

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-99731; File No. SR-OCC-2023-801)

March 13, 2024

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of No Objection to Advance Notice, as Modified by Partial Amendment No. 1 and Amendment No. 2, Concerning Modifications to the Amended and Restated Stock Options and Futures Settlement Agreement Between the Options Clearing Corporation and the National Securities Clearing Corporation

## I. INTRODUCTION

On August 10, 2023, the Options Clearing Corporation (“OCC”) filed with the Securities and Exchange Commission (“Commission”) advance notice SR-OCC-2023-801 (“Advance Notice”) pursuant to Section 806(e)(1) of Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, entitled Payment, Clearing and Settlement Supervision Act of 2010 (“Clearing Supervision Act”)<sup>1</sup> and Rule 19b-4(n)(1)(i)<sup>2</sup> under the Securities Exchange Act of 1934 (“Exchange Act”)<sup>3</sup> to change terms related to the physical settlement of equities arising out of certain futures and options contracts.<sup>4</sup> On August 30, 2023, notice of the Advance Notice was published in the *Federal Register* to solicit public comment and to extend the review period for the Advance Notice.<sup>5</sup>

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

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

<sup>3</sup> 15 U.S.C. 78a *et seq.*

<sup>4</sup> *See* Notice of Filing *infra* note 5, at 88 FR 59988.

<sup>5</sup> Securities Exchange Act Release No. 98214 (Aug. 24, 2023), 88 FR 59988 (Aug. 30, 2023) (File No. SR-OCC-2023-801) (“Notice of Filing”). On Aug. 10, 2023, OCC also filed a related proposed rule change (SR-OCC-2023-007) with the Commission pursuant to Section 19(b)(1) of the Exchange Act and Rule 19b-4 thereunder (“Proposed Rule Change”). 15 U.S.C. 78s(b)(1) and 17 CFR 240.19b-4, respectively. In the Proposed Rule Change, which was published in the *Federal Register* on Aug. 30, 2023, OCC seeks approval of proposed changes to its rules necessary to implement the Advance Notice. Securities Exchange Act Release No. 98215 (Aug. 24, 2023), 88 FR 59976 (Aug. 30, 2023) (File No. SR-OCC-2023-007). The initial comment period for the related Proposed Rule Change filing closed on Sept. 20, 2023. The Commission solicited further comment when it subsequently instituted proceedings to determine whether to approve or disapprove the Proposed Rule Change. The additional comment period closed on Dec. 26, 2023. *See* Securities Exchange Act Release No. 98932 (Nov. 14, 2023), 88 FR 80781 (Nov. 20, 2023) (File No. SR-OCC-2023-007).

On November 8, 2023, OCC filed Partial Amendment No. 1 to the Advance Notice.<sup>6</sup> On November 14, 2023, the Commission requested additional information for consideration of the Advance Notice from OCC, pursuant to Section 806(e)(1)(D) of the Clearing Supervision Act,<sup>7</sup> which tolled the Commission’s period of review of the Advance Notice until 120 days from the date the information requested by the Commission was received by the Commission.<sup>8</sup> On December 5, 2023, the Commission received OCC’s response to the Commission’s request for additional information.<sup>9</sup> On January 23, 2024, OCC filed Amendment No. 2 to the Advance Notice, which was published in the *Federal Register* for public comment on January 30, 2024.<sup>10</sup> The Commission has received public comment regarding the changes proposed in the Advance Notice.<sup>11</sup> The Commission is hereby providing notice of no objection to the Advance Notice as

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<sup>6</sup> Partial Amendment No. 1 delays implementation of the proposed change. In Partial Amendment No. 1, OCC proposes to implement the proposed rule change within 90 days of receiving all necessary regulatory approvals and would announce the specific date of implementation on its public website at least 14 days prior to implementation. The delay is proposed in light of the technical system changes that are required to implement the liquidity stress testing enhancements and to be able to provide sufficient notice to Clearing Members following receipt of approval.

<sup>7</sup> 12 U.S.C. 5465(e)(1)(D).

<sup>8</sup> See 12 U.S.C. 5465(e)(1)(E)(ii) and (G)(ii); Memorandum from the Office of Clearance and Settlement Supervision, Division of Trading and Markets, titled “Commission’s Request for Additional Information,” available at <https://www.sec.gov/comments/sr-occ-2023-801/srocc2023801-298099-727262.pdf>.

<sup>9</sup> See 12 U.S.C. 5465(e)(1)(E)(ii) and (G)(ii); Memorandum from the Office of Clearance and Settlement Supervision, Division of Trading and Markets, titled “Response to the Commission’s Request for Additional Information,” available at <https://www.sec.gov/comments/sr-occ-2023-801/srocc2023801-307799-792662.pdf>.

<sup>10</sup> See Securities Exchange Act Release No. 99427 (Jan. 24, 2024), 89 FR 5953 (Jan. 30, 2024) (File No. SR-OCC-2023-801) (“Notice of Amendment”).

