

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50509; File No. SR-OCC-2004-10)

October 8, 2004

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing and Order Granting Accelerated Approval of a Proposed Rule Change to Establish an Internal Cross-Margin Program

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹, notice is hereby given that on June 4, 2004, The Options Clearing Corporation (“OCC”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change described in Items I, II, and III below, which items have been prepared primarily by OCC. The Commission is publishing this notice and order to solicit comments from interested persons and to grant accelerated approval of the proposal.

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

OCC is seeking to amend its By-Laws and Rules as set forth below to create an internal cross-margining program that will permit a clearing member to establish a non-proprietary account for market professionals in which securities and security futures that are cleared by OCC in its capacity as a securities clearing agency may be cross-margined with commodity futures and options on such futures that are cleared by OCC in its capacity as a derivatives clearing organization (“DCO”) registered as such under the Commodity Exchange Act (the “CEA”).

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

¹ 15 U.S.C. 78s(b)(1).

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 significant aspects of these statements.²

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

The purpose of this filing is to make cross-margining available to non-proprietary market professionals where the positions to be cross-margined are all maintained with OCC. This program is similar to cross-margining programs currently in effect between OCC and the Chicago Mercantile Exchange and other commodities clearing organizations with one major difference. The positions to be cross-margined under this proposal are all cleared by OCC. There is no second clearing organization. For this reason the program is called "internal" cross-margining. Internal cross-margining is possible because OCC, in its capacity as a DCO, can now clear futures and futures options subject to the exclusive jurisdiction of the Commodity Futures Trading Commission ("CFTC").

In the existing "external" cross-margining programs, OCC contracts with a DCO, such as the Chicago Mercantile Exchange, to permit a clearing member of OCC that is (or has an affiliate that is) a clearing member of the DCO to margin as a single portfolio its positions in security options cleared by OCC and its (or its affiliate's) positions in related commodity futures and commodity options thereon cleared by the DCO. Margin is assessed based on the net risk of the portfolio, and to the extent that the contracts in the account are offsetting from a risk

² The Commission has modified the text of the summaries prepared by OCC.

perspective, the clearing member's margin requirement is less than it would be if the commodity positions were carried in accounts separate from the security positions.

Internal cross-margining functions in the same way except that the internal cross-margining account would contain only positions in contracts cleared by OCC. This greatly simplifies the arrangement in that it eliminates the need for contractual relationships between two clearing organizations, the holding of collateral for their joint benefit and loss sharing arrangements. As in the case of existing non-proprietary cross-margining programs, the internal non-proprietary cross-margining account would be treated as a segregated futures account under Section 6d of the CEA and, in accordance with Appendix B to Part 190 of the CFTC's regulations, would be separately segregated from the regular segregated futures account that an OCC clearing member may maintain under Article VI, Section 3(f) of OCC's By-Laws. That futures account is confined to customer transactions in futures, futures options, and security futures (to the extent that such security futures are carried in futures accounts by the clearing member's customers) and may not include positions in security options.

OCC is seeking approval of internal cross-margining only in relation to accounts of non-proprietary market professionals. A market professional is, in essence, a market-maker, specialist or person acting in a similar capacity on a securities exchange, or a member of a futures exchange trading for its own account. A non-proprietary market professional is any market professional that is required to be treated as a "customer" under the CEA and therefore excludes any market professional that is affiliated with the carrying clearing member in a way that would cause its account to be treated as a "proprietary account" under Section 1.3(y) of the CFTC's regulations.

In the absence of an internal cross-margining program, clearing members would be unable to carry futures positions of non-proprietary market professionals in the same account as their positions in security options because of the segregation requirements applicable to the former under the Commodity Exchange Act.

Since it granted approval of the first cross-margining program in 1988, the Commission has repeatedly found that cross-margining programs are consistent with clearing agency responsibilities under Section 17A of the Act and highly beneficial to the clearing organization, its clearing members, and the public.³ Cross-margining programs enhance clearing member and systemic liquidity which results in lower initial margin deposits. They reduce the risk that a clearing member will become insolvent in a distressed market and the corresponding risk that one insolvency could lead to multiple insolvencies in a ripple effect. They enhance the security of the clearing system.⁴

The following are particular points of interest about OCC's internal cross-margining program.

(1) Amended Definition

The existing definition of "Market Professional" in Article I of OCC's By-Laws is amended to substitute a reference to OCC in place of the reference to the Intermarket Clearing Corporation, which has been merged into OCC.

³ Securities Exchange Act Release No. 26153 (Oct. 3, 1988), 53 FR 39567 [SR-OCC-86-17].

⁴ Securities Exchange Act Release No. 32708 (Aug. 2, 1993), 58 FR 42586 [SR-OCC-93-13].

(2) Absence of Cross-Margining Agreement

All established external cross-margining programs involving OCC have a cross-margining agreement as the constitutive and governing document. The parties to these cross-margining agreements are the clearing organizations that clear the trades in the cross-margining accounts of a joint clearing member or a pair of affiliated clearing members. Internal cross-margining, however, does not require a cross-margining agreement because the only participating clearing organization is OCC.

(3) Requirement of Market Professional's Agreement

The terms governing the cross-margining arrangements between OCC and each participating clearing member are set forth in OCC's By-Laws and Rules. The rights and obligations of a non-proprietary market professional that wants the benefits of internal cross-margining vis-à-vis the clearing member through which it clears are not covered in the By-Laws and Rules and so must be made the subject of a separate agreement. The execution of such an agreement, the "Market Professional's Agreement for Internal Cross-Margining," is a requirement for the market professional's participation in the program.⁵

⁵ A copy of the form Market Professional's Agreement for Internal Cross-Margining is attached as part of the OCC filing.

(4) Amendments to Chapter XI of the Rules

Amendments to Rules 1104 through 1107 of Chapter XI of OCC's Rules, which governs the suspension of a clearing member, all relate to the liquidation of a suspended clearing member that participates in the internal cross-margining program. Similar to the separate rules that govern the liquidation of the segregated futures account, additional separate rules were created to govern the liquidation of the internal non-proprietary cross-margining account. They are both segregated accounts under the Commodity Exchange Act, and the positions and other assets of each account may not be commingled with those not in that account or be used to satisfy obligations other than those arising from activity in that account. Thus, in each place where special provision in OCC's Rules is made for the segregated futures account, a parallel provision for the internal non-proprietary cross-margining account has been inserted with a parallel purpose and effect.

(5) Regulatory Approvals

In addition to the approval of the Commission, OCC must also obtain the approval of the CFTC to the commingling of positions of non-proprietary market professionals in futures products with their security options positions. OCC is concurrently applying to the CFTC for such approval.

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

OCC does not believe that the proposed rule change will 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 Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder and particularly with the requirements of Section 17A(b)(3)(F)⁶ of the Act, which requires that the rules of a clearing agency be designed to provide for the safeguarding of securities and funds which are in its possession or control or for which it is responsible. By establishing an internal cross-margin program, OCC will provide its members with the benefits of cross-margining, including greater liquidity and more efficient use of collateral, in a manner that is consistent with OCC's overall risk management process.

The Commission finds good cause for approving the proposed rule change prior to the thirtieth day after the date of publication of notice of filing because such approval will allow OCC to implement the proposed rule change so that its members immediately have the benefits of cross-margining options on variability indexes with commodity futures on variability indexes.

⁶ 15 U.S.C. 78q-1(b)(3)(F).

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-2004-10 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-2004-10. 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

<http://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-2004-10 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).