. Each such participant will be subject to a minimum participation level based on the participant’s proportionate share of the total “risk margin” requirement posted by all OTC Index Options Members in the previous month for all positions (not limited to OTC option positions) held in accounts eligible to hold OTC options positions (“OTC Eligible Accounts”), after removing the defaulting clearing member.²⁹ This method of calculating the minimum participation level in the OTC Options Auction results in all OTC Index Option Members being required to participate in the OTC Options Auction based on their clearing activity related to all positions in OTC Eligible Accounts. Required participation ensures that the OTC Options Auction will have sufficient participants authorized to clear transactions in OTC index options and that the most active clearing members in OTC index options will submit bids for the largest percentage of the auction portfolio, increasing the likelihood of the acquisition of OTC options positions by clearing members with appropriate financial strength, risk management capabilities and trading expertise. Each participant may submit bids at varying quantities and varying prices, so long as the participant’s bids equal or exceed its minimum participation level. A participant may use bids from non-OTC Index Options Members and non-clearing members in order to meet its minimum participation level, subject to certain Corporation requirements including that it

²⁹ This minimum participation level will be multiplied by 1.15 to calculate each participant’s minimum bid size, such that the sum of all participants’ bids will equal 115% of the auction portfolio, in order to increase the likelihood that the entire auction portfolio will be allocated to participants.

guarantee the performance of such third parties. Each bid will indicate what percentage of the auction portfolio the participant is bidding on and the amount of the bid. Bids will be stated in terms of a price for the entire auction portfolio, and may be either positive or negative. (Negative bids imply an auction portfolio that has a negative net asset value and indicate how much the Corporation would be required to pay the participant to assume the relevant percentage of the auction portfolio.) The Corporation will rank the submitted bids from best to worst and the auction portfolio will be allocated among the bidding participants accordingly until the auction portfolio is exhausted. The bid price that is sufficient to clear the entire auction portfolio will become the single price to be used for all winning bids, even if a participant's stated bid was better.

In order to provide a strong incentive to ensure competitive bidding by the OTC Index Option Members required to participate in an OTC Options Auction, OTC Index Options Members who fail to win their minimum participation in the auction will be subject to a potential priority charge against its clearing fund contribution. If the cost of liquidating a suspended clearing member's positions exhausts the clearing member's margin and clearing fund contribution and any other assets of the suspended clearing member available to OCC, then OCC, pursuant to Section 5 of Article VIII of the By-Laws, would ordinarily withdraw the amount of the deficiency from the clearing fund and charge it on a proportionate basis against all other clearing members' computed contributions as fixed at the time. When an OTC Options Auction has been held in respect of a suspended OTC Index Options Member, however, some or all of any such remaining loss would be assessed first against the clearing fund contributions of any OTC Options Auction participant(s) whose bids are insufficiently competitive to be allocated a portion of the auction portfolio equal to such participant's minimum required participation.

This priority charge would be made regardless of the reason for the shortfall—*i.e.*, whether or not the loss resulted from the closing out of OTC options positions. The priority charge would be calculated based on an “assessment ratio,” which is formulated to provide incentive to all OTC Options Auction participants to participate to their full minimum participation level in the auction. The method of calculating the assessment ratio is such that if the net asset value of the auction portfolio is zero the assessment ratio will also be zero and no priority charge will be made. As the absolute net asset value of the auction portfolio (whether positive or negative) increases, the assessment ratio also increases, all other factors being equal. If all OTC Options Auction participants submit bids such that each receives an allocation of OTC options positions equal to its minimum participation level, no priority charge will be made regardless of whether or not there is a liquidation shortfall. If a liquidation shortfall remains after any priority charges, or if no priority charges were required, the Corporation will then make a proportionate charge against the clearing fund contributions of all clearing members, including those that participated in the OTC Options Auction, in the usual manner pursuant to Section 5 of Article VIII of OCC’s By-Laws.

In order to protect the estate of the suspended clearing member, OCC reserves some discretion in supervising the auction. In the event that the bid price that clears the entire auction portfolio is determined by OCC to be an outlier bid, OCC may choose as the winning bid a price that clears at least 80% of the auction portfolio. The remaining auction portfolio will then be re-auctioned as described above.