<sup>11</sup> Comments on the Advance Notice are available at <https://www.sec.gov/comments/sr-occ-2023-801/srocc2023801.htm>. The Commission received one comment supporting the proposed changes. See comment from John P. Davidson, Principal, Pirnie Advisory (Oct. 4, 2023), available at <https://www.sec.gov/comments/sr-occ-2023-801/srocc2023801-268179-645042.htm>. Since the proposal contained in the Advance Notice was also filed as a proposed rule change, all public comments received on the proposal are considered regardless of whether the comments are submitted on the Proposed Rule Change or the Advance Notice. Comments on the Proposed Rule Change are available at <https://www.sec.gov/comments/sr-occ-2023-007/srocc2023007.htm>. The Commission received comments on the proposed rule change that express concerns unrelated to the substance of the filing. See, e.g., comment from Gregory Englebert (Feb. 2, 2024) (raising concerns about a conflict of interest in the role of Financial Risk Management Officers as well as margin calls) comment from Curtis H. (Feb. 3, 2024)

modified by Partial Amendment No. 1 and Amendment No. 2 (hereinafter defined as the “Advance Notice”).

## II. BACKGROUND

The National Securities Clearing Corporation (“NSCC”) is a clearing agency that provides clearing, settlement, risk management, and central counterparty services for trades involving equity securities. OCC is the sole clearing agency for standardized equity options listed on national securities exchanges registered with the Commission, including options that contemplate the physical delivery of equities cleared by NSCC in exchange for cash (“physically settled” options).<sup>12</sup> OCC also clears certain futures contracts that, at maturity, require the delivery of equity securities cleared by NSCC in exchange for cash. As a result, the exercise and assignment of certain options or maturation of certain futures cleared by OCC effectively results in stock settlement obligations to be cleared by NSCC (“Exercise and Assignment Activity” or “E&A Activity”). NSCC and OCC maintain a legal agreement, generally referred to by the parties as the “Accord,” that governs the processing of such E&A Activity for firms that are members of both OCC and NSCC (“Common Members”).<sup>13</sup>

Under certain circumstances, the Accord currently allows NSCC not to guaranty the settlement of securities arising out of E&A Activity for a Common Member for whom NSCC

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(referencing short selling and margin), and comment from CK Kashyap (Feb. 5, 2024) (referring to broker risk management in response to margin).

<sup>12</sup> The term “physically-settled,” as used throughout the OCC Rulebook, refers to cleared contracts that settle into their underlying interest (i.e., options or futures contracts that are not cash-settled). When a contract settles into its underlying interest, shares of stock are sent (i.e., delivered) to contract holders who have the right to receive the shares from contract holders who are obligated to deliver the shares at the time of exercise/assignment in the case of an option and at the time of maturity in the case of a future. Capitalized terms used but not defined herein have the meanings specified in OCC’s Rules and By-Laws, available at <https://www.theocc.com/about/publications/bylaws.jsp>.

<sup>13</sup> Pursuant to OCC Rule 302, outside of certain limited exceptions, every Clearing Member that effects transactions in physically-settled options or futures must also be a participant of NSCC.

has ceased to act (e.g., due to a default by that member). To the extent NSCC chooses not to guaranty such transactions of a defaulting Clearing Member, OCC would have to engage in an alternate method of settlement outside of NSCC to manage the default. This presents two issues. First, based on historical data, the cash required for such alternative settlement could be as much as \$300 billion.<sup>14</sup> Second, because NSCC's netting process dramatically decreases the volume of securities settlement obligations that must be addressed, settlement of physically-settled options and futures outside of NSCC introduces significant operational complexities. Specifically, without NSCC's netting process, OCC would have to coordinate a significantly increased number of transactions on a broker-to-broker basis rather than through a single central counterparty, and the total value of settlement obligations that would need to be processed would be significantly higher.<sup>15</sup>

OCC proposes to revise the Accord to address these liquidity and operational issues. In particular, OCC and NSCC have agreed to modify the Accord to require NSCC to accept E&A activity from OCC (i.e., guaranty the positions of a defaulting Common Member), provided that OCC makes a payment to NSCC called the "Guaranty Substitution Payment," or "GSP." The GSP is designed to cover OCC's share of the incremental risk to NSCC posed by the defaulting Common Member's positions. The total risk posed to NSCC by a defaulting Common Member would be the sum of (i) the defaulter's unpaid deposit to the NSCC Clearing Fund ("Required

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<sup>14</sup> See Notice of Filing, 88 FR at 59989.

<sup>15</sup> For example, in 2022 it is estimated that netting through NSCC's continuous net settlement ("CNS") accounting system reduced the value of CNS settlement obligations from \$519 trillion to \$9 trillion, an approximately 98 percent reduction. See Notice of Filing, 88 FR at 59989.

