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SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-78056; File No. SR-OCC-2016-004)

June 13, 2016

Self-Regulatory Organizations; The Options Clearing Corporation; Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change Related to the Adoption of an Options Exchange Risk Control Standards Policy

I. Introduction

On March 4, 2016, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder,[2] a proposed rule change to adopt a new Options Exchange Risk Control Standards Policy and revise its Schedule of Fees to impose on clearing members a fee of two cents per cleared options contract (per side) executed on an options exchange that did not demonstrate sufficient risk controls designed to meet the proposed set of principles-based risk control standards. The proposed rule change was published for comment in the Federal Register on March 18, 2016.[3] The Commission received six comment letters on the proposed rule change.[4] On April 27, 2016, the Commission designated a longer

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 See Securities Exchange Act Release No. 34-77358 (March 14, 2016), 81 FR 14921 (March 18, 2016) (File No. SR-OCC-2016-004) ("Notice").

4 See Letters from Mark Dehnert, Managing Director, Goldman Sachs & Co., and Kyle Czepiel, Co-Chief Executive Officer, Goldman Sachs Execution & Clearing, L.P. (collectively, "Goldman Sachs"), dated March 28, 2016, to Secretary, Commission ("Goldman Sachs Letter"); Lisa J. Fall, President, BOX Options Exchange ("BOX"), dated April 6, 2016, to Brent J. Fields, Secretary, Commission ("BOX Letter"); James G. Lundy, Associate General Counsel, ABN AMRO Clearing Chicago LLC ("AACC"), dated April 8, 2016, to Brent J. Fields, Secretary, Commission ("AACC Letter"); Ellen Greene, Managing Director, Securities Industry and Financial Markets Association

period within which to approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to approve or disapprove the proposed rule change.[5] This order institutes proceedings under Section 19(b)(2)(B) of the Act[6] to determine whether to approve or disapprove the proposed rule change.

II. Description of the Proposed Rule Change

OCC proposes to adopt a new Options Exchange Risk Control Standards Policy ("Policy") for addressing the potential risks arising from erroneous trades executed on an options exchange that has not demonstrated the existence of certain risk controls that are consistent with a set of principles-based risk control standards developed by OCC. Among other things, the proposed rule change would establish risk control standards and require each options exchange to submit an annual certification, attesting that it has sufficient risk controls consistent with OCC's Policy.

The proposed rule change also would revise OCC's Schedule of Fees, in accordance with the proposed Policy, to charge and collect from clearing members a fee of two cents per cleared options contract (per side) ("Fee") executed on an options exchange that has not demonstrated to OCC that it has implemented sufficient controls designed to meet OCC's proposed Policy. The proposed rule change would require that any funds collected from the Fee be retained as earnings

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("SIFMA"), dated April 12, 2016, to Robert W. Errett, Deputy Secretary, Commission ("SIFMA Letter"); Michael J. Simon, Secretary and General Counsel, International Securities Exchange, LLC ("ISE"), dated April 20, 2016, to Brent J. Fields, Secretary, Commission("ISE Letter"); and Edward T. Tilly, Chief Executive Officer, Chicago Board Options Exchange, Inc. ("CBOE"), dated April 20, 2016, to Brent J. Fields, Secretary, Commission ("CBOE Letter").

5 See Securities Exchange Act Release No. 77720 (April 27, 2016), 81 FR 26609 (May 3, 2016).

6 15 U.S.C. 78s(b)(2)(B).

and, as such, be eligible for use for clearing member defaults under Article VIII, Section 5(d) of OCC's By-Laws,[7] but would prohibit such funds from being used for any other purpose. These funds would be available for use by OCC, subject to the unanimous approval from its Class A and B common stock shareholders, in accordance with Article VIII, Section 5(d) of OCC's By-Laws.[8]

Risk Control Standards

The proposed Policy includes the risk control standards to which an options exchange must attest in order to avoid the Fee charged on trades executed on its own platform. According to OCC, the proposed risk control standards were developed by OCC in consultation with the options exchanges and are designed to provide flexibility for each options exchange to develop specific risk controls that best suit its own marketplace while still guarding against risks related to erroneous transactions. The proposed Policy would include the following categories of risk controls: "Price Reasonability Checks,"[9] "Drill-Through Protections,"[10] "Activity-Based Protections,"[11] and "Kill-Switch Protections."[12]

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7 Under Article VIII, Section 5(d) of OCC's By-Laws, usage of current or retained earnings may be considered after the defaulting clearing member's margin has been exhausted, and it may be used to reduce in whole or in part the pro rata contribution otherwise made from the Clearing Fund to cover the loss.

