



8011-01p
SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-74981; File No. SR-OCC-2014-811)

May 15, 2015

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of No Objection to an Advance Notice, as Modified by Amendment No. 1 and Amendment No. 2, to Establish Procedures Regarding the Monthly Resizing of its Clearing Fund and the Addition of Financial Resources

On December 1, 2014, The Options Clearing Corporation (“OCC”) filed with the Securities and Exchange Commission (“Commission”) advance notice SR-OCC-2014-811 (“Advance Notice”) pursuant to Section 806(e)(1) of the Payment, Clearing, and Settlement Supervision Act of 2010 (“Payment, Clearing and Settlement Supervision Act”)¹ and Rule 19b-4(n)(1)(i) under the Securities Exchange Act of 1934 (“Exchange Act”).² On December 16, 2014, OCC filed amendment number 1 to the Advance Notice (“Amendment No. 1”), which amended and replaced, in its entirety, the Advance Notice as originally filed on December 1, 2014.³ The Advance Notice, as modified by Amendment No. 1, was published for comment in the Federal Register on January 26,

¹ 12 U.S.C. 5465(e)(1). The Financial Stability Oversight Council designated OCC a systemically important financial market utility on July 18, 2012. See Financial Stability Oversight Council 2012 Annual Report, Appendix A, <http://www.treasury.gov/initiatives/fsoc/Documents/2012%20Annual%20Report.pdf>. Therefore, OCC is required to comply with the Clearing Supervision Act and file advance notices with the Commission. See 12 U.S.C. 5465(e).

² 17 CFR 240.19b-4(n)(1)(i).

³ In Amendment No. 1, OCC amended the Advance Notice to include the Monthly Clearing Fund Sizing Procedure and the Financial Resource Monitoring and Call Procedure as exhibits to the filing, both defined hereinafter, as Exhibit 5A and Exhibit 5B, respectively. OCC requested confidential treatment for Exhibit 5A and Exhibit 5B pursuant to the Rule 24b-2 under the Exchange Act.

2015.⁴ On January 27, 2015, pursuant to section 806(e)(1)(D) of the Payment, Clearing and Settlement Supervision Act,⁵ the Commission required OCC to provide additional information concerning the Advance Notice.⁶ On March 4, 2015, OCC filed amendment number 2 to the Advance Notice (“Amendment No. 2”), which amended and replaced, in its entirety, Amendment No. 1.⁷ Notice of Amendment No. 2 was published for comment in the Federal Register on April 16, 2015.⁸ The Commission did not receive any

⁴ Securities Exchange Act Release No. 74091 (January 20, 2015), 80 FR 4001 (January 26, 2015) (SR-OCC-2014-811).

⁵ 12 U.S.C. 5465(e)(1)(D).

⁶ The Commission received a response from OCC with the further information for consideration on March 17, 2015, which, pursuant to Sections 806(e)(1)(E) and (G) of the Payment, Clearing and Settlement Supervision Act, initiated a new 60 day period of review. See 12 U.S.C. 5465(e)(1)(E) and 12 U.S.C. 5465(e)(1)(G).

⁷ Amendment No. 2 amended and replaced, in its entirety, Amendment No. 1. OCC filed Amendment No. 2 to clarify the operation of a Margin Call Event, as that term is defined and used hereinafter. To accommodate these clarifications, OCC made conforming changes to Exhibit 5B, the Financial Resources Monitoring and Call Procedure, and added the Clearing Fund Intra-Month Resizing Procedure as Exhibit 5C to provide additional clarity regarding the resizing of the clearing fund. OCC requested confidential treatment for Exhibit 5A, Exhibit 5B, and Exhibit 5C pursuant to the Rule 24b-2 under the Exchange Act. In Amendment No. 2, OCC also clarified that the definition of Financial Resources, hereinafter defined, takes into account the margin deposits of a Clearing Member or a Clearing Member Group, as applicable.