Fund Deposit”),<sup>16</sup> and (ii) the defaulter’s unpaid Supplemental Liquidity Deposit (“SLD”).<sup>17</sup> If OCC pays the GSP to NSCC, NSCC would be obligated under the amended Accord to accept that member’s E&A activity from OCC and conduct settlement through NSCC’s netting process and systems. NSCC would calculate how much of the defaulting Common Member’s Required Fund Deposit and SLD are attributable to the E&A Activity that OCC sends to NSCC, and that amount would be the GSP. Based on historical data, OCC’s GSP could be as much as \$6 billion, which is significantly less than the potential \$300 billion that could be required for alternative settlement outside of NSCC.<sup>18</sup>

As noted above, OCC amended the Advance Notice after filing. The primary purposes of the Amendment No. 2 were to provide for improved information sharing between OCC and NSCC, and ensure that the new process and timing for NSCC to calculate the GSP and OCC to pay the GSP will be consistent with relevant process and timing requirements necessitated by the industry transitions to a T+1 settlement cycle for securities.<sup>19</sup> OCC has labeled the proposed changes included in the initial filing to allow OCC to pay the GSP to NSCC and enhance OCC’s liquidity stress testing as Phase 1 of the proposed changes, and the additional changes in the amendment to enhance information sharing and facilitate the transition to T+1 as Phase 2.<sup>20</sup>

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<sup>16</sup> The Required Fund Deposit is calculated pursuant to Rule 4 (Clearing Fund) and Procedure XV (Clearing Fund Formula and Other Matters) of the NSCC Rules. *See* Notice of Filing, 88 FR at 59991, n.28.

<sup>17</sup> Under the NSCC Rules, in certain circumstances, NSCC collects the Supplemental Liquidity Deposit, which is an additional cash deposit from each of those Members who would generate the largest settlement debits in stressed market conditions. *See* Rule 4A of the NSCC Rules. *See also* Notice of Filing, 88 FR at 59991, n.29.

<sup>18</sup> *See* Notice of Filing, 88 FR at 59989

<sup>19</sup> On Feb. 15, 2023, the Commission adopted rules to shorten the standard settlement cycle for most broker-dealer transactions from T+2 to T+1. *See* Securities Exchange Act Release No. 96930 (Feb. 15, 2023), 88 FR 13872 (Mar. 6, 2023) (File No. S7-05-22).

<sup>20</sup> OCC has proposed a two-step implementation based on the categorization of changes as part of Phase 1 and Phase 2. *See* Notice of Amendment, 89 FR at 5968.

OCC also proposes to make conforming changes throughout its rules to accommodate the changes summarized above, as well as a number of changes to its rules to facilitate the proposed changes to the Accord noted above. For example, OCC proposes to change its rules to permit payment of the GSP to NSCC and revise other of its rules related to liquidity risk management to account for the potential need to make such a cash payment to NSCC.

**A. Information Sharing and the Guaranty Substitution Payment**

The proposed revisions to the Accord designed to introduce and facilitate the new GSP include the following: changes designed to facilitate improved information sharing between OCC and NSCC; changes that would define the calculation of the GSP; changes that would define the process and timing by which guaranty of the E&A Activity would transfer from OCC to NSCC;<sup>21</sup> and additional conforming changes to the Accord to support these and the other changes described in more detail below.

*Improved Information Sharing.* Currently, NSCC sends a file daily to OCC defining which securities are eligible to settle through NSCC. OCC then delivers to NSCC a file identifying securities to be physically settled at NSCC as a result of E&A Activity. This process would continue under the proposal, however, as part of Phase 1 NSCC would also communicate the GSP daily to OCC.<sup>22</sup> In Phase 2, NSCC would continue to communicate the GSP daily to OCC, but the calculation would differ, as described in more detail below.

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<sup>21</sup> Here, the “transfer” of the guaranty refers to the point at which OCC’s settlement guaranty with respect to E&A Activity ends and NSCC’s settlement guaranty begins.

<sup>22</sup> NSCC would communicate both the total amount of collateral required to cover the risk presented by each common clearing member and what percentage of that risk is attributable to OCC (i.e., the GSP) and therefore OCC would need to pay to require NSCC to guaranty the positions of a Common Member for whom NSCC has ceased to act. As described further below, OCC proposes to incorporate the total risk presented by each common member into its management of liquidity risk.

Also in Phase 2, OCC and NSCC would share additional information beyond the daily exchange of position files and communication of the GSP. Specifically, NSCC would communicate to OCC daily the single largest GSP observed in the prior 12 months (the “Historical Peak GSP”), which would in turn provide a data point for discussion between OCC and NSCC to confirm that OCC will likely be in a position to commit to paying the actual GSP in the event of the default of a Common Member.<sup>23</sup> NSCC would also communicate a set of margin and liquidity-related data to OCC daily (the “GSP Monitoring Data”). The GSP Monitoring Data would be for informational purposes and would facilitate OCC’s daily assessment of its ability to commit to pay the actual GSP in the event of the default of a Common Member.

