8011-01
SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-82310; File No. SR-OCC-2017-010)

Self-Regulatory Organizations; The Options Clearing Corporation; Order Approving Proposed Rule Change Relating to The Options Clearing Corporation's Default Management Policy

December 13, 2017

On October 12, 2017, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") proposed rule change SR-OCC-2017-010 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 November 1, 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

This proposed rule change by OCC will formalize OCC's Default Management Policy ("DM Policy"). The proposed rule change does not require any changes to the text of OCC's By-Laws or Rules.[4]

As described by OCC, the DM Policy would apply in the event of a default by a Clearing Member, settlement bank, or a financial market utility ("FMU") with which

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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. 34-81955 (Oct. 26, 2017), 82 FR 50707 (Nov. 1, 2017) (File No. SR-OCC-2017-010).

4 All terms with initial capitalization that are not otherwise defined herein have the same meaning as set forth in the OCC By-Laws and Rules.

OCC has a relationship.[5] The purpose of the DM Policy is to outline OCC's default management framework and describe the default management steps that OCC has authority to take depending upon the facts and circumstances of a default. The DM Policy focuses on Clearing Member default, which OCC believes is appropriate because Clearing Member default represents a substantial part of the overall default risk that is posed to OCC in connection with its central counterparty clearing services.[6] OCC notes that the DM Policy is part of a broader framework used by OCC to manage the default of a Clearing Member, settlement bank, or FMU, including OCC's By-Laws, Rules, and other policies and procedures. The broader framework is designed to collectively ensure that OCC would appropriately manage any such default consistent with OCC's obligations as a covered clearing agency.[7]

The DM Policy describes the authority of OCC's Board of Directors ("Board") or a Designated Officer[8] to summarily suspend a Clearing Member pursuant to OCC Rule

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5 The DM Policy identifies the following securities or commodities clearing organizations as examples of such FMUs: The Depository Trust Company, National Securities Clearing Corporation, and the Chicago Mercantile Exchange. In an event of default by one of these securities or commodities clearing organizations, or by a settlement bank, OCC has authority under certain conditions pursuant to Article VIII, Sections 1(a)(vii) and 5(b) of the By-Laws to manage the default using Clearing Member contributions to the Clearing Fund.

6 For purposes of the DM Policy, references to a Clearing Member suspension or default contemplate the circumstances specified in OCC Rule 1102, which constitute events of "default" under Interpretation and Policy .01 to the Rule.

7 On September 28, 2016, the Commission amended Rule 17Ad-22 under the Act by adding new Rule 17Ad-22(e) to establish requirements for the operation and governance of registered clearing agencies that meet the definition of a covered clearing agency, as defined by Rule 17Ad-22(a)(5). Standards for Covered Clearing Agencies, Securities Exchange Act Release No. 34-78961 (Sept. 28, 2016), 81 FR 70786 (Oct. 13, 2016).

8 For this purpose, the term Designated Officer includes the Executive Chairman, Chief Administrative Officer ("CAO"), Chief Operating Officer ("COO"), Chief

1102(a) in the event the Clearing Member defaults. The DM Policy further provides that, pursuant to OCC Rule 707, OCC may suspend a Clearing Member that participates in a cross-margining program in the event of a default regarding its cross-margining accounts. Upon any suspension of a Clearing Member, the DM Policy states that OCC would immediately notify a number of parties, including the suspended Clearing Member, regulatory authorities, participant and other exchanges (as applicable) in which the suspended Clearing Member is a common member, other Clearing Members,[9] and OCC's Board.[10]

In the event of a Clearing Member suspension, the DM Policy provides that OCC's Financial Risk Management Department ("FRM") shall prepare an exposure summary report to be provided to OCC's Management Committee detailing, among other things, the open obligations of the suspended Clearing Member, collateral deposited by the Clearing Member, obligations to other FMUs, and a summary of related entity exposure. The report summarizes the net settlement obligation of the suspended Clearing Member at the time of default. The DM Policy further provides that a recommendation as to any liquidity needs requiring a draw on OCC's credit facilities would be provided to OCC's Management Committee and subsequently be authorized, as applicable, by the Executive Chairman, CAO, or COO, as provided for in Article VIII, Section 5 of the By-

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Risk Officer ("CRO"), and Executive Vice President – Financial Risk Management ("EVP-FRM").

