

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-49841; File No. SR-OCC-2003-11)

June 9, 2004

Self-Regulatory Organizations; The Options Clearing Corporation; Order Approving A Proposed Rule Change Relating to Clearing Member Trade Assignment Processing

On October 14, 2003, pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934¹ (“Act”), The Options Clearing Corporation (“OCC”) filed with the Securities and Exchange Commission (“Commission”) a proposed rule change (File No. SR-OCC-2003-11) and on February 18, 2004, amended the proposed rule change. Notice of the proposal was published in the Federal Register on March 18, 2004.² The Commission received one comment letter.³ For the reasons discussed below, the Commission is approving the proposed rule change.

I. Description

The proposed rule change will amend OCC’s By-Laws and Rules to expand its clearing member trade assignment (“CTMA”) processing procedures, to increase OCC’s initial and minimum net capital requirements, and to increase OCC’s minimum clearing fund requirement for execution-only clearing members.

A. Background

CTMA processing permits one clearing member (“carrying clearing member”) to authorize another clearing member (“executing clearing member”) to direct that its exchange transactions be transferred to an account of the carrying clearing member for clearance and

¹ 15 U.S.C. 78s(b)(1).

² Securities Exchange Act Release No. 49378 (Mar. 9, 2004), 69 FR 12190 (Mar. 15, 2004).

³ Letter from John Berton and Georgia Bullitt, Ad Hoc CMTA Committee of the Securities Industry Association, March, 22, 2004.

settlement.⁴ Generally, the executing clearing member executes the transaction itself or guarantees the broker that executed the transaction and directs the transaction to be cleared into an account of the carrying clearing member through the options exchanges' systems for reporting matching trade information to OCC. A carrying clearing member does not have the ability to approve or reject such a direction before the transaction is entered into the exchanges' systems for reporting to OCC.

The matching trade information submitted by an exchange for a transaction that has been executed pursuant to a CMTA arrangement will identify both the carrying and executing clearing members by their assigned clearing numbers. OCC permits an executing clearing member to transfer transactions effected only on the exchange(s) designated by the carrying clearing member in a CMTA authorization filed with OCC. Accordingly, before a transaction is transferred to an account of the carrying clearing member for clearance, OCC's system confirms that (i) there is a valid CMTA arrangement between the carrying and executing clearing members and (ii) the exchange transaction was effected on a designated exchange. The carrying clearing member is then responsible for settling the trade and maintaining the resulting position. If their arrangement permits, a carrying clearing member may transfer the position back to the executing clearing member through OCC's systems to correct the execution member's good-faith error in identifying the carrying clearing member in the submitted trade information.⁵

⁴ The CMTA facility was developed to permit carrying clearing members to clear and settle transactions effected on an exchange where they are either not a member or do not maintain a presence for trade execution.

⁵ This commonly occurs if the executing clearing member has transposed digits of a carrying clearing member's clearing number causing the transaction to clear in an account of a wrong clearing member (assuming a valid CMTA arrangement exists between the executing and misidentified carrying clearing member).

OCC's CMTA facility supports two distinct types of business. First, clearing members that execute transactions for correspondent brokers use the process to transfer transactions to the correspondent brokers' clearing firms. Second, firms that execute trades for institutional and other customers with prime brokerage arrangements use the process to transfer the trades to the prime broker clearing member.

B. CMTA Rule Changes

The new OCC Rule 403 will require clearing members that are parties to a CMTA arrangement to register and provide certain details of their arrangement with OCC. Such registration will be effective when the clearing members provide matching information regarding their arrangement. Rule 403 will also establish certain actions for OCC's system to verify that a valid CMTA registration exists. Transactions that fail these checks will be transferred to a designated account or, if such designation has not been made, to the customers' account or segregated futures account of the executing clearing member, as applicable. A carrying clearing member is responsible for each transaction transferred to its account pursuant to a CMTA arrangement subject to its right to return the resulting position for certain specified reasons (as explained below). Notwithstanding that right, the carrying clearing member is responsible to effect premium or margin settlement, as applicable, on the business day after the trade was executed for any positions carried in its accounts after nightly processing.⁶

A position transferred pursuant to a CMTA arrangement may be returned to the

⁶ Certain exchanges submit matching trade information on a real time or intermittent basis during a trading day. OCC immediately processes such submissions and makes updated position information available for clearing member review throughout the day. For transactions effected on such exchanges, clearing members may be able to effect a return before OCC closes its window for the submission of returns, in which case the executing clearing member would be responsible for any premium or margin settlement.

executing clearing member upon notice for reasons to be specified in a standard agreement.⁷

The reasons that are being considered include: (i) the matching trade information did not conform to the trade information supplied to the carrying clearing member by the customer on whose behalf the trade was executed (e.g., transaction was for a put option in a particular series rather than a call option); (ii) the carrying clearing member's reasonable belief that the trade involved a violation of applicable law, rule, or regulation (e.g., failure to deliver a prospectus); (iii) the carrying clearing member no longer carries the account of the customer on whose behalf the trade was executed or has restricted the customer's ability to use the CMTA process; or (iv) the carrying clearing member was misidentified in the matching trade information. Returns must be completed pursuant to specified procedures by a prescribed cutoff time before trading commences on the business day after trade date. OCC will transmit certain information regarding the reasons given for a return, but will not validate the stated reasons. A position that has been assigned, exercised, or matured may not be transferred or returned under Rule 403 and will be dealt with in accordance with the provisions of the CMTA agreement between the clearing members.