*The Guaranty Substitution Payment.* As described above, NSCC would communicate to OCC the GSP amount each day. In the event of a Common Member default, this is the amount OCC would need to pay to require NSCC to guaranty the positions of the defaulting Common Member. Under both Phases 1 and 2, the GSP for a given member would be the amount necessary to cover the risk posed by the member’s E&A Activity, and would be calculated by determining the portion of the defaulting Clearing Member’s Required Fund Deposit and SLD that the member owes to NSCC that is attributable to the member’s E&A Activity at OCC. The calculation of OCC’s portion of the Required Fund Deposit obligation would differ between Phases 1 and 2, with a precise calculation in Phase 2 replacing a proxy from Phase 1.

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<sup>23</sup> NSCC would provide the Historical Peak GSP to OCC daily, and OCC would communicate to NSCC whether OCC has Clearing Fund cash in excess of the Historical Peak GSP. If OCC does not have sufficient cash in the Clearing Fund, this would allow OCC and NSCC to escalate discussion of whether OCC will likely be in a position to commit to paying the actual GSP (e.g., what other resources OCC has, whether the actual GSP is likely to be as large as the historical peak). The comparison of OCC’s resources to the Historical Peak GSP would not affect whether OCC is permitted to send E&A Activity to NSCC.

In Phase 1, NSCC would approximate the percentage of the member's Required Fund Deposit attributable to E&A Activity by referencing the day-over-day change in gross market value of the Common Member's positions at NSCC. OCC acknowledges that this gross market value proxy methodology overestimates or underestimates the Required Fund Deposit attributable to a Common Member's E&A Activity, but states that current technology constraints prohibit NSCC from performing a precise calculation of the GSP on a daily basis for every Common Member. The Phase 2 changes to the Accord would introduce a more precise allocation of the Required Fund Deposit portion of the GSP, which would help eliminate the potential over- or under-estimation of OCC's portion of the Required Fund Deposit.<sup>24</sup> Specifically, in Phase 2, NSCC would calculate OCC's portion of the Required Fund Deposit as a difference between the Required Fund Deposit of the Common Member's entire portfolio and the Required Fund Deposit of the Common Member's portfolio prior to the submission of E&A Activity. This more precise calculation would completely replace the Phase 1 gross market value proxy. Under both Phases 1 and 2, the SLD portion of the GSP would be the Common Member's unpaid SLD associated with any E&A Activity.

*Guaranty Transfer.* As described above, the purpose of the proposed changes is to increase the circumstances under which NSCC must assume the obligation to guaranty E&A Activity. Currently, the guaranty for such transactions transfers from OCC to NSCC after NSCC has received Required Fund Deposits from the Common Members. The guaranty would not transfer if a member fails to satisfy its obligations to NSCC. Under the proposed changes, the guaranty would transfer after NSCC has received Required Fund Deposits from the Common

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<sup>24</sup> See Notice of Amendment, 89 FR at 5964-65. OCC and NSCC agreed that performing the necessary technology build during Phase 1 would delay the implementation of the proposal. NSCC will incorporate those technology updates in connection with Phase 2 of this proposal. See Notice of Amendment, 89 FR at 5957, n.32.



Members or at such time that OCC pays the GSP if a Common Member fails to satisfy its obligations to NSCC.

## **B. Liquidity Risk Management**

The changes to the Accord regarding the GSP and transfer of the guaranty are designed to resolve a potential gap in OCC's liquidity risk management. As noted above, the potential liquidity exposure to OCC posed by E&A Activity would be dramatically reduced by the proposed changes because it would go through NSCC's netting process. However, that reduction would only occur if OCC has sufficient liquid resources to pay the GSP. The potential payment of the GSP is, therefore, a liquidity demand that OCC must manage.

OCC's Liquidity Risk Management Framework ("LRMF") sets forth a comprehensive overview of OCC's liquidity risk management practices and governs OCC's policies and procedures as they relate to liquidity risk management.<sup>25</sup> OCC proposes changes to the LRMF as well as to *OCC's Comprehensive Stress Testing & Clearing Fund Methodology, and Liquidity Risk Management Description*<sup>26</sup> to incorporate the GSP into OCC's liquidity stress testing practices by treating the GSP as a potential liquidity demand.<sup>27</sup>

To implement this change, OCC would add an amount representing the potential GSP to each member account on each day on which options expire. The amount would be based on historical data. Specifically, OCC would add the peak GSP observed in the prior 12 months for

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<sup>25</sup> See Securities Exchange Act Release No. 89014 (June 4, 2020), 85 FR 35446 (June 10, 2020) (File No. SR-OCC-2020-003).

<sup>26</sup> OCC provided a marked version of the *Comprehensive Stress Testing & Clearing Fund Methodology, and Liquidity Risk Management Description* to the Commission as exhibit 5D to File No. SR-OCC-2023-801.

