



8011-01
SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-80555; File No. SR-OCC-2017-004)

April 28, 2017

Self-Regulatory Organizations; The Options Clearing Corporation; Order Approving Proposed Rule Change Concerning Enhancements to OCC's Stock Loan Programs

On February 28, 2017, The Options Clearing Corporation (“OCC”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change SR-OCC-2017-004 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ and Rule 19b-4 thereunder.² The proposed rule change was published for comment in the Federal Register on March 14, 2017.³ The Commission did not receive any comment letters on the proposed rule change. This order approves the proposed rule change.

I. Description of the Proposed Rule Change

OCC operates two Stock Loan Programs—the Hedge Program and Market Loan Program—in which a participating clearing member can lend an agreed-upon number of shares of eligible stock⁴ to another clearing member in exchange for an agreed-upon

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 34-80323 (March 8, 2017), 82 FR 13690 (March 14, 2017) (File No. SR-OCC-2017-004) (“Notice”).

⁴ See OCC Rules 2202 and 2202A (providing that stock loans under the Hedge Program and the Market Loan Program, respectively, must effect transfer only of “Eligible Stock,” as defined in Article I of OCC’s By-laws). OCC permits clearing members to execute stock loans involving 6,191 eligible securities as of March 29, 2017, available at <https://www.theocc.com/webapps/stock-loan-eligible-securities>.

value of U.S. dollar cash collateral and then novate the loan to OCC for clearing.⁵ The Hedge Program permits clearing members to bilaterally execute stock loans and negotiate collateralization and other terms before submitting such stock loans to OCC for novation and clearing.⁶ The Market Loan Program is operationally similar to the Hedge Program, but it permits clearing members to execute stock loans through a multilateral loan market.⁷ In each case, upon completion of the novation process, OCC, in its capacity as a central counterparty, guarantees return of (i) loaned stock, or that stock's value, to the lending clearing member, and (ii) the value of cash collateral to the borrowing clearing member.⁸ In addition, OCC makes mark-to-market margin payments on a daily basis to ensure stock loans remain fully collateralized.

OCC proposes a number of changes to the Stock Loan Programs and its Rules governing those Programs.⁹ First, to improve trade certainty and transparency concerning clearing member exposures, OCC proposes amendments to its rules governing the Stock Loan Programs to do the following: (1) require clearing members to have policies and procedures to reconcile stock loan positions each business day; (2) state

⁵ The Hedge Program is governed by Article XXI of OCC's By-Laws and Chapter XXII of OCC's Rules. The Market Loan Program is governed by Article XXIA of OCC's By-Laws and Chapter XXIIA of OCC's Rules. The Commission understands that OCC cleared approximately 10-15% of the overall U.S.-equities stock loan market through the two programs, as of November 2015.

⁶ The Commission understands that the Hedge Program accounts for approximately 95% of cleared stock loan volume at OCC, as of November 2015.

⁷ Automated Equity Finance Markets, Inc. is the sole loan market through which clearing members can execute stock loans in the Market Loan Program.

⁸ See OCC Rules 2202(b) and 2202A(b).

⁹ For a more detailed description of the specific rule changes OCC is proposing, see Notice, supra note 3.

explicitly that the controlling record for stock loan positions for margin and other purposes is OCC's "golden" record; and (3) provide that stock loan positions remain in effect until OCC's records reflect stock loan terminations. Second, to mitigate risks that may arise in the event of a clearing member suspension, OCC proposes amendments to its rules governing the Stock Loan Programs to do the following: (1) provide a two-day trading window in which clearing members must execute close-out transactions, also known as "buy-in" or "sell-out" transactions; (2) provide broad authority for OCC to use reasonable prices to settle close-out transactions; and (3) permit OCC to close out and re-establish the matched-book stock loan positions of a suspended Hedge Program clearing member through termination by offset and "re-matching" with other clearing members. Each of these proposals is discussed in more detail below.

A. Proposed Measures to Improve Trade Certainty and Transparency

OCC proposes three amendments to the rules governing its Stock Loan Programs that are intended to improve trade certainty and transparency for clearing members and OCC.

