

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50141; File No. SR-OCC-2004-14)

August 3, 2004

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change Relating to Segregation of Long Leg After Close Out of Short Leg of a Spread

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ notice is hereby given that on June 25, 2004, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which items have been prepared primarily by OCC. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The proposed rule change would amend Article VI (Margins), Rule 611 (Segregation of Long Positions) of OCC's Rules by adding Interpretation & Policy .01 to Rule 611. The Interpretation would make clear when clearing members must instruct OCC to segregate the long leg of a spread following the close out of the short leg.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, OCC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. OCC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most

¹ 15 U.S.C. 78s(b)(1).

significant aspects of such statements.²

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

The purpose of the proposed rule change is to amend Rule 611 in order to better align its provisions with those of Commission Rule 15c3-3 by clarifying when a clearing member must instruct OCC to segregate the long leg of a spread after the short leg has been closed out.³

Background

Each OCC clearing member conducting a public securities business is required under Article VI (Clearance of Exchange Transactions), Section 3 (Maintenance of Accounts) paragraph (e) of OCC's By-Laws to maintain customer positions in a separate customers' account. As positions are carried in this account on an omnibus basis (i.e., identified by clearing member rather than by customer) and may include long options that are fully paid securities subject to the possession or control requirement of Commission Rule 15c3-3, OCC normally maintains all long positions in customers' accounts as segregated. Segregated long positions are free of any lien in favor of OCC, and their value does not reduce the margin requirement on short positions in the account.⁴

In recognition of exchange rules allowing a clearing member to give its customers margin relief on short options positions "spread" against qualified long option positions, OCC Rule 611(c) affords a clearing member the opportunity to release such long positions from segregation. The effect of this release is to subject the long position to OCC's lien and to provide corresponding margin relief to the clearing member. Rule 611(c) further provides that a

² The Commission has modified parts of these statements.

³ 17 CFR 240.15c3-3.

⁴ Article I, Section S.(6) of OCC's By-Laws; OCC Rules 602(d)(1) and 611(d)(1).

clearing member shall not permit a long position to remain unsegregated after the spread is broken, but it does not specify how quickly the clearing member must resegment the long position.

Segregation Instructions Under Rule 611

Clearing members may instruct OCC to release long customer positions from segregation or to resegment positions that were previously released from segregation either by submitting a machine-readable data file or by making appropriate entries on an online screen. In either case, OCC's window for accepting such instructions runs from the start of trading through 7:00 PM Central Time each day. Prior to submitting these instructions, however, many clearing members first reconcile their activity and end of day position records with OCC's records through files generated by OCC's data service. In addition, certain clearing members use these machine readable data service files to generate their segregation instructions. As data service is typically not available until 10:00 PM Central Time, three hours after the closing of the window for accepting instructions, files containing segregation instructions based upon the current day's closing position inventory are typically not processed until the following business day. Same day processing of instructions for clearing members not relying upon OCC's data service for balancing or generating segregation instructions is likewise impractical given the narrow processing timeframe between the close of trading and 7:00 PM Central Time.

The resulting one-day lag is likely to cause either a temporary under- or over-segregation of customer long option positions. The effect of an over-segregated situation is an overstatement of the clearing member's margin requirement, as long contracts eligible for margin credit at OCC would not be recognized. There is, however, no violation of either OCC Rule 611(c) or Commission Rule 15c3-3.

The effect of an under-segregated situation is an understatement of the clearing member's margin requirement, as long contracts no longer eligible for margin credit at OCC are nevertheless given credit for one more day in OCC's margin calculations. This situation occurs when a customer closes out the short leg of a spread. The long leg remains subject to OCC's lien until the clearing member's re-segregation instructions are processed the following day.