⁸ Securities Exchange Act Release No. 74713 (April 10, 2015), 80 FR 20534 (April 16, 2015) (SR-OCC-2014-811). OCC also filed the proposal contained in the Advance Notice as a proposed rule change under Section 19(b)(1) of the Exchange Act and Rule 19b-4 thereunder. See Securities Exchange Act Release No. 73853 (December 16, 2014), 79 FR 76417 (December 22, 2014) (SR-OCC-2014-22). On March 13, 2015, OCC withdrew SR-OCC-2014-22 and filed the proposal previously contained therein as SR-OCC-2015-009. See Securities Exchange Act Release No. 74603 (March 27, 2015), 80 FR 17808 (April 2, 2015) (SR-OCC-2015-009). The Commission did not receive any comments on the proposed rule change.

comments on the Advance Notice or any of the amendments thereto. This publication serves as a notice of no objection to the Advance Notice.

I. Description of the Advance Notice

The proposal establishes new procedures to govern: (i) OCC's resizing of the clearing fund on a monthly basis pursuant to OCC Rule 1001(a) ("Monthly Clearing Fund Sizing Procedure"); and (ii) the addition of Financial Resources⁹ through an intra-day margin call on one or more Clearing Members¹⁰ pursuant to OCC Rule 609 and, if necessary, an intra-month increase of the clearing fund pursuant to OCC Rule 1001(a) to ensure that OCC maintains adequate Financial Resources in the event of a default of a Clearing Member or Clearing Member Group¹¹ presenting the largest exposure to OCC ("Financial Resource Monitoring and Call Procedure").¹²

⁹ For purposes of this Advance Notice, "Financial Resources" means, with respect to a projected loss that is attributable to a particular Clearing Member or Clearing Member Group, as defined hereinafter, the sum of (i) the margin deposits (less any excess margin a Clearing Member or Clearing Member Group may have on deposit at OCC) and deposits in lieu of margin with respect to the accounts of such Clearing Members or Clearing Member Groups, and (ii) the value of OCC's clearing fund, including both the Base Amount, as defined hereinafter, and the prudential margin of safety, as described below.

¹⁰ "Clearing Member" is defined, in relevant part, as a person or organization that has been admitted to membership in the Corporation pursuant to the provisions of the By-Laws and Rules. See OCC By-Laws, Article I.

¹¹ "Clearing Member Group" is defined as a Clearing Member and any Member Affiliates of such Clearing Member. "Member Affiliate" is defined as an affiliated entity of a Clearing Member that controls, is controlled by, or under common control with, the Clearing Member. See OCC By-Laws, Article I.

¹² According to OCC, the procedures described herein will be in effect until the development of a new standard clearing fund sizing methodology and a revised methodology for the intra-month increase of Financial Resources. Following such development, OCC has stated that it will file a separate rule change and advance notice with the Commission that will include a description of the new

a. Monthly Clearing Fund Sizing Procedure

According to OCC, under the Monthly Clearing Fund Sizing Procedure, OCC will continue to use its daily stress test exposures under simulated default scenarios (as described in the first sentence of OCC Rule 1001(a)) to calculate the size of the clearing fund and resize the clearing fund on the first business day of each month. However, instead of resizing the clearing fund based on the *average of the daily calculations* during the preceding calendar month, OCC intends to resize the clearing fund using a new formula, which is the sum of: (i) an amount equal to the peak five-day rolling average of clearing fund draws observed over the preceding three calendar months using the daily idiosyncratic default and minor systemic default scenario calculations based on OCC's daily Monte Carlo simulations ("Base Amount"); and (ii) a prudential margin of safety determined by OCC that is currently set at \$1.8 billion.¹³ OCC believes that the Monthly Clearing Fund Sizing Procedure provides a sound and prudent approach to ensure that it maintains adequate Financial Resources to protect against a default of a Clearing Member or Clearing Member Group presenting the largest exposure to OCC. By sizing the Base Amount of the clearing fund using the peak five-day rolling average over the preceding three month look-back period, rather than an average over the preceding month, OCC

and revised methodologies as well as a revised Monthly Clearing Fund Sizing Procedure and Financial Resource Monitoring and Call Procedure.