1. Daily Reconciliation of Stock Loan Positions

Clearing members that participate in the Hedge Program and the Market Loan Program execute and terminate stock loans on a bilateral basis. Following execution or termination of stock loans, OCC requires clearing members to promptly report stock loans directly to OCC, or to facilitate such reporting to OCC through the Depository Trust Corporation ("DTC"), ensuring OCC accepts stock loans for clearing and records the novation or termination for margin and other purposes. Under the current trade-reporting process, clearing members may fail to report (or to have DTC report) stock

loans to OCC in a timely manner, increasing uncertainty in the novation process and decreasing transparency with respect to OCC's stock loan positions and obligations as a central counterparty and guarantor. The current process thereby presents risk management risks both to OCC and clearing members.

To address these risk management risks, OCC proposes to require each clearing member to have adequate policies and procedures to perform daily reconciliations of stock loan positions against OCC's records and to resolve stock loan discrepancies, if any, by 9:30 a.m. Central Time the following business day.¹⁰ These proposed rule changes, according to OCC, would improve trade certainty and transparency for clearing members participating in the Hedge Program and the Market Loan Program and thereby reduce operational and other risks for OCC and clearing members.

2. Controlling Records for Stock Loan Positions

To support and supplement the proposed daily reconciliation requirements for clearing member participation in the Stock Loan Programs, OCC proposes to explicitly state in its rules that OCC's stock loan records constitute the controlling records for margin and other purposes. Specifically, the proposed rules would specify that OCC's records, which OCC refers to as the "golden copy" records, prevail in the event of a conflict with clearing member records and that clearing members must continue to perform on obligations relating to open stock loan positions identified in the golden copy records.¹¹ The proposed rules, according to OCC, support trade certainty and

¹⁰ See Proposed Rule 2205 of the Hedge Program and Proposed Rule 2205A of the Market Loan Program.

¹¹ See Proposed Articles XXI and XXIA of OCC's By-Laws.

transparency in the Hedge and Market Loan Programs.

3. Termination Records for Stock Loan Positions

Finally, to conform OCC's stock loan termination provisions to the proposed changes relating to controlling records described above, OCC proposes rule changes to clarify that stock loans would be considered terminated for margin and other purposes only when OCC's records reflect termination of the stock loan.¹² OCC states that these conforming changes also would support trade certainty and transparency in the Stock Loan Programs by ensuring consistency among and within the different rules applicable to the Stock Loan Programs.

B. Proposed Measures to Mitigate Stock Loan Risks in the Event of a Clearing Member Suspension

In addition to the proposals intended to improve trade certainty and transparency, the proposed rule change also proposes three amendments to address certain risks that may arise in the event that OCC suspends a clearing member participant in the Stock Loan Programs.

1. Stock Loan Close-Out Timeframe in the Event of a Clearing Member Suspension

Under current Stock Loan Program rules, OCC may seek to close out a suspended clearing member's stock loan positions by instructing non-suspended clearing member counterparties to execute close-out transactions within a reasonable period of time.¹³

¹² See Proposed Rule 2209 in the Hedge Program and Proposed Rule 2209A in the Market Loan Program.

¹³ More specifically, Rules 2209(b) and (f) and 2211 of the Hedge Program, and Rules 2209A(b) and (c) and 2211A of the Market Loan Program require clearing members to execute close-out transactions in a "commercially reasonable

Although non-suspended clearing members must be prepared to defend the timeliness of close-out transactions under current rules, clearing members are not required to execute close-out transactions based on OCC's instructions within a specific period of time. Accordingly, if non-suspended clearing members execute buy-in or sell-out transactions over an extended period of time following OCC's close-out instruction, OCC incurs a risk that close-out prices may vary significantly from the prices used to mark the stock loan positions to market for margin purposes. OCC's credit exposure, in part, depends on the significance of these price differences relative to the suspended clearing member's available margin resources.