<sup>27</sup> OCC would incorporate this potential liquidity demand at the level of a group of affiliated members.

the member to the potential liquidity risk posed by the member.<sup>28</sup> The reliance on the peak GSP observed in a 12-month lookback, however, raises two issues that OCC proposes to address in its management of liquidity risk.

First, future liquidity exposures may exceed past exposures, so holding enough liquidity to meet historical demands does not ensure that OCC will hold enough to meet future exposures. To address this issue, OCC proposes to incorporate a member's total Required Fund Deposit and SLD obligations to NSCC (not just the portion represented in the GSP), into its liquidity risk management. As with most risk management, there is no guaranty that a future GSP could not exceed OCC's stress test exposures, but the proposed change increases the likelihood that OCC would have sufficient cash to pay the GSP.<sup>29</sup>

Second, the more E&A Activity that OCC sends to NSCC, the larger the amount of Required Fund Deposit and SLD attributable to E&A Activity. However, the level of E&A Activity varies predictably based on the expiration cycle of options such that different expiration cycles consistently present different volumes. Put simply, different expiration cycles are likely to pose different levels of liquidity risk to OCC in the form of the potential size of the GSP. Based on its analysis, OCC proposes to separate expirations into five categories.<sup>30</sup> For each day,

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<sup>28</sup> OCC states that the one-year lookback allows for the best like-to-like application of a historical GSP as there is a cyclical nature to option standard expirations with quarterly (i.e., Mar., June, Sept., and Dec.) and Jan. generally being more impactful than non-quarterly expirations. *See* Notice of Filing, 88 FR at 59998. OCC states further that the one-year lookback allows behavior changes of a Clearing Member to be recognized within an annual cycle. *See id.*

<sup>29</sup> For example, assume the largest member obligation to NSCC would have been \$100, but the largest GSP (representing the amount attributable to E&A Activity) would only have been \$75. Rather than hold \$75 and hope that the future exposures do not exceed past demands, OCC would hold \$100 to cover a future GSP.

<sup>30</sup> OCC provided its analysis supporting the specific categories to the Commission in confidential Exhibit 3E to File No. SR-OCC-2023-007. The confidential Exhibit 3E sets forth data related to OCC's liquidity stress testing for Sufficiency and Adequacy scenarios with and without the inclusion of the GSP, including Available Liquidity Resources, Minimum Cash Requirement thresholds, and liquidity breaches.

OCC proposes to apply the peak obligation observed over the prior 12 months within the relevant expiration category for that day.<sup>31</sup> The five categories that OCC proposes to employ are the following:

- Standard Monthly Expiration: typically the third Friday of each month;
- End of Week Expirations: the last business day of the week, excluding the third Friday of each month;
- End of Month Expirations: the last trading day of the month;
- Bank Holiday Expirations: days where banks are closed but the markets are open,<sup>32</sup>
- Daily Expirations: all other days with an expiration that do not fall into any of the categories above (typically most Mondays through Thursdays).

Notwithstanding this categorization and the underlying analysis, OCC proposes to impose two floors to certain expirations. First, the peak obligation applied in the End of Week, End of Month, and Bank Holiday categories cannot be lower than the peak obligation observed in the Daily Expirations category. Second, the obligation applied in the Standard Monthly Expiration category cannot be lower than the peak obligation observed in either the End of Week, End of Month, or Daily Expiration category. As discussed below, the imposition of the

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<sup>31</sup> For example, for a standard monthly expiration, which is typically the third Friday of the month, OCC would look at the peak obligation observed across all standard monthly expirations in the preceding 12 months.

<sup>32</sup> The Bank Holiday category recognizes that for Veterans Day and Columbus Day, the equity and equity derivative markets are open for trading, but the banking system is closed. Because of this, settlement at NSCC encompasses two days of equity trading and E&A Activity. This creates the possibility of a significant outlying GSP requirement due to the settlement of two days of activity simultaneously. In OCC's view this necessitates the ability to separately risk manage such occurrences through the creation of the Bank Holiday category. Additional supporting data in support of the creation of the Bank Holiday Expiration category is included as Exhibit 3E to File No. SR-OCC-2023-007.

floors would help OCC control for the possibility of an unusually large liquidity demand that is not related to the different expiration cycles.

The liquidity risk management changes described above are part of Phase 1. Additionally, OCC proposes changes to its Rules and By-Laws to allow OCC to pay the GSP out of its liquid resources.<sup>33</sup> Under Phase 2, OCC proposes to make further clarifying and definitional changes in the LRMF, but the substance of the Phase 1 changes would persist in Phase 2.

### **C. Transition to T+1**

Phase 1 of the proposed changes are primarily designed to provide OCC the right to require NSCC to accept and guaranty the E&A Activity of a Common Member even if that member has not met its obligations to NSCC. The mechanism by which OCC would exercise that right would be the payment of the GSP to NSCC, and OCC would account for such payment as a potential liquidity demand that it must manage. Phase 1 does not, however, materially change the time at which OCC would cease (and NSCC would start) to guaranty the E&A Activity.<sup>34</sup>

Under the current Accord, NSCC's guaranty attaches (and OCC's ceases) when NSCC has received all Required Fund Deposits taking into account the E&A Activity.<sup>35</sup> Currently, NSCC's guaranty would not attach if a Common Member defaults on its obligations to NSCC.