A carrying clearing member may not effect a return after the prescribed cutoff time. Initiating a return after the applicable cutoff time might subject the carrying clearing member to disciplinary action. In the case of a position returned to an executing clearing member due to a misidentification of the carrying clearing member, the executing clearing member may retransfer

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OCC clearing members have formed an ad hoc committee under the auspices of the Securities Industry Association to collaborate on a standard form agreement. That agreement is currently in draft form.

the position to the correct carrying clearing member in order to correct the error.⁸

A registered CMTA arrangement may only be terminated as specified in Rule 403, which permits clearing members to either mutually or unilaterally terminate the arrangement.⁹ Terminations by mutual agreement will be effective when OCC receives notice of termination from both clearing members. Unilateral terminations will be effective the next business day after notice of the termination has been given to OCC and the other clearing member. Transactions effected after the effective time of a termination will be treated as failed CMTAs and will be the responsibility of the executing clearing member.

Other rule changes relating to CMTAs include additional definitions of terms used in CMTA processing (e.g., “carrying clearing member” and “executing clearing member”) and other conforming changes.

C. Increases in Net Capital and Minimum Clearing Fund Requirements

OCC has also reassessed the risks associated with CMTA transactions. With the increase in the number of permissible reasons for returning a position, OCC believes that there is an increased possibility that executing clearing members, including execution-only firms, will be required to make premium or margin settlement for a position before it can be closed out or otherwise managed. To address this possibility, OCC will increase its initial and minimum net

⁸ There is no approval process associated with position transfers between clearing members to correct clearing errors. OCC determined not to include an approval process for such transfers based on discussions with clearing members during the development of ENCORE Release 3.0. Clearing members claimed that an approval process would be inefficient from an operational and administrative perspective, would increase system overhead, and would adversely affect their ability to review position changes on a timely basis.

⁹ OCC has retained the right to terminate all CMTA arrangements of a suspended clearing member.

capital requirements for all clearing members and will increase the minimum clearing fund deposit for execution-only firms. Initial required net capital will be increased from \$1 million to \$2.5 million, and minimum net capital would be increased from \$750,000 to \$2 million.¹⁰ The minimum clearing fund deposit for execution-only firms will be increased from \$150,000 to \$150,000 plus \$15 times the firm's average daily executed volume for the preceding calendar month. The increases are being applied to all clearing members because over 80% of OCC's clearing members are eligible to use the CMTA facility.

The special net capital requirements for firms providing facilities management services and stock settlement services are being increased proportionately.¹¹ A firm providing such services will be required to have a minimum net capital of \$4 million plus \$200,000 times the number of firms over four that it services. Clearing members will be given a one-year grace period from October 1, 2003, to achieve compliance with the new requirements. However, the OCC's membership/margin committee shall have the discretion to extend that deadline to a date no later than October 1, 2006, for clearing members admitted to membership after the date of this approval order, provided that such clearing members undertake not to engage in a CMTA execution business during the period of such extension.

Execution-only clearing members pose a special risk because they do not ordinarily carry positions overnight and therefore do not ordinarily deposit margin with OCC. This means that if a position is returned to an execution-only member and if the execution-only member fails

¹⁰ These new capital standards are consistent with the capital requirements of other clearing organizations. For example, the Chicago Mercantile Exchange's initial net capital requirement is \$2 million, while the Board of Trade Clearing Corporation is \$2.5 million.

¹¹ Securities Exchange Act Release No. 49478 (Mar. 25, 2004), 69 FR 17258 (Apr. 1, 2004) [File No. SR-OCC-2003-09] (proposing new OCC Rule 309A).

to make settlement, the only asset of the member that OCC can draw upon to liquidate the position is the member's clearing fund deposit. Accordingly, OCC will increase the minimum clearing fund requirement for execution-only members to \$150,000 plus \$15 times average daily executed volume for the preceding month. Execution-only firms will also be given the one-year grace period described above to comply with this new minimum.

OCC also will make conforming changes to the definitional provisions of its by-laws, qualification standards for admission, various financial responsibility rules, and the rule defining monthly contributions to the clearing fund.

II. Comment Letter

John Berton and Georgia Bullitt, on behalf of the Ad Hoc CMTA Committee of the Securities Industry Association, expressed their support for the proposed rule. Among other things, they contended that it will provide “definitional clarity regarding the CTMA process and appropriate procedures to protect against systemic risk in connection with options clearing.”

III. Discussion

Section 17A(b)(3)(F) of the Act¹² requires that the rules of a clearing agency be designed to promote the prompt and accurate clearance and settlement of securities transactions and to assure the safeguarding of securities and funds that are in the custody or control of the clearing agency or for which it is responsible. The Commission finds that the proposed rule change is consistent with OCC's obligations under Section 17A(b)(3)(F) because it substantially clarifies the rights and responsibilities of OCC members that participate in the CMTA facility, which should help OCC promote the prompt and accurate clearance and settlement of securities transactions and also provide greater certainty and transparency over how CMTA transactions

¹² 15 U.S.C. 78q-1(b)(3)(F).

will be processed. In addition, increasing members' net capital and minimum clearing fund requirements should appropriately protect itself against the greater risk it faces as a result of its expansion of its CMTA services.

IV. Conclusion

On the basis of the foregoing, the Commission finds that the proposed rule change is consistent with the requirements of the Act and in particular with the requirements of Section 17A of the Act¹³ and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (File No. SR-OCC-2003-11) be, and hereby is, approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.¹⁴

Margaret H. McFarland
Deputy Secretary

¹³ 15 U.S.C. 78q-1.

¹⁴ 17 CFR 200.30-3(a)(12).