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SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-72803; File No. SR-OCC-2014-803)

August 11, 2014

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing of an Advance Notice to Better Manage Risks Concentration and Other Risks Associated with Accepting Deposits of Common Stocks for Margin Purposes

Pursuant to Section 806(e)(1) of Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act entitled the Payment, Clearing, and Settlement Supervision Act of 2010 (“Clearing Supervision Act”)<sup>1</sup> and Rule 19b-4(n)(1)(i)<sup>2</sup> of the Securities Exchange Act of 1934 notice is hereby given that on July 16, 2014, The Options Clearing Corporation (“OCC”) filed with the Securities and Exchange Commission (“Commission”) the advance notice as described in Items I and II below, which Items have been prepared by OCC.<sup>3</sup> 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

This advance notice is filed by OCC in connection with a proposed change that would permit OCC to better manage concentration and other risks (i.e., wrong-way risk) associated with accepting deposits of common stock for margin purposes. In order to manage such risks, OCC proposes to add an proposed Interpretation and Policy that will

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<sup>1</sup> 12 U.S.C. 5465(e)(1).

<sup>2</sup> 17 CFR 240.19b-4(n)(1)(i).

<sup>3</sup> OCC also filed the proposals contained in this advance notice as a proposed rule change under Section 19(b)(1) of the Securities Exchange Act of 1934 and Rule 19b-4 thereunder. 15 U.S.C. 78s(b)(1); 17 CFR 240.19b-4. *See* SR-OCC-2014-14.

provide OCC with discretion with respect to giving value to margin collateral deposited by a single clearing member.

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

In its filing with the Commission, the clearing agency 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. The clearing agency has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of such statements.

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

1. Purpose

The purpose of the proposed change is to permit OCC to better manage concentration risk and other risks (i.e., wrong-way risk) associated with accepting deposits of common stock for margin purposes.<sup>4</sup> Accordingly, in order to manage such risks, OCC proposes to add an Interpretation and Policy to Rule 604, which specifies the forms of margin assets accepted by OCC, that will provide OCC with discretion with respect to giving value to assets deposited by a single clearing member to satisfy its margin requirement(s). In addition, OCC proposes to make clarifying amendments to an existing Interpretation and Policy under Rule 604 that gives OCC discretion to not give value to a particular type of margin collateral across all clearing members.

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<sup>4</sup> This proposed change has also been filed as a proposed rule change filing (SR-OCC-2014-14).

## Background

OCC Rule 604 lists the types of assets that clearing members may deposit with OCC to satisfy their margin requirement(s) as well as sets forth eligibility criteria for such assets. Common stocks, including Exchange Traded Funds (“ETFs”) and Exchange Traded Notes (“ETNs”), are the most common form of margin assets deposited by clearing members and currently comprise 68% of the \$60.6 billion in clearing member margin deposits held by OCC (not including deposits in lieu of margin). Since 2009, OCC has used STANS, its daily automated Monte Carlo simulation-based margining methodology, to value common stocks deposited by clearing members as margin.<sup>5</sup> The value given to margin deposits depends on factors that include the price volatility and the price correlation relationship of common stock collateral to the balance of the cleared portfolio. The approach used by STANS incentivizes clearing members who chose to meet their margin obligations with deposits of common stocks to choose common stocks that hedge their related open positions.

Notwithstanding the value STANS gives to deposits of common stocks, certain factors warrant OCC adjusting the value STANS gives to all clearing member margin deposits of a particular type of margin collateral. Such factors are set forth in Rule 604, Interpretation and Policy .14, and include the number of outstanding shares, number of outstanding shareholders and overall trading volume. OCC is proposing to add a new Interpretation and Policy to Rule 604 (the “Interpretation”) so that OCC has discretion to not give margin credit to a particular clearing member when such clearing member deposits a concentrated amount of any common stock and when a common stock,

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<sup>5</sup> See Securities Exchange Act Release No. 58158 (July 15, 2008), 73 FR 42646 (July 22, 2008) (SR-OCC-2007-20).

deposited as margin, presents “wrong-way risk” to OCC. In addition, the Interpretation will provide OCC discretion to grant margin credit to a clearing member when it deposits shares of common stock that serve as a hedge to the clearing member’s related open positions and would otherwise be not be given margin credit.<sup>6</sup>

#### Concentrated Deposits of Common Stock

OCC has determined that in the event it is necessary to liquidate a clearing member’s positions (including the clearing member’s margin collateral), OCC may be exposed to risk arising from a large quantity of a particular common stock deposited as margin by a clearing member. Specifically, depending on the relationship between the average daily trading volume of a particular security and the number of outstanding shares of such security deposited by a clearing member as margin, it is possible that the listed equities markets may not be able to quickly absorb all of the common stock OCC seeks to sell, or OCC may not be able to auction such securities, without an appreciable negative price impact. This occurrence, referred to as “concentration risk,” is greatest when the number of shares being sold is large and the average daily trading volume is low.