OCC Rule 611(c) and Commission Rule 15c3-3

Rule 611(c) provides that no clearing member shall "instruct the Corporation to release from segregation, or permit to remain unsegregated, any long position in option contracts carried in a customer's account or firm non-lien account for any customer or non-customer unless the clearing member is simultaneously carrying in such account for such customer or non-customer a short position in option contracts and the margin required to be deposited by such customer or non-customer with respect to such short position has been reduced as a result of the carrying of such long position." As the purpose of Rule 611(c) has always been to facilitate compliance with Commission Rule 15c3-3 and not to establish any addition or more stringent requirements, Rule 15c3-3 is the appropriate point of reference for determining how quickly a clearing member is obligated to regain possession or control of the long leg of a spread once the short leg has been closed out.

Rule 15c3-3(b)(2) provides that a broker will not be deemed to be in violation of the rule if "solely as a result of normal business operations, temporary lags occur between the time when a security is required to be in the possession or control of the broker or dealer and the time that it is placed in his physical possession or under his control, provided that the broker or dealer takes timely steps in good faith to establish prompt physical possession or control." Rule 15c3-3(d) provides further guidance as to when the broker must initially determine that control is required.

Not later than the next business day, a broker or dealer, as of the preceding business day, shall determine from his books or records the quantity of fully-paid securities and excess margin securities in his possession or control and the quantity of fully-paid securities and excess margin securities not in his possession or control.

Rule 15c3-3(d) goes on to provide that “If such books and records indicate, as of such close of the business day, that such broker or dealer has not obtained physical possession or control of all fully-paid and excess margin securities as required by this rule” certain specified maximum time limits for issuing instructions and/or obtaining possession or control will apply. Those time limits vary depending on the situation. In the case of securities subject to a lien securing moneys borrowed or in the case of securities loaned, the broker-dealer must issue instructions for the release or the return of the securities no later than the business day following the determination that control must be obtained and must actually obtain possession or control within two business days after that in the case of securities securing a loan or within five days in the case of loaned securities. Time frames of up to 45 days apply in other circumstances. These time frames appear to reflect an assessment of reasonableness given the nature of the situation and of industry practices.

While there are no provisions of Rule 15c3-3 establishing such specific time lines in the context of long options, OCC believes a reasonable interpretation of the more general provisions of Rule 15c3-3 is that they do not require the segregation of long leg of a spread more promptly than the second business day following the day on which the short leg is closed if, as seems to be the case, a lag of that duration occurs “as a result of normal business operations.” Accordingly, OCC believes it is appropriate to clarify Rule 611(c) to provide more certainty regarding when segregation should occur. Therefore, OCC is adopting an interpretation of Rule 611(c) providing that when the short leg of a spread is closed out, a clearing member must issue re-segregation instructions with respect to the long leg as soon thereafter as is reasonably practicable and in any

event at or prior to the time OCC requires so that OCC can implement the instruction not later than the opening of business on the second business day following the day on which the short leg was closed.

OCC believes that the proposed changes to its rules are consistent with the purpose and requirements of Section 17A of the Act because it provides greater clarity as to when clearing members need to issue segregation instructions to OCC under Rule 611 to further the protection of investors.

(B) Self-Regulatory Organization's Statement on Burden on Competition

OCC does not believe that the proposed rule change would impose any burden on competition.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were not and are not intended to be solicited with respect to the proposed rule change, and none have been received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The foregoing rule change has become effective pursuant to Section 19(b)(3)(A)(i) of the Act⁵ and Rule 19b-4(f)(1)⁶ thereunder because it constitutes a stated policy, practice or interpretation with respect to the meaning, enforcement or administration of an existing rule. At any time within sixty days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in

⁵ 15 U.S.C. 78s(b)(3)(A)(i).

⁶ 17 CFR 240.19b-4(f)(1).

furtherance of the purposes of the Act.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act.

Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>) or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-OCC-2004-14 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-OCC-2004-14. 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 Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth

Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of OCC and on OCC's Web site at www.optionsclearing.com.

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-2004-14 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission by the Division of Market Regulation, pursuant to delegated authority.⁷

Margaret H. McFarland
Deputy Secretary

⁷ 17 CFR 200.30-3(a)(12).