8 See Article VIII, Section 5(d).

9 According to OCC, Mandatory Price Reasonability Checks would prevent limit orders, complex orders, and market maker quotes from being entered and displayed on an options exchange if the price on such order or quote is outside a defined threshold set in relation to the current market price or National Best Bid or Offer ("NBBO").

10 OCC states that Drill-Through Protections are closely related to Price Reasonability Checks and would require all orders, including market orders, limit orders, and complex orders, to be executed within pre-determined price increments of the NBBO.

11 OCC explains that Activity-Based Protections would extend an options exchange's Risk Controls to factors beyond price and are most commonly designed to address risks associated with a high frequency of trades in a short period of time. OCC notes that

Certification Process

Under the proposed rule change, each options exchange would certify to OCC that it has implemented risk controls consistent with OCC's Policy using a designed form, which must be signed by an executive officer. OCC would then evaluate each options exchange's risk controls for compliance with OCC's Policy by reviewing each options exchange's certification and supporting materials, including, but not be limited to, its proposed rule changes filed with the Commission, approved rules, information circulars, and written procedures.

If OCC[13] is unable to determine that an options exchange has risk controls sufficient to meet the Policy, OCC would furnish the options exchange with a concise written statement of the reasons as soon as reasonably practicable and the options exchange would have 30 calendar days following receipt of the concise written statement to present further evidence of its sufficient risk controls to OCC. After submission of any further evidence by the options exchange, OCC would have 30 days to conduct a second review and make a recommendation to OCC's Risk

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Activity-Based Protections may address the maximum number of contracts that may be entered as one order, the maximum number of contacts that may be entered or executed by one firm over a certain period of time, and the maximum number of messages that may be entered over a certain period of time.

12 According to OCC, Kill-Switch Protections would provide options exchanges, and their market participants, with the ability to cancel existing orders and quotes and/or block new orders and quotes on an exchange-wide or more tailored basis (e.g., symbol specific, by Clearing Member, etc.) with a single message to the options exchange after established trigger events are detected. According to OCC, a trigger event may include a situation where a market participant is disconnected from an options exchange due to an abnormally large order or manual errors in the system by a market participant causing multiple erroneous trades to occur.

13 OCC does not specify in the proposed rule change which part of OCC would be responsible for evaluating certifications.

Committee[14] regarding whether the options exchange has sufficient risk controls. Within 30 days of receiving the recommendation, OCC's Risk Committee would review the recommendation and the options exchange's supporting materials, as appropriate, to determine whether the options exchange has risk controls sufficient to meet the Policy. OCC would furnish the options exchange with a concise written statement of the Risk Committee's determination and the reasons for such determination as soon as reasonably practicable following the Risk Committee's review.

On June 30 of each year (following the effective date of the proposed rule change), OCC would post a notice to its website to which clearing members (but not the general public) have access, with respect to each options exchange, whether: (1) the options exchange has implemented sufficient risk controls to meet the Policy ("Compliant Options Exchange"); (2) OCC was unable to determine the options exchange has sufficient risk controls that meet the Policy ("Non-Compliant Options Exchange"); or (3) a certification has not been submitted by the options exchange.

Collection of Proposed Fee

Beginning on the first business day that is at least 60 days after OCC posts such notice, OCC would charge and collect the Fee for trades executed on a Non-Compliant Options Exchange. The Fee would continue to be charged to and collected from clearing members, and the notice would remain posted on OCC's website to which clearing members (but not the

[14] OCC's Risk Committee is chaired by a public Director and it does not currently have an options exchange representative. In the event OCC's Risk Committee has an exchange representative at some time in the future, such exchange representative would be recused from a decision on the appeal of a determination of an options exchange's compliance with the Policy.

general public) have access, until the options exchange is able to demonstrate that its risk controls satisfy the Policy.

Under the proposed rule change, any funds collected from the Fee would be retained as earnings and, as such, be eligible for use for clearing member defaults under Article VIII, Section 5(d) of OCC's By-Laws,[15] but such funds would be prohibited from being used for any other purpose. These funds would be available for use by OCC, subject to the unanimous approval from its Class A and B common storck shareholders, in accordance with Article VIII, Section 5(d) of OCC's By-Laws.[16]

Exception and Escalation Processes

The proposed Policy also provides that, on rare occasions, OCC may grant exceptions to the Policy to appropriately address immediate business issues and provides for an escalation process to report breaches of the Policy.[17]

III. Summary of Comment Letters

The Commission received six comment letters in response to the proposed rule change.[18] Five comment letters were written in support of the proposed rule change and one comment letter from BOX, objecting to the proposed rule change. The supporting comment letter from ISE also responded to BOX's objections.