9 OCC Rule 1103 requires OCC to notify all Clearing Members of the suspension as soon as possible.

10 With respect to pending transactions of a suspended Clearing Member, the DM Policy provides that these will be handled pursuant to OCC Rule 1105, provided that OCC has no obligation to accept the trades effected by a suspended Clearing Member post-suspension.

Laws. These practices ensure that OCC's Management Committee remains properly informed and can make appropriate decisions in the default management process.

The DM Policy describes OCC's existing authority under OCC Rule 505 to extend the time for OCC's settlement obligations (i.e., payment obligations owed by OCC to Clearing Members). The DM Policy notes that, as set forth in OCC Rule 505, any such determination to extend the settlement time and the reasons thereof will be promptly reported by OCC to the Commission and the Commodity Futures Trading Commission ("CFTC"); however, the effectiveness of the extension would not be conditioned upon such reporting. The DM Policy notes that such an extension may be necessary as a result of a Clearing Member default or a failure of a Clearing Member's settlement bank.

To address situations in which a Clearing Member's settlement bank fails or experiences an operational outage that prevents the Clearing Member from meeting its settlement obligations to OCC, the DM Policy provides that OCC requires each Clearing Member to maintain procedures detailing how it would meet its settlement obligations in such an event. The DM Policy further provides that a Designated Officer would determine whether to enact alternate settlement procedures in the event that a Clearing Member's settlement bank is unable to perform.

The DM Policy sets forth the sequence or "waterfall" of financial resources that OCC may use to meet its obligations in the event of a Clearing Member suspension to provide certainty regarding the order in which these resources would be applied. Specifically, the DM Policy describes that OCC is able to use the following financial resources: (i) margin deposits of the suspended Clearing Member; (ii) deposits in lieu of

margin of the suspended Clearing Member;[11] (iii) Clearing Fund deposits of the suspended Clearing Member; (iv) Clearing Fund deposits of non-defaulting Clearing Members; (v) Clearing Fund assessments against Clearing Members; and (vi) the current or retained earnings of OCC, subject to the unanimous approval of certain OCC shareholders.[12]

In the case of a suspended Clearing Member, the DM Policy outlines the means by which OCC may close out positions and liquidate collateral of the suspended Clearing Member pursuant to OCC's Rules, including certain provisions under Chapter XI of the Rules. Based upon recommendations from OCC's risk staff, the EVP-FRM may take any one, or any combination, of the following actions pursuant to the terms of OCC's By-Laws and Rules: (i) net the suspended Clearing Member's positions by offset; (ii) effect close out open short positions, long positions, and collateral through market transactions; (iii) transfer the positions and related collateral to a non-suspended Clearing Member; (iv) effect hedging transactions to reduce the risk to OCC of open positions; (v) conduct a private auction of the positions and collateral of the suspended Clearing Member; (vi) exercise unsegregated and segregated long options; (vii) set cash settlement values or perform buy-in or sell-out processes; and (viii) defer close-out, as may be authorized by certain officers of OCC.[13]

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11 See OCC Rules 610(f) and (g).

12 See OCC By-Law Article VIII, Section 5(d). In lieu of charging a loss or deficiency proportionately to the computed Clearing Fund contributions of non-defaulting Clearing Members, OCC may charge the loss or deficiency to current or retained earnings. This discretion applies in connection with any loss by reason of the failure of a bank or securities or commodities clearing organization to perform an obligation to OCC.

13 The DM Policy also provides that any determination to defer close-out or hedging transactions under the Close-out Action Plan (as discussed herein) would be

In addition, the DM Policy specifies that OCC risk staff will develop a Close-out Action Plan ("CAP") and present it to the EVP-FRM for approval. The DM Policy provides that upon approval of the CAP by the EVP-FRM, FRM, and other designated business officers/departments will be responsible for its execution. The DM Policy also provides that OCC's legal department would advise OCC's Management Committee on OCC's authority to execute the proposed CAP and describe the responsibilities for the execution, monitoring, and reporting of the CAP and escalation of issues to OCC's Management Committee. The CAP process is designed to ensure that OCC has an appropriate process in place to analyze its exposures, take into consideration current and expected market conditions, and evaluate the tools and resources available to deal with those exposures under the circumstances so that OCC can appropriately manage any default in a manner that would protect Clearing Members, investors, the public interest, and the markets that OCC serves.