¹³ According to OCC, it computes its exposure under the idiosyncratic default scenario and minor systemic default scenario on a daily basis. The greater of these two exposures will be that day's peak exposure. To calculate the rolling five-day average, OCC will compute the average of the peak exposure for each consecutive five-day period observed over the prior three-month period. To determine the Base Amount, OCC will use the largest five-day rolling average observed over the past three-months.

believes that the new resizing formula should be more responsive to sudden increases in exposure and less sensitive to short-run reductions in exposures that could inappropriately reduce the overall size of the clearing fund. OCC further asserts that the prudential margin of safety provides an additional buffer to absorb potential future exposures not previously observed during the look-back period. The Monthly Clearing Fund Sizing Procedure will be supplemented by the Financial Resource Monitoring and Call Procedure, which is described below, to provide further assurance that the Financial Resources are adequate to protect against such risk of loss.

b. Financial Resource Monitoring and Call Procedure

According to OCC, under the Financial Resource Monitoring and Call Procedure, OCC will use the same daily idiosyncratic default calculation that is currently used under the Monthly Clearing Fund Sizing Procedure to monitor daily the adequacy of the Financial Resources to withstand a default by the Clearing Member or Clearing Member Group presenting the largest exposure under extreme but plausible market conditions.¹⁴ If such a daily idiosyncratic default calculation projected a draw on the clearing fund (“Projected Draw”) that is at least 75% of the clearing fund maintained by OCC, OCC will be required to issue an intra-day margin call pursuant to OCC Rule 609 against the Clearing Member or Clearing Member Group that caused such a draw

¹⁴ According to OCC, since the minor systemic default scenario contemplates the simultaneous default of two Clearing Members and OCC maintains Financial Resources sufficient to cover a default by a Clearing Member or Clearing Member Group presenting the greatest exposure to OCC, OCC does not use the minor systemic default scenario to determine the adequacy of the Financial Resources under the Financial Resource Monitoring and Call Procedure.

(“Margin Call Event”).¹⁵ The amount of the intra-day margin call made pursuant to a Margin Call Event will be the difference between the Projected Draw and the Base Amount of the clearing fund (“Exceedance Above Base Amount”).

In the case of a Clearing Member Group that causes the Exceedance Above Base Amount, the Exceedance Above Base Amount will be pro-rated among the individual Clearing Members that compose the Clearing Member Group based on each individual Clearing Member’s proportionate share of the total risk for such Clearing Member Group as defined in OCC Rule 1001(b) (i.e., the margin requirement with respect to all accounts of the Clearing Member Group exclusive of the net asset value of the positions in such accounts aggregated across all such accounts). In the case of an individual Clearing Member or a Clearing Member Group, the intra-day margin call will be subject to a limitation under which it cannot exceed the lower of: (a) \$500 million; or (b) 100% of the net capital of a Clearing Member (the “500/100 Limitation”).¹⁶ This limitation will apply in aggregate to all Margin Call Events within the same monthly period. Therefore,

¹⁵ OCC Rule 609 authorizes OCC to require the deposit of additional margin in any account at any time during any business day by any Clearing Member for, among other reasons, the protection of OCC, other Clearing Members or the general public. Under OCC Rule 609, a Clearing Member must meet a required deposit of intra-day margin in immediately available funds at a time prescribed by OCC or within one hour of OCC’s issuance of debit settlement instructions against the bank account of the applicable Clearing Member.

¹⁶ According to OCC, implementing the 500/100 Limitation on the intra-day margin call avoids placing a “liquidity squeeze” on the subject Clearing Member or Clearing Member Group based on exposures presented by a hypothetical stress test, which otherwise could cause a default on the intra-day margin call. OCC back-testing results determined that intra-day margin calls resulting from a Margin Call Event would have been made against Clearing Members or Clearing Member Groups that are large, well-capitalized firms, with more than sufficient resources to satisfy the call for additional margin subject to the 500/100 Limitation.

if the same Clearing Member or Clearing Member Group is subject to more than one Margin Call Event in the same month, the total amount of funds that are collected cannot exceed the 500/100 Limitation. The 500/100 Limitation will remain in place until OCC has collected all funds to satisfy the next monthly clearing fund resizing.¹⁷

Additionally, OCC will rely on OCC Rule 608 to preclude the withdrawal of such additional margin amount until all of the funds from the next monthly clearing fund resizing have been collected. Based on three years of back-testing data, OCC determined that a Margin Call Event would have occurred in 10 of the months during this period. During each of these 10 months, the maximum call amount would have been equal to \$500 million.¹⁸ After giving effect to the intra-day margin calls (i.e., increasing the Financial Resources by \$500 million), there was only one Margin Call Event where there was still an observed stress test exceedance of Financial Resources.