OCC anticipates that the likelihood of having to use this alternative auction is small. Nevertheless, in view of the fact that positions in OTC index options are expected to be large and that there may be no active trading market in options with terms precisely identical to the terms

of the OTC index options in question, OCC believes that this is an appropriate failsafe provision. It should be noted that the Chicago Mercantile Exchange Inc. (“CME”) has rules allowing its clearing house and certain CME committees to administer an auction process to liquidate positions in interest rate swaps (“IRS”) in the event of a default of a CME clearing member authorized to submit IRS for clearing (an “IRS Member”).³⁰ Although the financial safeguards supporting IRS clearing, including its “guaranty fund,” and the IRS auction process are different from OCC’s clearing fund and OTC Options Auction in that, among other things, there is a separate guaranty fund for IRS, the IRS auction shares certain similarities with the OTC Options Auction. In particular, the IRS auction process requires mandatory participation of IRS clearing members with open interest in a position being auctioned and, in order to provide incentive for IRS Members to submit quality bids in an IRS auction, provides that in the event there is a loss to CME’s clearing house associated with an IRS Member’s default, IRS Members that do not submit quality bids in an IRS auction are subject to having their IRS guaranty fund deposit assessed before assessments are made against other IRS clearing members’ guaranty fund deposits. In its original rule filing, OCC had proposed a different failsafe solution whereby OCC could terminate open positions of a suspended clearing member by setting a close-out value that non-defaulting clearing members holding the opposite side of the suspended clearing member’s positions would be required to accept or pay in settlement of the terminated positions. However, clearing members objected to that proposed method and have advocated the auction procedures

³⁰ See CME Rules 8G14, 8G25 and 8G802.B. See also Commodity Futures Trading Commission Rule Change Submission No. 12-061RR of CME, the Board of Trade of the City of Chicago Inc. and the New York Mercantile Exchange, available at: <http://www.cmegroup.com/market-regulation/files/12-061rr.pdf>

proposed here in lieu of the early termination proposal.³¹ Clearing members in an OTC advisory group were active in designing the OTC Options Auction procedures, including the priority charges.

Impact of Clearing OTC Options on Other OCC-Cleared Products

Cleared OTC options will not be fungible with listed options. However, an OTC option may have economic characteristics that are substantially similar or identical to the characteristics of options in series of listed options that OCC clears. While it is possible that in any given instance a market participant may elect to enter into an OTC option in lieu of an economically similar listed product, OCC does not believe that its clearing of OTC options will adversely affect the efficiency or liquidity of the listed markets. The OTC options markets currently exist to accommodate a variety of commercial and other needs of market participants, including the ability to customize the terms of transactions. While the availability of an OCC guarantee for OTC transactions in which the parties would otherwise be exposed to each others' creditworthiness may cause transactions that currently occur in the non-cleared OTC markets to migrate to the cleared-OTC markets, OCC does not believe it will cause significant migration from the listed markets to the cleared OTC markets. The limitation of the OTC options markets to ECPs as well as the significant minimum transaction size and tenor requirements that are applicable to certain transactions in the currently proposed OTC options under the S&P License Agreement will limit the use of cleared OTC options and should help to ensure that there is no substantial migration from the listed markets to the OTC markets for this product. The existing

³¹ See comment letter from Alessandro Cocco, Managing Director of J.P. Morgan Clearing Corporation and J.P. Morgan Securities LLC, to Ms. Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (January 30, 2012), available at <http://www.sec.gov/comments/sr-occ-2011-19/occ201119-2.pdf>.

bilateral OTC options markets have existed for years alongside the listed options markets, and OCC believes that dealers in such bilateral options often use the listed markets to hedge positions taken in such bilateral options and other OTC derivatives.

Notice of Launch Date

Following approval of this rule change by the Commission, OCC expects to provide notice to its clearing members of the date on which it intends to implement this rule change and begin clearing OTC options.