A. Supporting Comments

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15 See Article VIII, Section 5(d).

16 Id.

17 OCC does not provide additional information in the proposed rule change regarding its process for granting exceptions and which part of OCC would be responsible for granting such exceptions, aside from identifying who must approve exceptions and be notified exceptions to the Policy.

18 See supra note 4.

Five commenters, Goldman Sachs, AACC, SIFMA, CBOE and ISE, submitted comment letters in support of the proposed rule change. All of these commenters express concern regarding the risk that erroneous trades may pose to the listed-options market and its participants. Each of these commenters support effective risk management controls by an options exchange to minimize the risk of erroneous trades and the attendant consequences. Recognizing the role OCC plays in the listed-options market, these commenters state that OCC's proposed rule change would minimize the likelihood of erroneous trades occurring and reduce risk[19] by incentivizing options exchanges to create risk controls.[20] One commenter states that because clearing members guarantee the clearance and settlement of trades by their clients, it is critical for clearing member risk management purposes that there be robust and centralized risk controls at the options exchanges.[21]

In addition to expressing general support for the objective of the proposed rule change, commenters also support specific aspects of the proposed rule change. One commenter supports OCC's principles-based approach and states that such approach would allow options exchanges

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19 See CBOE Letter, supra note 4, at 1; SIFMA Letter, supra note 4, at 2.

20 See Goldman Letter, at 2 (stating that OCC's rule will provide appropriate and necessary incentives to create necessary risk controls at all Options Exchanges.); SIFMA Letter, at 2 (stating that the proposed rule change provides strong incentives for Options Exchanges to comply with risk control standards in the Policy since an exchange's non-compliance will be "punitive" to clearing members transacting on that exchange.); AACC Letter, supra note 4, at 1 (supporting the use of a fee to incentivize Options Exchanges to adopt and maintain risk controls that are consistent with the risk control standards in the Policy and the use of the fee to provide additional funds for OCC to manage the increased risk and to cover the potential losses caused by erroneous or violative transactions); ISE Letter, supra note 4, at 4 (stating that the Fee was added to provide "strong encouragement to the options exchanges to comply with the Policy).

21 See Goldman Letter, supra note 4, at 2.

to develop specific risk controls in each category best-suited for their markets.[22] Another commenter describes the Policy's certification requirement as "exceedingly reasonable" and notes that this requirement is consistent with certification requirements in other areas of the financial services industry, including those instituted by the Commission and other self-regulatory organizations, such as Financial Industry Regulatory Authority.[23] According to this commenter, OCC's proposed approach for the certification and review process would provide reasonable steps for the options exchanges to communicate and escalate issues raised by OCC in connection with the evaluation of an options exchange.[24]

Two commenters reference the relationship between the proposed rule change and the existing regulatory framework. One commenter claims that the proposed rule change complements Rule 15c3-5 ("Market Access Rule")[25] under the Act and Regulation Systems Compliance and Integrity ("Regulation SCI")[26] by providing additional and "much needed layers of protections" at the options exchange level.[27] The other commenter similarly suggests that the proposed rule change, in conjunction with the Market Access Rule, will "advance a strong, centralized structure of risk controls."[28]

Finally, one commenter provides several recommendations that it believes would further improve the proposed rule change. In particular, this commenter suggests that the proposed rule

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22 See CBOE Letter, supra note 4, at 2.

23 See AACC letter, supra note 4, at 2.

24 Id.

25 See 17 CFR 240.15c3-5.

26 See Securities Exchange Act Release No. 73639 (November 19, 2014), 79 FR 72252 (December 5, 2014) (Regulation SCI Adopting Release).

27 See AACC Letter, supra note 4, at 1.

28 See SIFMA Letter, supra note 4, at 2.

change be amended to specify that the options exchanges make their risk controls visible and transparent to members, trading permit holders, and customers.[29] For the "backup alternative messaging systems" that are a part of the Kill Switch Protections, the commenter recommends that OCC clarify in the proposed rule change that the options exchanges would need to provide the methodology, access protocols, controls, and management of such systems.[30] The same commenter urges that the proposed rule change be clarified to require options exchanges to bear the full cost of the Fee to prevent the options exchanges from passing the cost along to their member firms, trading permit holders, and/or customers.[31]

B. Objecting Comments

One commenter, BOX, raises several objections to the proposed rule change.