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<sup>33</sup> For example, OCC proposes changes to its rules to allow OCC to borrow funds from the Clearing Fund to pay the GSP, which is consistent with OCC's use of the Clearing Fund to address other liquidity needs such as to cover losses resulting from a member's failure to satisfy an obligation on a confirmed trade accepted by OCC. *See* OCC Rule 1006(a)(i).

<sup>34</sup> The Commission described the current timing and process under which OCC's guaranty ceases and NSCC's guaranty attaches in a prior order. *See* Securities Exchange Act Release No. 81266 (July 31, 2017), 82 FR 36484, 36486-87 (Aug. 4, 2017) (File No. SR-OCC-2017-013).

<sup>35</sup> *See id.* at 36487.

Under Phase 1 of the proposed changes, however, OCC would have the opportunity to pay the GSP to NSCC as an effective substitution for the defaulted member's obligations with respect to the E&A Activity. Phase 1, therefore, allows for a change in who pays NSCC, but does not alter the timing of payment.

Phase 2 will alter the timing of payment, primarily to accommodate the transition from a T+2 settlement cycle to a T+1 settlement cycle.<sup>36</sup> Under the current process, which takes place in a T+2 settlement cycle, there is sufficient time after expiration for NSCC and OCC to determine whether a member has defaulted before NSCC begins to process settlement of the E&A Activity. However, in a T+1 settlement cycle, settlement processing could begin before NSCC or OCC become aware of a member default. Thus, in a T+1 environment, the timing and process by which OCC's guaranty would cease (and NSCC's would attach) would need to shift.

Specifically, under Phase 2, OCC would commit to payment of the GSP (regardless of whether a member has defaulted) prior to NSCC's acceptance of E&A Activity. If OCC is unable to commit to pay the GSP, NSCC would be permitted, but not required, to reject the E&A Activity. The process would vary slightly between expirations occurring on a Friday and expirations occurring Monday through Thursday. For a Friday expiration, NSCC would communicate the GSP to OCC and OCC would subsequently commit to pay the GSP on Saturday morning. For Monday through Thursday expirations, OCC's transmission of the E&A Activity itself to NSCC would constitute a commitment by OCC to pay the GSP related to that E&A Activity.<sup>37</sup> For all expirations, OCC would send the E&A Activity to NSCC by 1 a.m. the

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<sup>36</sup> See Securities Exchange Act Release No. 96930 (Feb. 15, 2023), 88 FR 13872 (Mar. 6, 2023) (File No. S7-05-22).

<sup>37</sup> The requirement to commit prior to calculation of the final GSP for E&A Activity arising Monday through Thursday highlights the importance of the improved information sharing described above.

morning after expiration (e.g., 1 a.m. Saturday for a Friday expiration). This would help ensure that, in a T+1 settlement environment, NSCC has OCC's commitment to pay the GSP before NSCC must begin processing any E&A Activity from OCC.

### **III. DISCUSSION AND NOTICE OF NO OBJECTION**

Although the Clearing Supervision Act does not specify a standard of review for an advance notice, the stated purpose of the Clearing Supervision Act is instructive: 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 ("SIFMUs") and strengthening the liquidity of SIFMUs.<sup>38</sup>

Section 805(a)(2) of the Clearing Supervision Act authorizes the Commission to prescribe regulations containing risk management standards for the payment, clearing, and settlement activities of designated clearing entities engaged in designated activities for which the Commission is the supervisory agency.<sup>39</sup> Section 805(b) of the Clearing Supervision Act provides the following objectives and principles for the Commission's risk management standards prescribed under Section 805(a):<sup>40</sup>

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

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<sup>38</sup> See 12 U.S.C. 5461(b).

<sup>39</sup> 12 U.S.C. 5464(a)(2).

<sup>40</sup> 12 U.S.C. 5464(b).

Section 805(c) provides, in addition, that the Commission’s risk management standards may address such areas as risk management and default policies and procedures, among other areas.<sup>41</sup>

The Commission has adopted risk management standards under Section 805(a)(2) of the Clearing Supervision Act and Section 17A of the Exchange Act (the “Clearing Agency Rules”).<sup>42</sup> The Clearing Agency Rules require, among other things, each covered clearing agency to establish, implement, maintain, and enforce written policies and procedures that are reasonably designed to meet certain minimum requirements for its operations and risk management practices on an ongoing basis.<sup>43</sup> As such, it is appropriate for the Commission to review advance notices against the Clearing Agency Rules and the objectives and principles of these risk management standards as described in Section 805(b) of the Clearing Supervision Act. As discussed below, the Commission believes the changes proposed in the Advance Notice are consistent with the objectives and principles described in Section 805(b) of the Clearing Supervision Act,<sup>44</sup> and in the Clearing Agency Rules, in particular Rules 17Ad-22(e)(1), (e)(7), and (e)(20).<sup>45</sup>

A. *Consistency with Section 805(b) of the Clearing Supervision Act*

The proposal contained in OCC’s Advance Notice is consistent with the stated objectives and principles of Section 805(b) of the Clearing Supervision Act. In particular, the proposal is

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<sup>41</sup> 12 U.S.C. 5464(c).