* * *

The proposed changes to OCC's By-Laws are consistent with the purposes and requirements of Section 17A of the Exchange Act³² because they are designed to permit OCC to clear OTC options subject to the same basic rules, procedures and risk management practices that have been used successfully by OCC in clearing transactions in listed options. OCC believes that clearance and settlement of OTC options pursuant to this rule filing is fully consistent with OCC's obligations with respect to the prompt and accurate clearance and settlement of securities transactions and the protection of securities investors and the public interest. The proposed rule change is not inconsistent with any existing rule of OCC.

The proposals contained in the advance notice shall not take effect until all regulatory actions required with respect to the proposals are completed.

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

OCC does not believe that the proposed changes contained in the advance notice will have any impact or impose any burden on competition.

³² 15 U.S.C. 78q-1.

(C) Clearing Agency's Statement on Comments on the Advance Notice Received from Members, Participants, or Others

Written comments were not and are not intended to be solicited with respect to the advance notice, and, except as discussed below, none have been received. OCC has been actively engaged with a number of clearing members that have expressed an interest in clearing OTC Options. The following are the only substantive written comments that were received, and they have been addressed, in the manner indicated:

- OCC received a written comment that the role of the Default Management Advisory Committee, as described in the OTC Options Auction procedures that were attached as Exhibit 5 to this rule filing, should be clarified. OCC has revised the procedures to clarify that the Default Management Advisory Committee will be a standing committee and will be formed from the inception of OCC's clearing of OTC Options. It will not be an *ad hoc* committee formed at the time of a default.
- OCC received a written comment asking that the Membership/Risk Committee have a role in setting exercise settlement values with respect to OTC index options in unusual circumstances pursuant to Section 4(a)(2) of Article XVII of the ByLaws. OCC has revised the rules to provide that OCC will consult with that committee when appropriate in setting exercise settlement values pursuant to Section 4(a)(2).
- OCC received a written comment asking for limitations on the indemnification of OCC by clearing members under Section 6(f) of Article XVII of the ByLaws. In response to this comment OCC has added an

exclusion from the indemnity for claims, liabilities, or expenses that result primarily from OCC's gross negligence or willful misconduct or from OCC conduct that causes the offer or sale of the OTC Options to become subject to the registration provisions of Section 5 of the Securities Act.³³

III. Date of Effectiveness of the Advance Notice and Timing for Commission Action

The proposed changes contained in the advance notice may be implemented pursuant to Section 806(e) (1)(G) of Clearing Supervision Act³⁴ if the Commission does not object to the proposed changes within 60 days of the later of (i) the date that the advance notice was filed with the Commission or (ii) the date that any additional information requested by the Commission is received. The clearing agency shall not implement the proposed changes contained in the advance notice if the Commission objects to the proposed changes.

The Commission may extend the period for review by an additional 60 days if the proposed changes raise novel or complex issues, subject to the Commission providing the clearing agency with prompt written notice of the extension. Proposed changes may be implemented in fewer than 60 days from the date the advance notice is filed, or the date further information requested by the Commission is received, if the Commission notifies the clearing agency in writing that it does not object to the proposed changes and authorizes the clearing agency to implement the proposed changes on an earlier date, subject to any conditions imposed by the Commission.

³³ 15 U.S.C. 77e.

³⁴ 12 U.S.C. 5465.

OCC has also filed the advance notice as a proposed rule change pursuant to Section 19(b)(1) of the Act³⁵ and Rule 19b-4 thereunder.³⁶ Pursuant to those provisions, 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.

The clearing agency shall post notice on its web site of proposed changes that are implemented.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. 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

³⁵ 15 U.S.C. 78s(b)(1).

³⁶ 17 CFR 240.19b-4.

- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-OCC-2012-14 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-OCC-2012-14. 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 advance notice that are filed with the Commission, and all written communications relating to the advance notice 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 filings also will be available for inspection and copying at the principal office of OCC and on OCC's website at

http://www.optionsclearing.com/components/docs/legal/rules_and_bylaws/sr_occ_12_14.pdf.

All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-OCC-2012-14 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

By the Commission.

Kevin O'Neill
Deputy Secretary