The DM Policy provides that OCC would generally liquidate all positions and collateral of a suspended Clearing Member, and the proceeds would be attributed to the account type from which they originated. It also specifies that as a registered clearing agency with the Commission and a registered derivatives clearing organization with the CFTC, OCC is required to comply with regulatory requirements to safeguard customer assets.

In the event of a default, OCC would immediately demand any pledged collateral of the suspended Clearing Member from custodian(s) to ensure those resources are available for default management purposes. For example, the DM Policy provides that,

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reported to the Board and/or the Board Risk Committee, as required under OCC Rule 1106.

among other things, cash and proceeds from any liquidated collateral or demand of payment on a letter of credit would be placed in the appropriate liquidating settlement account, pursuant to OCC Rule 1104. The DM Policy further provides that all pledged valued margin collateral will be moved by OCC's Collateral Services Department into an OCC account and may be transferred to an auction recipient, delivered to a liquidating agent, or delivered to a liquidating settlement account. In the case of deposits in lieu of margin, however, the DM Policy states that OCC would only demand such collateral to meet obligations arising from the assignment of a related contract.

After the close-out of the positions and collateral of the suspended Clearing Member is completed, the DM Policy describes that the Executive Chairman, CAO, or COO would determine whether, consistent with Article VIII, Section 5(a) of OCC's By-Laws, an assessment must be made against the Clearing Fund in connection with the liquidation. In the event of a shortfall whereby the close-out of the suspended Clearing Member does not result in enough resources to cover its obligations, the DM Policy states that each Clearing Member, consistent with Article VIII, Section 6 of OCC's By-Laws, may be assessed an additional amount equal to the amount of its initial Clearing Fund deposit, as determined by the Executive Chairman, CAO, or COO. The DM Policy notes that any such assessment decision would be communicated via e-mail in accordance with the applicable OCC procedure covering the assessment process. The DM Policy also specifies that a Clearing Member is liable for further assessments until the balance of OCC's losses are covered or the Clearing Member has withdrawn from membership as set forth in Article VIII, Sections 6 and 7 of OCC's By-Laws.

The DM Policy provides that, on at least an annual basis, OCC's default management working group will provide OCC's Management Committee with recommended areas for testing, including close-out procedures, and that the Management Committee is responsible for reviewing and ultimately approving the overall test plan.[14] In addition, the DM Policy specifies that the default management working group maintains the authority to approve individual test plans and overall plan changes, but that any changes to the overall plan would be reported to and reviewed by OCC's Management Committee. The DM Policy further provides that testing is recommended and performed more frequently than annually if a material change is made to OCC's default management procedures or if it is deemed necessary by OCC's default management working group.

In addition, the DM Policy outlines the execution of the testing plan and the review of the results of the testing plan, including the production of annual reports to OCC's Management Committee and Risk Committee of OCC's Board regarding the results of OCC's default tests to provide appropriate oversight over the default testing process.

II. Discussion and Commission Findings

Section 19(b)(2)(C) of the Act[15] 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 rules and regulations thereunder

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14 The DM Policy also provides that Clearing Members are required to participate in default management testing pursuant to OCC Rules 218(c) and (d). See Securities Exchange Act Release No. 80372 (April 4, 2017), 82 FR 17311 (April 10, 2017) (SR-OCC-2017-003).

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

applicable to such organization. The Commission finds that the proposal is consistent with Section 17A(b)(3)(F) of the Act[16] and Rules 17Ad-22 (e)(4)(ix) and (e)(13)[17] thereunder, as described in detail below.

