

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-52035; File No. SR-OCC-2002-16)

July 14, 2005

Self-Regulatory Organizations; The Options Clearing Corporation; Order Granting Approval of a Proposed Rule Change Relating to Unsegregation of Long Option Positions

I. Introduction

On July 9, 2002, The Options Clearing Corporation (“OCC”) filed with the Securities and Exchange Commission (“Commission”) proposed rule change SR-OCC-2002-16 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”).¹ On December 12, 2002, and January 11, 2005, OCC amended the proposed rule change. Notice of the proposal was published in the Federal Register on March 14, 2005.² No comment letters were received. For the reasons discussed below, the Commission is granting approval of the proposed rule change.

II. Description

OCC Rule 611 permits a clearing member to issue instructions to OCC to release from segregation a long position in options contracts carried in a customers’ account or firm non-lien account provided that the clearing member is simultaneously carrying in such account for such customer a short position in option contracts and the margin requirement of the customer has been reduced as a result of carrying the long option position. The proposed rule change amends Rule 611(c) to permit a clearing member to issue such instructions where one leg of the spread is a long option position and the other is a long or short position in a security futures contract.

The proposed rule change was submitted in light of joint margin rules that were adopted by the Commission and by the Commodity Futures Trading Commission (“CFTC”) on August 1,

¹ 15 U.S.C. 78s(b)(1).

² Securities Exchange Act Release No. 51331, (March 8, 2005), 70 FR 12525.

2002,³ pursuant to Section 7(c)(2) of the Act and related provisions of the Commodity Exchange Act governing the setting of margin requirements for security futures. The proposed rule is drafted in such a way that its operation is dependent on the joint margin rules and the rules of the exchanges and security futures markets adopted thereunder. Only if a particular spread position involving a long option qualifies for reduced margin treatment under those rules could the option be unsegregated pursuant to Rule 611. With approval of this proposed rule change, consistency between the joint margin rules and Rule 611(c) will be assured.⁴

Section 7(c)(2)(B) of the Act requires that the margin requirements for security futures products be consistent with the margin requirements for comparable options contracts traded on any exchange registered pursuant to section 6(a) of the Act.⁵ Clearing members are permitted under the joint margin rules⁶ and exchange and security futures market rules adopted thereunder⁷ to reduce a customer's margin requirement when the customer has offsetting positions in security futures and options on the same underlying interest. Accordingly, OCC is amending its Rule 611(c) to also allow a clearing member to unsegregate long option positions in a customers'

³ Securities Exchange Act Release No. 46292, 67 FR 53146 (August 14, 2002) [File No. S7-16-01].

⁴ OCC has requested a no action position from the Commission's Division of Market Regulation that a clearing member that gives an instruction to unsegregate long option positions pursuant to this amended rule will not be deemed to be in violation of Rules 15c3-3, 8c-1, and 15c2-1 under the Act. Supra, note 12.

⁵ 15 USC 78g(c)(2)(B)(iii)(I).

⁶ Supra, note 3.

⁷ See, e.g., Securities Exchange Act Release Nos. 47460 (March 6, 2003), 68 FR 12123 (March 13, 2003) [File No. SR-NYSE-2003-05], 47541 (March 20, 2003), 68 FR 14725 (March 26, 2003) [File No. SR-CBOE-2002-67], and 47550 (March 20, 2003), 68 FR 15015 (March 27, 2003) [File No. SR-NASD-2003-45 (Orders approving amendments to NYSE Rule 431, CBOE Rule 12.3, and NASD Rule 2520 relating to margin requirements for security futures contracts.)

account or in a firm non-lien account when the customer holds an offsetting long or short security futures position and the clearing member has reduced the customer's margin requirement in recognition of the spread.⁸

Rule 15c3-3 under the Act requires broker-dealers to maintain physical possession or control of customer fully-paid and excess margin securities.⁹ Rules 8c-1 and 15c2-1 under the Act, which govern hypothecation of customer securities, also place limitations on broker-dealers' rights to encumber customer securities.¹⁰ In order to permit compliance by clearing members with Rule 15c3-3 and with the hypothecation rules, OCC's Rule 611(a) presently provides that long option positions in a customers' account established under Article VI, Section 3(e) of OCC's By-Laws are deemed to be segregated and therefore not subject to OCC's lien except to the extent that the clearing member gives contrary instructions to OCC in accordance with the rule.¹¹ Under Rule 611(c), a clearing member is entitled to give an instruction to unsegregate such a long position if the long position constitutes the long leg of a spread position, the short leg that constitutes the short leg of the spread position is held by the same customer, and the customer's margin requirement has been reduced to reflect the net risk of the spread position. OCC has requested and has been granted no action relief from the Commission's