To mitigate these risks, OCC proposes to require clearing members to execute close-out transactions within a fixed two-day trading window in the event of a clearing member suspension. More specifically, OCC proposes to require non-suspended clearing members to execute close-out transactions by the end of the business day following OCC's instruction to close out stock loans with the suspended clearing member. If a non-suspended clearing member is unable to execute the close-out transactions within that two-day timeframe, OCC itself would terminate the clearing member's relevant stock loans and effect settlement based on the market price of the underlying securities, as determined by OCC. According to OCC, the proposed changes are intended to ensure that non-suspended clearing members execute close-out transactions in a timeframe consistent with OCC's two-day liquidation assumption for stock loan margin purposes, which should reduce OCC's credit exposure from significant differences between clearing member-effectuated close-out prices and the prices used to collect mark-to-market payments from

manner" and to be prepared to defend the timing, prices, and costs of such transactions.

the suspended clearing member.

2. Reasonable Prices for Stock Loan Close-Out Transactions in the Event of a Clearing Member Suspension

Under current rules, OCC may seek to close out a suspended clearing member's stock loan positions by instructing non-suspended clearing member counterparties to execute buy-in or sell-out transactions. These close-out transactions must be executed in a "commercially reasonable manner."¹⁴ If a borrowing clearing member is suspended and unable to return securities under a stock loan, OCC may instruct the lending clearing member to execute a "buy-in" transaction for the number of shares in the stock loan's underlying security that would be necessary to return the lending clearing member to its position prior to entering into the stock loan with the suspended clearing member. If the lending clearing member is suspended and unable to return the value of collateral, OCC similarly may instruct the borrowing clearing member to execute a "sell-out" transaction for the number of shares in the underlying security that would be necessary to return the borrowing clearing member to its position prior to entering into the stock loan. In each case, the non-suspended clearing member's stock loan position is terminated and settled based on the price reported for the close-out transaction.

To incentivize "reasonable" pricing of close-out transactions in the event of a clearing member suspension, OCC proposes to provide itself authority to withdraw from a clearing member's account the value of any difference between clearing member-reported prices and "reasonable" close-out transaction prices, as determined by OCC

¹⁴ Id.

based on an assessment of market conditions at the time of execution.¹⁵ This proposed price-substitution authority, according to OCC, would incentivize non-suspended clearing members to execute and report close-out transactions in a commercially reasonable manner.¹⁶

3. Re-Matching in the Event of a Hedge Clearing Member Suspension

Under OCC's current rules, in the event of a clearing member suspension, OCC can fully unwind a suspended Hedge Clearing Member's matched-book positions¹⁷ only if it recalls all borrowed securities from specific borrowing clearing members and returns those securities to specific lending clearing members. Under current rules, this recall-and-return process is operationally complex because the nature of these unwinds would require OCC to (i) effect transfer of significant numbers of securities to significant numbers of non-suspended clearing members; and (ii) settle an equal number of payments against final settlement prices. Moreover, during this recall-and-return process, the non-suspended clearing members may experience unexpected imbalances in their

¹⁵ See Proposed Rule 2211. The proposal provides that a clearing member may demonstrate that a close-out transaction was executed at a "reasonable" price by providing evidence that the transaction fell within the underlying stock's trading range on the date of execution. *Id.* To the extent a clearing member impacts the market price of an underlying security through close-out transactions, OCC, in its discretion, may consider such impact in its assessment of market conditions at the time of execution.

¹⁶ If the close-out transaction is not executed within the two-day period provided in Proposed Rule 2212, however, the stock loan would be terminated and settled based on OCC's marking price at the end of the period.

¹⁷ See definition of "Matched-Book Positions" in Article I of OCC's By-laws. A clearing member that maintains a "matched book" for stock loans generally borrows no more of a specific security than it lends to other clearing members in the program. See also Notice, *supra* note 3 at 8.

overall stock loan positions, resulting in increased margin requirements or price risks relating to re-execution of the stock loans in a potentially distressed market.¹⁸

To address these operational complexities and the potential consequences for both OCC and its clearing members, OCC proposes new rules that would permit it to terminate a suspended Hedge Clearing Member's matched-book stock loans in the Hedge Program by offset and to "re-match" the positions of the non-suspended counterparties according to priorities established by OCC's matching algorithm.¹⁹ According to OCC, re-matching stock loans pursuant to an algorithm would facilitate orderly and efficient termination and re-establishment of stock loans involving a suspended Hedge Clearing Member, thereby mitigating operational and pricing risks that may arise for non-suspended clearing members during the recall-and-return process.