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

The Commission finds OCC's proposed changes to be consistent with Section 17A(b)(3)(F) of the Act,[18] which requires, among other things, that the rules of a clearing agency be designed to promote the prompt and accurate clearance and settlement of securities transactions, in general, to protect investors and the public interest. As noted above, the DM Policy focuses on the processes that OCC would use to take timely action to contain losses and liquidity demands in an event of default by a Clearing Member, such as closing out open positions and collateral of a defaulted Clearing Member, using alternate settlement bank procedures, or relying on Clearing Fund contributions of Clearing Members under certain conditions. In this regard, the DM Policy is designed to ensure that OCC can maintain its resilience in the event of a default, thereby enabling OCC to continue to provide its clearance and settlement services to the public in such circumstances. By formalizing the components of the DM Policy, OCC has taken measures to provide that its rules are designed to promote the prompt and accurate clearance and settlement of securities transactions, and, in general, to protect investors and the public interest.

B. *Consistency with Rule 17Ad-22(e)(4)(ix)*

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16 15 U.S.C. 78q-1(b)(3)(F).

17 17 CFR 240.17Ad-22(e)(4)(ix), (e)(13).

18 15 U.S.C. 78q-1(b)(3)(A).

Rule 17Ad-22(e)(4)(ix)[19] requires each covered clearing agency to establish, implement, maintain and enforce written policies and procedures reasonably designed to effectively identify, measure, and manage its credit exposures to participants and those arising from its payment, clearing, and settlement processes, including by describing its process to replenish any financial resources it may use following a default or other event in which use of such resources is contemplated. The DM Policy describes the process by which OCC may initiate a Clearing Fund assessment to replenish financial resources that may be used following a default and the attendant suspension of a Clearing Member. Specifically, the DM Policy provides that where the liquidation of a suspended Clearing Member results in a shortfall, certain officers of OCC may require that all Clearing Members be assessed an additional amount equal to the amount of their respective Clearing Fund deposits, consistent with OCC's By-Laws, and that a Clearing Member is liable for further assessments until the balance of OCC's losses are covered or the Clearing Member has withdrawn from membership as set forth in OCC's By-Laws. In addition, the DM Policy also provides that, pursuant to the waterfall of financial resources used in the event of a Clearing Member suspension, OCC could use current or retained earnings, consistent with OCC's By-Laws, to continue meeting its financial obligations. Accordingly, the Commission finds that the proposed changes are consistent with Rule 17Ad-22(e)(4)(ix).[20]

C. *Consistency with Rule 17Ad-22(e)(13)*

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19 17 CFR 240.17Ad-22(e)(4)(ix).

20 Id.

Rule 17Ad-22(e)(13)[21] requires each covered clearing agency to establish, implement, maintain and enforce written policies and procedures reasonably designed to ensure that it has the authority and operational capacity to take timely action to contain losses and liquidity demands and continue to meet its obligations by, at a minimum, requiring its participants and, when practicable, other stakeholders to participate in the testing and review of its default procedures, including any close-out procedure, at least annually and following material changes thereto. The DM Policy, among other things, sets forth OCC's authority and operational capabilities to take timely action to contain losses and liquidity demands and continue to meet its obligations. For example, the DM Policy sets forth the procedures by which OCC would suspend a Clearing Member as well as the waterfall of financial resources that OCC would use to contain losses arising from the Clearing Member's default. The DM Policy also describes, among other things, the various means by which OCC may close-out the positions of a suspended Clearing Member and the process it uses to make such determinations, which OCC believes helps ensure that it has sufficient operational capacity to take timely action to contain losses and liquidity demands and continue to meet its obligations. In addition, the DM Policy sets forth OCC's processes for managing annual default management testing, or more frequent testing following a change to OCC's default management procedures. Accordingly, the Commission finds that these policies and procedures are consistent with the requirements in Rule 17Ad-22(e)(13).[22]

III. Conclusion

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21 17 CFR 240.17Ad-22(e)(13).

22 Id.

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 Act[23] and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[24] that the proposed rule change (SR-OCC-2017-010) be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated Authority.[25]

Eduardo A. Aleman
Assistant Secretary

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23 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).

24 15 U.S.C. 78s(b)(2).

25 17 CFR 200.30-3(a)(12).

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