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<sup>6</sup> Consistent with the language contained in existing Interpretation & Policy .14, the Interpretation provides OCC with discretion in determining the amount of margin credit given to deposits of common stock by an individual clearing member as such determination would be based on positions held and common stock deposits made by such clearing member on a given business day. However, as discussed in the following two sections, OCC also has developed certain automated processes as well as additional internal policies that describe how OCC presently intends to exercise such discretion. These additional internal policies are included in OCC’s collateral risk management policy, which will not be implemented until approval of this rule change with changes thereto being subject to additional rule filings.

OCC's existing authority to not give value to otherwise eligible forms of margin is broad in its application since such authority only provides OCC with the discretion to not give value across all clearing member deposits of a particular common stock. However, concentration risk may be a clearing member and account-specific risk. In order to mitigate the concentration risk of a single clearing member, OCC plans to implement automated processes to monitor the composition of a clearing member's margin deposits. Such processes will identify concentration risk at both an account level and across all accounts of a clearing member. OCC proposes to add the Interpretation so that OCC has discretion to limit the margin credit granted to an individual clearing member that maintains a concentrated margin deposit of otherwise eligible common stock.

For the reasons stated above, OCC considers a common stock's average daily trading volume and the number of shares a clearing member deposited as margin to be the two most significant factors when making a decision to limit margin credit due to concentration risk. Accordingly, OCC will not give margin credit to clearing member margin deposits of a particular common stock in respect of a particular account when the deposited amount of such common stock is in excess of two times the average daily trade volume of such common stock over the most recent three month period. OCC's systems will continually assess the composition of clearing member margin deposits for each account maintained by the clearing member, including intra-day collateral substitutions in such accounts, to determine if a clearing member has a margin deposit with a concentrated amount of common stock. With respect to a given account, OCC's systems will automatically set appropriate limits on the amount of a particular common stock for

which a clearing member may be given margin credit for any one of a its tier accounts. In addition, and with respect to all of a clearing member's accounts, OCC will impose an add-on margin charge if, in aggregate, a clearing member deposits a concentrated amount of a particular common stock as margin across all of its accounts.<sup>7</sup> The add-on margin charge will operate to negate the margin credit given to the concentrated margin deposit, and will be collected, when applicable, as part of OCC's standard morning margin process.<sup>8</sup> OCC will assess the add-on margin charge across all of a clearing member's accounts on a pro-rata basis (based on the amount of the particular common stock in each of a clearing member's accounts).

OCC staff has been monitoring concentrated common stock positions, assessing the impact of the proposed change described in this filing and contacting clearing members affected by the proposed change. OCC believes that clearing members will be able to comply with the proposed change without making significant changes to their day-to-day business operations. In December 2013, an information memo was posted to inform all members of the upcoming change. Since January 2014, staff has been in contact with any clearing member that would be affected by the proposed change. On a

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<sup>7</sup> OCC believes that this policy is consistent with proposed Rule 17Ad-22(e)(5), which requires covered clearing agencies to set and enforce concentration limits to manage its or its participant's credit exposure. *See* 79 FR 16866, 16972 (March 26, 2014).

<sup>8</sup> Since the 2-day limit is first checked at each account, it is possible that a clearing member with multiple accounts may have more than 2-days of a given common stock on deposit in aggregate. To control this condition, a final check is done on the aggregate amount of shares held by a clearing member across all of its accounts. For example, if a particular clearing member has three accounts each holding 2-days volume of a specific common stock, the clearing member check would identify that the member was holding six days of volume in aggregate. To mitigate this risk, an add-on charge equal to the market value of four days of volume would be applied to all accounts holding that security on a pro-rata basis.

weekly basis, any clearing member that would see a reduction of 10% or more of its collateral value is contacted and provided an explanation of the policy and a list of concentrated positions observed in this analysis. On a monthly basis, all clearing members exhibiting any concentration risk are contacted to provide an explanation of the proposed policy and a list of concentrated positions. In both cases, clearing members are encouraged to proactively reduce concentrated positions to conform to the proposed policy. As of June 2014, twenty-five members would be affected. Implementation of the Interpretation would result in disallowing \$1.2 billion in collateral value and result in margin calls for six members totaling \$710 million. Moreover, in July 2014, OCC made an automated report concerning concentrated margin deposits of common stock available to all clearing members.