II. Discussion and Commission Findings

Section 19(b)(2)(C) of the Act²⁰ directs the Commission to approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to such organization. The Commission finds that the proposal is consistent

¹⁸ OCC's present margin methodology nets matched-book stock loan positions prior to calculating clearing member exposures. Thus, a non-suspended clearing member's margin requirements may increase on account of the temporary stock loan imbalances resulting from a clearing member suspension.

¹⁹ OCC's matching algorithm would implement priorities in OCC's Proposed Rule 2212(d), which establishes an order of operations based on the size of stock loan positions and the existence of master securities lending agreements between the non-suspended clearing members.

²⁰ 15 U.S.C. 78s(b)(2)(C).

with Section 17A(b)(3)(F) of the Act²¹ and Rules 17Ad-22(e)(13)²² and 17Ad-22(e)(23)²³ thereunder, as described in detail below.

A. Consistency with Section 17A(b)(3)(F) of the Act

The Commission finds that the proposed rule change is consistent with Section 17A(b)(3)(F) of the Act,²⁴ which requires, among other things, that the rules of a clearing agency be designed to do the following: (1) promote the prompt and accurate clearance and settlement of securities transactions; and (2) assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible. The Commission believes each of the proposals in OCC's proposed rule change discussed above is consistent with promoting the prompt and accurate clearance and settlement of securities transactions and assuring the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible.

First, the Commission believes that OCC's three proposals to improve trade certainty and transparency in the Stock Loan Programs are consistent with promoting the prompt and accurate clearance and settlement of securities transactions as well as assuring the safeguarding of securities and funds which are in OCC's custody or control, or for which it is responsible. The Commission believes that OCC's proposal to require clearing members to implement adequate policies and procedures to reconcile stock loan

²¹ 15 U.S.C. 78q-1(b)(3)(F).

²² 17 CFR 240.17Ad-22(e)(13).

²³ 17 CFR 240.17Ad-22(e)(23).

²⁴ 15 U.S.C. 78q-1(b)(3)(F).

positions with OCC's records on a daily basis would promote the prompt and accurate clearance and settlement of stock loan transactions, and assure the safeguarding of securities and funds exchanged through the programs, by reducing financial and other risks to OCC and clearing members. The Commission also believes that OCC's proposal to provide explicitly in its rulebook that its stock loan records would prevail in the event of a conflict with clearing member records, and that clearing members must continue to perform on all stock loan positions reflected in OCC's records, promotes the prompt and accurate clearance and settlement of securities transactions and assures the safeguarding of securities and funds by encouraging clearing members to understand, manage, and promptly report stock loan transactions.

Finally, the Commission believes that OCC's proposal to provide that stock loan positions remain in effect until OCC's records reflect stock loan terminations promotes the prompt and accurate clearance and settlement of stock loan transactions and assures the safeguarding of securities and funds exchanged through the programs by emphasizing that OCC's records supersede the records of clearing members and further encouraging clearing members to understand, manage, and promptly report stock loan transactions. The Commission therefore finds these specific proposals are consistent with promoting the prompt and accurate clearance and settlement of securities transactions and assuring the safeguarding of securities and funds which are in OCC's custody or control, or for which it is responsible as guarantor in the Stock Loan Programs.

Second, the Commission believes that OCC's three proposals to mitigate certain risks in the event of a clearing member suspension are consistent with promoting the prompt and accurate clearance and settlement of securities transactions and assuring the

safeguarding of securities and funds which are in OCC's custody or control, or for which it is responsible. The proposal to provide a two-day trading window in which clearing members must execute close-out transactions, or opt for mandatory settlement, is consistent with promoting the prompt and accurate clearance and settlement of securities transactions and assuring the safeguarding of securities and funds by requiring non-suspended clearing members to complete close-out transactions in a timeframe that is consistent with OCC's liquidation assumptions. The proposed alignment of the close-out period with OCC's liquidation assumptions mitigates OCC's credit risks by reducing the risk that close-out prices vary too significantly from the prices used to mark the suspended clearing member's stock loans to market. OCC's proposed price-substitution authority also promotes the prompt and accurate clearance and settlement of stock loan transactions and assures the safeguarding of securities and funds under the programs by further encouraging non-suspended clearing members to execute close-out transactions in a commercially reasonable manner, thereby reducing financial risk to OCC.