To address this one observed instance, the Financial Resource Monitoring and Call Procedure will require OCC to increase the size of the clearing fund, if a Projected Draw exceeds 90% of the clearing fund (“Clearing Fund Intra-month Increase Event”), after applying any funds then on deposit with OCC from the applicable Clearing Member or Clearing Member Group pursuant to a Margin Call Event. The amount of such increase (“Clearing Fund Increase”) will be the greater of: (a) \$1 billion; or (b) 125% of the difference between (i) the Projected Draw, as reduced by the deposits resulting from

¹⁷ The Risk Committee of the Board of Directors (“Risk Committee”) will be notified, and can take action to address potential Financial Resource deficiencies, in the event that a Projected Draw resulted in a Margin Call Event and, as a result of the 500/100 Limitation, the intra-day margin call is less than the Exceedance Above Base Amount, but the Projected Draw is not large enough to result in an increase in the clearing fund as discussed below.

the Margin Call Event, and (ii) the clearing fund. Each Clearing Member's proportionate share of the Clearing Fund Increase will equal its proportionate share of the variable portion of the clearing fund for the month in question as calculated pursuant to OCC Rule 1001(b).

According to OCC, it will notify the Risk Committee, Clearing Members and appropriate regulatory authorities of the Clearing Fund Increase on the business day that the Clearing Fund Intra-month Increase Event occurs. OCC believes that this will ensure that OCC management maintains authority to address any potential Financial Resource deficiencies when compared to its Projected Draw estimates. The Risk Committee will then determine whether the Clearing Fund Increase is sufficient, and will retain authority under the Risk Committee charter to increase the Clearing Fund Increase or the intra-day margin call made pursuant to a Margin Call Event in its discretion. Clearing Members will be required to meet the call for additional clearing fund assets by 9:00 AM CT on the second business day following the Clearing Fund Intra-Month Increase Event. OCC believes that this collection process ensures that additional clearing fund assets are promptly deposited by Clearing Members following notice of a Clearing Fund Increase, while also providing Clearing Members with a reasonable period of time to source such assets. According to OCC, based on its back-testing results, after giving effect to the intra-day margin call in response to a Margin Call Event plus the prudential margin of safety, the Financial Resources would have been sufficient upon implementing the one instance of a Clearing Fund Intra-month Increase Event.

¹⁸ The back-testing analysis performed by OCC assumed that a single Clearing Member caused the Exceedance Above Base Amount.

OCC believes the Financial Resource Monitoring and Call Procedure strikes a prudent balance between mutualizing the burden of requiring additional Financial Resources and requiring the Clearing Member or Clearing Member Group causing the increased exposure to bear such burden. In the event a Projected Draw exceeds 75% of the clearing fund, the Clearing Member or Clearing Member Group that triggers the exceedance will be assessed an intra-day margin call to address the increase in exposure.. However, where a Projected Draw exceeds 90% of OCC's clearing fund, OCC determined that it should mutualize the burden of the additional Financial Resources at this threshold through a Clearing Fund Increase. OCC believes that this balance will provide OCC with sufficient Financial Resources without increasing the likelihood that its procedures, based solely on stress testing results, will cause a liquidity strain that could result in the default of a Clearing Member or Clearing Member Group.

II. Discussion and Commission Findings

Although Title VIII does not specify a standard of review for an advance notice, the Commission believes that the stated purpose of Title VIII is instructive.¹⁹ The stated purpose of Title VIII is to mitigate systemic risk in the financial system and promote financial stability by, among other things, promoting uniform risk management standards for systemically-important financial market utilities and strengthening the liquidity of systemically important financial market utilities.²⁰

¹⁹ See 12 U.S.C. 5461(b).

²⁰ Id.

Section 805(a)(2) of the Payment, Clearing and Settlement Supervision Act²¹ authorizes the Commission to prescribe risk management standards for the payment, clearing, and settlement activities of designated clearing entities and financial institutions engaged in designated activities for which it is the supervisory agency or the appropriate financial regulator. Section 805(b) of the Payment, Clearing and Settlement Supervision Act²² states that the objectives and principles for the risk management standards prescribed under Section 805(a) shall be to:

- promote robust risk management;
- promote safety and soundness;
- reduce systemic risks; and
- support the stability of the broader financial system.