#### Wrong-Way Risk

OCC is also proposing to use the Interpretation to address the risk that the common stock a clearing member has deposited as margin and which is issued by the clearing member itself or an affiliate of the clearing member will lose value in the event the clearing member providing such margin defaults, which is known as “wrong-way risk.” Wrong-way risk occurs when a clearing member makes a deposit of common stock issued by it or an affiliate and, in the event the clearing member defaults, the clearing member’s common stock margin deposit will also be losing value at the same time because there is likely to be a strong correlation between the clearing member’s creditworthiness and the value of such common stock. In order to address wrong-way risk, the Interpretation will implement automated systems that will not give margin credit to a clearing member that deposits common stock issued by such clearing member or an

affiliate as margin collateral. OCC proposes to define “affiliate” broadly in the Interpretation to include any entity with direct or indirect equity ownership of 10% of the clearing member, or any entity for which the clearing member holds 10% of the direct or indirect equity ownership.<sup>9</sup>

OCC has addressed the impact of the change designed to address wrong-way risk. As of June 2014, there were 73 clearing members whose parent or an affiliate has issued securities trading on U.S. exchanges. There are six clearing members that would be affected by virtue of having made margin deposits of their own or an affiliate’s common stock. In total, these shares equaled \$132 million and accounted for less than one half of one percent of the total market value of valued securities pledged as margin at OCC. In July 2014, OCC made information available to each clearing member that indicates which of its deposits of common stock would not receive margin credit due to wrong-way risk considerations, as described above.<sup>10</sup>

#### Deposits That Hedge Open Positions

In addition to the above, OCC also proposes to include language in the Interpretation so that it has discretion to give margin credit to common stock deposited as margin that would otherwise not be given margin credit in circumstances when such common stock acts as a hedge (i.e., the member holds an equivalent short position in cleared contracts on the same underlying security). This condition will be checked in both the account and clearing member level. For example, if a clearing member deposits

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<sup>9</sup> This standard is based on the provisions of OCC Rule 215(a)(5).

<sup>10</sup> OCC believes that by providing such information clearing members will be better able to adjust their margin deposits at OCC to conform to the proposed change once it is approved.

the common stock of an affiliate as margin collateral, which, pursuant to the above, would ordinarily not be given value for the purposes of granting margin credit, OCC may nevertheless give value to such common stock for the purposes of granting margin credit to the extent such common stock acts as a hedge against open positions of the clearing member. In this case, a decline in the value of the margin deposit would be wholly or partially offset by an increase in the value in the open position. Moreover, in such a situation, OCC will systematically limit the margin credit granted to the lesser of a multiple of the daily trading volume or the “delta equivalent position”<sup>11</sup> for the particular common stock, taking into account the hedging position.<sup>12</sup> OCC believes that this policy will further encourage clearing members to deposit margin collateral that hedges their related open positions and is in line with the valuation methods within STANS. This

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<sup>11</sup> The “delta equivalent position” is the equivalent number of underlying shares represented by the aggregation of cleared products on that same underlying instrument. This value is calculated using the “delta” of the option or futures contract, which is the ratio between the theoretical change in the price of the options or futures contract to the corresponding change in the price of an underlying asset. Thus, delta measures the sensitivity of an options or futures contract price to changes in the price of the underlying asset. For example, a delta of +0.7 means that for every \$1 increase in the price of the underlying stock, the price of a call option will increase by \$0.70. Delta for an option or future can be expressed in shares of the underlying asset. For example, a standard put option with a delta of -.45 would have a delta of -45 shares, because the unit of trading is 100 shares.

<sup>12</sup> Assume, for example, an average daily trade volume of 250 shares, a threshold of 2 times the average daily trade volume, and a delta of -300 shares for the options on a particular security in a particular account. A position of 700 shares that did not hedge any short options or futures would receive credit for only 500 shares (*i.e.*, 2 times the average daily trade volume). If the net long position in the account, when combined with the delta of short option and futures position, were only 400, credit would be given for the entire 700 shares since the delta equivalent position is below the 500 share threshold. However, if the option delta were +300, the net long position would be 1000, and credit would only be given for 500 shares because the delta equivalent position would exceed the 500 share threshold.

policy will also facilitate OCC's management of its and its participants' credit exposure<sup>13</sup> as well as the liquidation of a clearing member's portfolio should the need arise.