Authority to Prescribe Risk Control for Options Exchanges

BOX questions whether OCC has the authority generally to prescribe risk controls for options exchanges under the Act.[32] BOX asserts that it is unable to find a provision in the Act or otherwise that grants OCC with the authority to regulate the options exchanges. Moreover, BOX contends that because the U.S. Congress gave the Commission express authority under the Act to regulate the national securities exchanges, including options exchanges, any industry-wide requirements imposed on the options exchanges should be mandated by the Commission, not OCC.

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29 See AACC Letter, supra note 4, at 2.

30 Id.

31 Id. at 3.

32 See BOX Letter, supra note 4, at 2.

BOX also asserts that it is the Commission's role, through the rule filing process under Section 19(b) of the Act and the rules and regulations thereunder, to determine whether the rules and procedures of the individual options exchanges meet the requirements of Section 6 of the Act. BOX argues that allowing OCC to require options exchanges to have certain procedures and rules would give OCC the authority to determine the sufficiency of an options exchange's rules thus giving OCC the ability to act as a "de facto regulator" over the options exchanges and, more broadly, the options markets.[33]

Burden on Competition

BOX states that the proposed rule change would impose burdens on competition that OCC fails to justify. First, according to BOX, even if OCC deems an options exchange to be in compliance with OCC's Policy, a substantial burden would be placed on individual options exchanges, including, but not limited to, expending initial resources to ensure that an exchange has the required risk controls in place and devoting resources annually to ensure that the exchange is continually compliant with OCC's risk control standards. BOX contends that this burden would be especially high for smaller exchanges.

Second, BOX states that the potential application of an increased clearing fee to a single exchange could have devastating effects on that exchange's ability to compete in the "highly competitive environment" in the options market where any increase in fees can make "a world of difference."[34] BOX attributes this to the "direct effect it will have on the total transaction cost to market participants and the effect it will have on the exchange's revenue."[35] BOX asserts that

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33 Id. at 2-3.

34 Id. at 3-4.

35 Id.

firms would include the Fee in their determination of where to route trade orders based upon the total transaction costs. As a result, BOX argues that, options exchanges would have to decrease all fees by two cents to "maintain the status quo or be at an economic disadvantage to their competition."[36]

The Proposed Fee is a De Facto Fee on the Options Exchanges inconsistent with Section 17A(b)(3)(D) of the Act

BOX argues that the charging of an additional fee for transactions occurring on a specific exchange is essentially the same as charging a fee on the exchange directly and is not consistent with Section 17A(b)(3)(D) of the Act. It also questions whether OCC is permitted to charge different fees for clearing transactions based on the executing exchange, which departs from treating all options exchange the same.[37]

C. Comments in Response to BOX

One commenter, ISE, submitted a comment letter to respond to BOX's objections to the proposed rule change.

Authority to Prescribe Risk Control for Options Exchanges

ISE suggests that BOX's arguments regarding whether OCC has the authority to regulate options exchanges lack legal reasoning.[38] ISE argues that the relevant legal question for Commission consideration is whether the Act gives OCC authority to adopt the Policy, which, according to ISE it does. Moreover, ISE contends that, as the sole registered clearing agency for

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36 Id, at 5. Cf. Another commenter urges that the proposed rule change be clarified to require the options exchanges to bear the full cost of the Fee (or any increased incentive fee) to prevent the options exchanges from passing this increased cost along to their member firms, trading permit holders, and/or customers. See AACC Letter, supra note 4, at 3.

37 See BOX Letter, supra note 4, at 5.

38 See ISE Letter, supra note 4, at 2.

all listed options transactions and a systemically important financial market utility, risks that arise from erroneous transactions are exactly the risks that OCC has authority to address under Section 17A of the Act.[39]

Burden on Competition

ISE states that BOX fails to analyze its burden on competition claim under the governing law. ISE argues that the appropriate questions to pose when evaluating the proposed rule change's burden on competition are: (1) whether any discriminatory effect on exchanges that do not adopt the Policy is necessary or appropriate; and (2) whether there is a further inappropriate or unnecessary discriminatory effect on smaller exchanges. ISE contends that because OCC has the authority to adopt the Policy, treating transactions on Compliant Options Exchanges more favorably than those on Non-Compliant Options Exchanges is neither inappropriate nor unreasonable. Furthermore, ISE claims that the Act does not contain provisions that require less robust regulations or "special treatment" for smaller exchanges such as BOX.[40]

Charging De Facto Fees on the Exchange

ISE asserts that OCC has the authority to adopt the Fees based on whether an options exchange meets OCC's risk control standards. According to ISE, the relevant question under the Act is whether the adoption of the Policy and imposition of the associated Fee results in unfair discrimination. Although ISE concedes that the proposed rule change "clearly discriminates between exchanges," it contends that requiring clearing members that transact on non-compliant

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39 Id. at 2.