<sup>42</sup> 17 CFR 240.17Ad-22. *See* Securities Exchange Act Release No. 68080 (Oct. 22, 2012), 77 FR 66220 (Nov. 2, 2012) (S7-08-11). *See also* Securities Exchange Act Release No. 78961 (Sept. 28, 2016), 81 FR 70786 (Oct. 13, 2016) (S7-03-14) (“Covered Clearing Agency Standards”). OCC is a “covered clearing agency” as defined in Rule 17Ad-22(a)(5). *See* 17 CFR 240.17Ad-22(a)(5).

<sup>43</sup> 17 CFR 240.17Ad-22.

<sup>44</sup> 12 U.S.C. 5464(b).

<sup>45</sup> 17 CFR 240.17Ad-22(e)(1); 17 CFR 240.17Ad-22(e)(7); and 17 CFR 240.17Ad-22(e)(20).

consistent with promoting robust risk management, promoting safety and soundness, reducing systemic risks, and supporting the stability of the broader financial system.<sup>46</sup>

The Advance Notice is consistent with promoting robust risk management, specifically liquidity risk management, as well as safety and soundness primarily because the introduction of the GSP would allow OCC to require NSCC to accept E&A Activity in the event of a Common Member default, so long as OCC pays the GSP to NSCC. Processing E&A Activity through NSCC's netting system would significantly reduce the risk posed by such E&A Activity by reducing the volume and value of settlement obligations.<sup>47</sup> It would also reduce OCC's potential liquidity demands as a result of the E&A Activity from an amount that could exceed its available liquid resources to an amount that would fall well within its current liquid resources. Reducing OCC's liquidity risk in this manner is consistent with both sound risk management practices and safety and soundness more broadly. The information sharing contemplated under the proposed changes is also consistent with promoting robust risk management because it will allow OCC to better understand and monitor its exposures and provide for more dialogue between NSCC and OCC, which could, in turn, allow them to better manage the risks posed by the E&A Activity.

To the extent the proposed changes are consistent with promoting OCC's safety and soundness, they are also consistent with reducing systemic risks and supporting the stability of the broader financial system. OCC has been designated as a SIFMU, in part, because its failure or disruption could increase the risk of significant liquidity or credit problems spreading among

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<sup>46</sup> 12 U.S.C. 5464(b).

<sup>47</sup> As noted above, it is estimated that, in 2022, netting through NSCC's CNS accounting system reduced the value of CNS settlement obligations by approximately 98% or \$510 trillion from \$519 trillion to \$9 trillion. *See* Notice of Filing, 88 FR at 59977.



financial institutions or markets.<sup>48</sup> The proposed changes would support OCC’s ability to continue providing services to the options markets by addressing losses and shortfalls arising out of the default of a Common Member. OCC’s continued operations would, in turn, help support the stability of the financial system by reducing the risk of significant liquidity or credit problems spreading among market participants that rely on OCC’s central role in the options market. Further, Phase 2 is consistent with supporting the stability of the broader financial system because the proposed changes in Phase 2 are designed to support the shortening of the standard settlement cycle for most broker-dealer transactions from T+2 to T+1.

Accordingly, and for the reasons stated above, the changes proposed in the Advance Notice are consistent with Section 805(b) of the Clearing Supervision Act.<sup>49</sup>

B. *Consistency with Rule 17Ad-22(e)(1) under the Exchange Act*

Rule 17Ad-22(e)(1) under the Exchange Act requires, in part, that a covered clearing agency establish, implement, maintain, and enforce written policies and procedures reasonably designed to provide for a well-founded, clear, transparent, and enforceable legal basis for each aspect of its activities in all relevant jurisdictions.<sup>50</sup> In adopting Rule 17Ad-22(e)(1), the Commission provided guidance that a covered clearing agency generally should consider in establishing and maintaining policies and procedures that address legal risk.<sup>51</sup> The Commission stated that a covered clearing agency should consider, *inter alia*, whether its contracts are consistent with relevant laws and regulations.<sup>52</sup>

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<sup>48</sup> See Financial Stability Oversight Council (“FSOC”) 2012 Annual Report, Appendix A, <https://home.treasury.gov/system/files/261/here.pdf> (last visited Feb. 17, 2022).

<sup>49</sup> 12 U.S.C. 5464(b).

<sup>50</sup> 17 CFR 240.17Ad-22(e)(1).

<sup>51</sup> See Covered Clearing Agency Standards, 81 FR at 70802.