#### Other Proposed Changes

OCC is also proposing to make certain clarifying changes in order to accommodate the adoption of the Interpretation into its Rules. Primarily, OCC proposes to add language to OCC Rule 604, Interpretation and Policy .14, to clarify that such Interpretation and Policy concerns OCC's authority to not give value to certain margin deposits for all clearing members (whereas the Interpretation applies to particular clearing member(s)). In addition, OCC proposes to remove language from OCC Rule 604, Interpretation and Policy .14, to improve readability as well as to remove "factors" concerning number of shares and affiliates since OCC's authority with respect to such factors will be more clearly described in the Interpretation. Finally, OCC proposes to renumber the Interpretations and Policies of Rule 604 in order to accommodate the adoption of the Interpretation.

#### 2. Statutory Basis

OCC believes that the proposed change to OCC's Rules is consistent with Section 805(b) of the Clearing Supervision Act<sup>14</sup> because the proposed change will reduce systemic risk.<sup>15</sup> OCC believes that the proposed changes to its margin policy, as described above, will reduce the risk that clearing member margin assets would be insufficient should OCC need to use such assets to close-out positions of a defaulted

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<sup>13</sup> OCC also believes that this policy is consistent with proposed Rule 17Ad-22(e)(5). *See* Fn. 6, *supra*.

<sup>14</sup> 12 U.S.C. 5464(b).

<sup>15</sup> 12 U.S.C. 5464(b)(3).

clearing member. For the same reasons, the proposed change will reduce systemic risk because it will promote confidence that OCC will be able to timely meet its settlement obligations because the proposed change will diminish the likelihood that a large percentage of a defaulting clearing member's margin assets would not be available to OCC in the event of a clearing member default. The proposed change is not inconsistent with the existing rules of OCC, including any other rules proposed to be amended or any advance notice filings pending with the Commission.

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

Written comments on the advance notice were not and are not intended to be solicited with respect to the advance notice and none have been received.

(C) Advance Notices Filed Pursuant to Section 806(e) of the Clearing Supervision Act

The proposed change would provide OCC with additional discretion with respect to giving value to clearing member deposits of margin collateral. OCC is filing this advance notice pursuant to Section 806(e)(1) of the Clearing Supervision Act<sup>16</sup> because the change could be deemed to materially affect the nature or level of risks presented by OCC.

As described above in Paragraph II.A, OCC proposes to add the Interpretation so that it has discretion to not give value to concentrated equity security margin deposits and deposits of margin collateral that present wrong-way risk to OCC. In addition, the Interpretation will provide OCC with discretion to give value to securities deposited as margin that would otherwise not be given margin credit in circumstances when such

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<sup>16</sup> 12 U.S.C. 5465(e)(1).

securities act as a hedge against open positions held in the same account. Paragraph II.A also discusses how OCC presently intends to exercise such discretion through the implementation of automated systems and additional internal policies. This proposed change will facilitate OCC's liquidation of a clearing member's margin collateral should such clearing member default and thereby promote robust risk management, safety and soundness and reduce systemic risk because the proposed change will increase the likelihood that OCC will maintain uninterrupted operations notwithstanding the clearing member default. Accordingly, OCC believes that these changes will reduce risks to OCC and its participants.

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

The designated clearing agency may implement this change if it has not received an objection to the proposed change within 60 days of the later of (i) the date that the Commission receives the notice of proposed change, or (ii) the date the Commission receives any further information it requests for consideration of the notice. The designated clearing agency shall not implement this change if the Commission has an objection.

The Commission may, during the 60-day review period, extend the review period for an additional 60 days for proposed changes that raise novel or complex issues, subject to the Commission providing the designated clearing agency with prompt written notice of the extension. The designated clearing agency may implement a change in less than 60 days from the date of receipt of the notice of proposed change by the Commission, or the date the Commission receives any further information it requested, if the Commission notifies the designated clearing agency in writing that it does not object to the proposed

change and authorizes the designated clearing agency to implement the change on an earlier date, subject to any conditions imposed by the Commission.

The designated clearing agency shall post notice on its website of proposed changes that are implemented.

The proposal shall not take effect until all regulatory actions required with respect to the proposal are completed.<sup>17</sup>

#### 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
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-OCC-2014-803 on the subject line.

##### Paper Comments:

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

All submissions should refer to File Number SR-OCC-2014-803. 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

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<sup>17</sup> OCC also filed the proposals contained in this advance notice as a proposed rule change under Section 19(b)(1) of the Securities Exchange Act of 1934 and Rule 19b-4 thereunder. *See supra* note 3.

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 am and 3:00 pm. Copies of the filing also will be available for inspection and copying at the principal office of OCC and on OCC's website ([http://www.theocc.com/components/docs/legal/rules\\_and\\_bylaws/sr\\_occ\\_14\\_803.pdf](http://www.theocc.com/components/docs/legal/rules_and_bylaws/sr_occ_14_803.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-2014-803 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

By the Commission.

Kevin M. O'Neill  
Deputy Secretary

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