40 Id. at 3.

options exchanges to pay higher fees is "eminently fair discrimination." ISE argues that the Policy and Fee are discriminatory only against those options exchanges that have not adopted risk protections that OCC deems necessary for it to discharge its obligations as a registered clearing agency and systemically important financial market utility. ISE also notes that the risk control standards in the proposed rule change were developed in consultation with a working group that included all the options exchanges, including BOX.[41]

ISE contends that BOX's conclusion of the Fee being a de facto fee on options exchanges is grounded in "faulty logic" and "without merit." ISE asserts that an options exchange can avoid having clearing members pay the Fee by complying with the Policy. ISE believes that an options exchange that chooses not to comply with the Policy is making an "economic decision" that non-compliance is economically preferable. Moreover, ISE argues that because an options exchange establishes its own fees, an options exchange that chooses not to incur the cost of compliance can charge lower fees than a competitor that is compliant. Thus, ISE believes that the proposed Fee levels the playing field and avoids "economically rewarding exchanges" that choose to avoid the costs of complying with the Policy.[42]

IV. Proceedings to Determine Whether to Approve or Disapprove SR-OCC-2016-004 and Grounds for Disapproval Under Consideration

The Commission is instituting proceedings pursuant to Section 19(b)(2)(B) of the Act[43] to determine whether the proposed rule change should be approved or disapproved. Institution of proceedings is appropriate at this time in view of the legal and policy issues raised by the proposed rule change. As noted above, institution of proceedings does not indicate that the

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41 Id. at 3-4.

42 Id. at 4.

43 15 U.S.C. 78s(b)(2)(B).

Commission has reached any conclusions with respect to any of the issues involved. Rather, the Commission seeks and encourages interested persons to comment on the proposed rule change, and provide arguments to support the Commission's analysis as to whether to approve or disapprove the proposed rule change.

Pursuant to Section 19(b)(2)(B) of the Act,[44] the Commission is providing notice of the grounds for disapproval under consideration. The Commission is instituting proceedings to allow for additional analysis of the proposed rule change's consistency with the Act and the rules thereunder. Specifically, the Commission believes that OCC's proposed rule change raises questions as to whether it is consistent with: (i) Section 17A(b)(3)(I) of the Act,[45] which provides that clearing agency rules cannot impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act; (ii) Section 17A(b)(3)(D) of the Act,[46] which requires clearing agency rules to provide for the equitable allocation of reasonable dues, fees and other charges among its participants; (iii) Rule 17Ad-22(d)(1) under the Act,[47] which requires clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide a well-founded, transparent, and enforceable legal framework; and (iv) Rule 17Ad-22(d)(7) under the Act,[48] which requires clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed

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44 15 U.S.C. 78s(b)(2)(B).

45 15 U.S.C. 78q-1(b)(3)(I).

46 15 U.S.C. 78q-1(b)(3)(D).

47 17 CFR 240.17Ad-22(d)(1).

48 17 CFR 240.17Ad-22(d)(7).

to evaluate the potential sources of risks that can arise when a clearing agency establishes links to clear or settle trades, and ensure that the risks are managed prudently on an ongoing basis.

V. Request for Written Comments

The Commission requests that interested persons provide written submissions of their views, data, and arguments with respect to issues raised by the proposed rule change. In particular, the Commission invites the written views of interested persons concerning whether the proposed rule change is consistent with Sections 17A(b)(3)(I) and 17A(b)(3)(D) of the Act and Rules 17Ad-22(d)(1) and 17Ad-22(d)(7) under the Act, or any other provision of the Act, or the rules and regulations thereunder.

Interested persons are invited to submit written data, views, and arguments on or before [insert date 21 days from publication in the Federal Register]. Any person who wishes to file a rebuttal to any other person's submission must file that rebuttal on or before [insert 35 days from the date of publication in the Federal Register]. 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-2016-004 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-2016-004. 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 website (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 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 a.m. and 3:00 p.m. Copies of such filings also will be available for inspection and copying at the principal office of OCC and on OCC's website at http://www.theocc.com/components/docs/legal/rules_and_bylaws/sr_occ_16_004.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-2016-004 and should be submitted on or before [insert date 21 days from publication in the Federal Register]. If comments are received, any rebuttal comments should be submitted on or before [insert 35 days from the date of publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[49]

Robert W. Errett
Deputy Secretary

[49] 17 CFR 200.30-3(a)(57).

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