Finally, the proposed rule changes in the Hedge Program to permit OCC to terminate and re-establish a suspended clearing member's positions through offset and "re-match" promote the prompt and accurate clearance and settlement of securities transactions and assure the safeguarding of securities and funds by facilitating orderly and efficient termination and re-establishment of stock loans involving a suspended clearing member, which mitigates operational and pricing risks that may arise for OCC and clearing members during the recall-and-return process. The Commission therefore finds that these aspects of the proposal are consistent with promoting prompt and accurate clearance and settlement of securities transactions and assuring the safeguarding

of securities and funds which are in OCC's custody or control, or for which it is responsible.

Based on the conclusions discussed above, the Commission finds that OCC's proposed rule changes are consistent with promoting the prompt and accurate clearance and settlement of securities transactions and assuring the safeguarding of securities and funds which are in OCC's custody or control, or for which it is responsible as a guarantor in the Stock Loan Programs. Accordingly, the Commission finds that the proposals are consistent with Section 17A(b)(3)(F) of the Act.²⁵

B. Consistency with Rules 17Ad-22(e)(13) and (e)(23) of the Act

The Commission finds that OCC's proposals are consistent with Rules (e)(13) and (e)(23) under the Act.²⁶ Rule 17Ad-22(e)(13) under the Act requires each covered clearing agency to establish, implement, maintain, and enforce policies and procedures reasonably designed to, among other things, ensure it has the authority and operational capacity to take timely action to contain losses and continue to meet its obligations in the event of a clearing member default.²⁷ More generally, Rule 17Ad-22(e)(23) under the Act requires covered clearing agencies to establish, implement, maintain, and enforce policies and procedures reasonably designed to, among other things, provide for the public disclosure of all relevant rules and material procedures, including key aspects of default rules and procedures.²⁸

²⁵ 15 U.S.C. 78q-1(b)(3)(F).

²⁶ 17 CFR 240.17Ad-22(e)(13), and 17 CFR 240.17Ad-22(e)(23).

²⁷ 17 CFR 240.17Ad-22(e)(13).

²⁸ 17 CFR 240.17Ad-22(e)(23).

The Commission believes that the proposed changes relating to clearing member suspension are consistent with Rule 17Ad-22(e)(13) under the Act. By proposing a fixed trading window in which clearing members must either execute close-out transactions relating to a clearing member suspension or opt for OCC-mandated settlements, OCC is seeking new authority that the Commission believes will better ensure that OCC can take timely actions to contain suspension-related losses and continue to meet stock loan-related obligations in the Stock Loan Programs. The Commission further believes that the proposed authority permitting OCC to withdraw the value of any difference between the clearing member-reported prices and OCC-determined close-out prices likewise better ensures that OCC can contain suspension-related losses, as clearing members would be further incentivized to execute timely close-out transactions at market prices. Finally, the Commission believes that the proposal relating to re-matching-in-suspension better ensures that OCC has authority and operational capacity to contain losses and meet obligations to clearing members in the Hedge Program, in particular through new rules and mechanisms that reduce the operational, credit, and re-execution risks attendant to the recall-and-return process. The Commission therefore believes OCC's proposal is consistent with Rule 17Ad-22(e)(13) under the Act.

The Commission also believes that OCC's proposals are consistent with Rule 17Ad-22(e)(23) under the Act. Each aspect of OCC's proposed rule change is proposed to be disclosed publicly in OCC's rules governing the Stock Loan Programs, including the key suspension-related aspects of its rules providing for close-out transaction timeframes, new price-substitution authority, and termination and re-matching-in-

suspension. The Commission therefore believes that OCC's proposal is consistent with Rules 17Ad-22(e)(23) under the Act.

III. Conclusion

On the basis of the foregoing, the Commission finds that the proposed change is consistent with the requirements of the Act, and in particular, with the requirements of Section 17A of the Act²⁹ and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,³⁰ that the proposed rule change (SR-OCC-2017-004) be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³¹

Eduardo A. Aleman
Assistant Secretary

²⁹ In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

³⁰ 15 U.S.C. 78s(b)(2).

³¹ 17 CFR 200.30-3(a)(12).

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