⁸ Under OCC Rule 611(a), all positions in security futures are deemed to be unsegregated because a futures contract, which represents a potential liability as well as a potential asset, is never deemed to be fully-paid or to represent excess margin securities. Accordingly, this rule filing addresses only the case where long put or call options are spread against long or short futures contracts.

⁹ 17 CFR 240.15c3-3(b).

¹⁰ 17 CFR 240.8c-1 and 15c2-1.

¹¹ The provisions of Rule 611 also apply to long option positions of certain "non-customers" carried in a "firm non-lien account" under Article VI, Section 3(a) of OCC's By-Laws. At present, no clearing member carries such an account.

Division of Market Regulation regarding the proposed rule change with respect to Rules 8c-1, 15c2-1 and 15c3-3 of the Act.¹²

III. Discussion

Section 17A(b)(3)(F) of the Act 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 which are in the clearing agency's custody or control or for which it is responsible.¹³ The purpose of OCC's Rule 611(c) is to provide consistency between the clearing level-margin requirement under OCC's rules and the customer-level margin requirement under applicable exchange rules. The joint margin rules and the customer margin rules adopted by the security exchanges and the security futures markets permit reduced customer margin levels for specific offsetting positions in options and security futures. By allowing clearing members to issue instructions to unsegregate long option positions in order to take advantage of the offsets allowed at the customer level, the proposed rule change eliminates a disparity in the customer-level and clearing-level margin requirements and thereby reduces the likelihood that clearing members will experience a financial "squeeze" resulting because the amount of clearing-level margin the member is required to deposit with OCC is

¹² Letter from Bonnie Gauch, Attorney, Division of Market Regulation to William H. Navin, General Counsel, OCC (July 14, 2005). Specifically, the letter states that the Division will not recommend to the Commission that enforcement action be taken pursuant to Exchange Act Rules 8c-1, 15c2-1, and 15c3-3 if, in accordance with the amendments to Rule 611, a broker-dealer releases from segregation or permits to remain unsegregated, a customer long option position if (1) the broker-dealer is simultaneously carrying in that customer's account an offsetting security future contract, and (2) the margin required to be deposited by the customer with respect to the security future contract has been reduced as a result of the carrying of the long option position.

¹³ 15 U.S.C. 78q-1(b)(3)(F).

greater than the amount of customer-level margin the member collects from its customers.¹⁴

As a consequence of the proposed rule change, OCC will collect less margin from its clearing members than it does under current Rule 611(c). However, this result is consistent with the joint margin rules and with the exchange and security futures market rules which were approved by the Commission. Furthermore, because the proposed rule change requires that any long options position that is used to offset a security futures position will be unsegregated and therefore subject to OCC's lien, OCC and its members will be protected from financial loss in the event an OCC member fails to meet its obligations with respect to such short security futures position. Accordingly, because the proposed rule change is designed so that it provides consistent treatment between OCC's rules, the joint margin rules, and the margin rules of the exchanges and the security futures markets without jeopardizing the adequacy of collateral available to OCC, the proposed rule change should promote the prompt and accurate clearance and settlement of securities transactions and should help assure the safeguarding of securities and funds which are in OCC's custody or control or for which OCC is responsible.

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 Section 17A of the Act and the rules and regulations thereunder.

¹⁴ The Commission has previously approved similar amendments to Rule 611(c). See, e.g., Securities Exchange Act Release No. 31626 (December 21, 1992), 57 FR 62588 (December 31, 1992) [File No. SR-OCC-92-14] (Order approving a proposed rule change that eliminated the requirement that spread positions be carried for the same customer and be on a contract-for-contract basis. The rule change gave clearing-level spread margin treatment to pairs of positions where the customer's margin requirement had been reduced in accordance with applicable exchange margin rules).

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (File No. SR-OCC-2002-16) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.¹⁵

J. Lynn Taylor
Assistant Secretary

¹⁵ 17 CFR 200.30-3(a)(12).