The Commission has adopted risk management standards under Section 805(a)(2) of the Payment, Clearing and Settlement Supervision Act (“Clearing Agency Standards”).²³ The Clearing Agency Standards became effective on January 2, 2013, and require registered clearing agencies that perform central counterparty (“CCP”) services to establish, implement, maintain, and enforce written policies and procedures that are reasonably designed to meet certain minimum requirements for their operations and risk management practices on an ongoing basis.²⁴ As such, it is appropriate for the

²¹ 12 U.S.C. 5464(a)(2).

²² 12 U.S.C. 5464(b).

²³ 17 CFR 240.17Ad-22.

²⁴ The Clearing Agency Standards are substantially similar to the risk management standards established by the Board of Governors of the Federal Reserve System governing the operations of designated financial market utilities that are not

Commission to review advance notices against these Clearing Agency Standards, and the objectives and principles of these risk management standards as described in Section 805(b) of the Payment, Clearing and Settlement Supervision Act.²⁵

The Commission believes that the proposal in this Advance Notice is designed to further the objectives and principles of Section 805(b) of the Payment, Clearing and Settlement Supervision Act.²⁶ The Commission believes that the Monthly Clearing Fund Sizing Procedure and Financial Resource Monitoring and Call Procedure promote robust risk management by setting forth a process that ensures OCC is able to collect funds, in a timely manner, to effectively manage a potential default of a Clearing Member or Clearing Member Group to which it has the greatest exposure. Given that OCC is designated as a systemically-important financial market utility, OCC's ability to effectively manage a default contributes to promoting safety and soundness, reducing systemic risks, and supporting the stability of the broader financial system.

The Commission believes that the proposal in this Advance Notice is consistent with Clearing Agency Standards, in particular, Rule 17Ad-22(b)(3) under the Exchange Act,²⁷ which, in relevant part, requires registered clearing agencies that perform central counterparty services to establish, implement, maintain and enforce written policies and

clearing entities and financial institutions engaged in designated activities for which the Commission or the Commodity Futures Trading Commission is the Supervisory Agency. See Financial Market Utilities, 77 FR 45907 (August 2, 2012).

²⁵ 12 U.S.C. 5464(b).

²⁶ 12 U.S.C 5464(b).

²⁷ 17 CFR 240.17Ad-22(b)(3).

procedures reasonably designed to maintain sufficient financial resources to withstand, at a minimum, a default by the participant family to which it has the largest exposure in extreme but plausible market conditions. The Commission believes that this proposal is consistent with Exchange Act Rule 17Ad-22(b)(3)²⁸ because the Monthly Clearing Fund Sizing Procedure and Financial Resource Monitoring and Call Procedure should ensure that OCC can obtain sufficient financial resources in a timely manner to withstand a default of the Clearing Member or Clearing Member Group presenting it the largest exposure.

By using a peak five-day rolling average and extending the look-back period from one to three calendar months, the Monthly Clearing Fund Sizing Procedure should be more responsive than OCC's existing resizing formula to sudden increases in exposure and less sensitive to short-run reductions in exposure that could inappropriately reduce the overall size of the clearing fund. Furthermore, the prudential margin of safety, which is currently \$1.8 billion, will provide an additional buffer to absorb potential future exposures that may not be observed during the look-back period. In addition, the Financial Resource Monitoring and Call Procedure will establish a process by which OCC will be able to respond to increases in exposure on an intra-month basis. In doing so, the Commission believes the Financial Resource Monitoring and Call Procedure should ensure that a balance is struck between mutualizing the burden of the additional financial resources across all Clearing Members, while also requiring the Clearing Member or Clearing Member Group causing the increased exposure to bear the burden.

III. Conclusion

²⁸

Id.

IT IS THEREFORE NOTICED, pursuant to Section 806(e)(1)(I) of the Payment, Clearing and Settlement Supervision Act,²⁹ that the Commission DOES NOT OBJECT to advance notice proposal (SR-OCC-2014-811) and that OCC is AUTHORIZED to implement the proposal as of the date of this notice or the date of an order by the Commission approving a proposed rule change that reflects rule changes that are consistent with this advance notice proposal (SR-OCC-2015-009), whichever is later.

By the Commission.

Jill M. Peterson,
Assistant Secretary.

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²⁹ 12 U.S.C. 5465(e)(1)(I).