<sup>52</sup> See *id.*

On February 15, 2023, the Commission adopted a final rule to shorten the standard settlement cycle for most broker-dealer transactions from two business days after the trade date to one business day after the trade date.<sup>53</sup> Currently, and under Phase 1, the terms of the Accord are designed for consistency with a T+2 settlement cycle. As described above, the terms of the Accord under Phase 2, which OCC intends to implement on the T+1 compliance date established by the Commission,<sup>54</sup> would be designed for consistency with a T+1 settlement cycle.

Accordingly, the proposal to amend the Accord to conform to a T+1 settlement cycle is consistent with Rule 17Ad-22(e)(1) under the Exchange Act.<sup>55</sup>

C. *Consistency with Rule 17Ad-22(e)(7) under the Exchange Act*

Rule 17Ad-22(e)(7) under the Exchange Act requires that a covered clearing agency establish, implement, maintain, and enforce written policies and procedures reasonably designed to effectively measure, monitor, and manage the liquidity risk that arises in or is borne by the covered clearing agency, including measuring, monitoring, and managing its settlement and funding flows on an ongoing and timely basis, and its use of intraday liquidity.<sup>56</sup> In adopting Rule 17Ad-22(e)(7), the Commission provided guidance that a covered clearing agency generally should consider in establishing and maintaining policies and procedures that address liquidity risk.<sup>57</sup> The Commission stated that a covered clearing agency should consider, *inter alia*, whether it maintains sufficient liquid resources in all relevant currencies to settle securities-

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<sup>53</sup> See Securities Exchange Act Release No. 96930 (Feb. 15, 2023), 88 FR 13872 (Mar. 6, 2023) (File No. S7-05-22).

<sup>54</sup> See Notice of Amendment, 89 FR at 5968.

<sup>55</sup> 17 CFR 240.17Ad-22(e)(1).

<sup>56</sup> 17 CFR 240.17Ad-22(e)(7).

<sup>57</sup> See Covered Clearing Agency Standards, 81 FR at 70823.

related payments and meet other payment obligations on time with a high degree of confidence under a wide range of stress scenarios.<sup>58</sup>

OCC's LRMF sets forth a comprehensive overview of OCC's liquidity risk management practices and governs OCC's policies and procedures as they relate to liquidity risk management. As described above, the potential cash necessary to manage a member default without utilizing NSCC's settlement process could exceed OCC's available liquid resources. The proposed changes to the Accord would allow OCC to send E&A Activity to NSCC even in the event of a Common Member default, which, based on an analysis of historical data, would reduce OCC's potential liquidity to an amount that is within the scope of its current resources.

To take advantage of the proposed changes to the Accord, OCC must be prepared to make a cash payment to NSCC (i.e., the GSP). OCC proposes to recognize that potential payment obligation as an input to OCC's liquidity risk processes. In particular, OCC proposes to consider the full amount of a Common Member's past obligations to NSCC rather than consider only the portion of such obligation attributable to E&A Activity. OCC's reliance on historical data would allow it to approximate, but not predict potential future exposures. Reliance solely on past GSP requirements would not position OCC to cover a future peak GSP. The incorporation of the full amount of a Common Member's past obligations, however, would provide a buffer to increase the likelihood that OCC would be in a position to pay a future GSP that exceeds historical GSP requirements. OCC also proposes to align its measurement of the potential obligation to pay NSCC with the cyclical nature of the products that OCC clears,<sup>59</sup> and

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<sup>58</sup> *See id.*

<sup>59</sup> Alignment with the cyclical nature of the products would be achieved, as described above, through the use of expiration categories when incorporating collateral requirements into OCC's stress testing. To balance this process, however, OCC would also impose floors across expiration categories that would help control for the possibility for an unusually large liquidity demand that is not related to the different expiration cycles.

to increase its information sharing with NSCC, which would allow OCC to better monitor the potential liquidity need posed by the GSP.

Accordingly, the proposed changes to the Accord regarding the GSP and to OCC's internal liquidity risk management rules are consistent with Rule 17Ad-22(e)(7) under the Exchange Act.<sup>60</sup>

D. *Consistency with Rule 17Ad-22(e)(20) under the Exchange Act*

Rule 17Ad-22(e)(20) under the Exchange Act requires that a covered clearing agency establish, implement, maintain, and enforce written policies and procedures reasonably designed to identify, monitor, and manage risks related to any link the covered clearing agency establishes with one or more other clearing agencies, financial market utilities, or trading markets.<sup>61</sup> For the purposes of Rule 17Ad-22(e)(20), "link" means, among other things, a set of contractual and operational arrangements between two or more clearing agencies, financial market utilities, or trading markets that connect them directly or indirectly for the purpose of participating in settlement.<sup>62</sup>

In adopting Rule 17Ad-22(e)(20), the Commission provided guidance that a covered clearing agency generally should consider in establishing and maintaining policies and procedures that address links.<sup>63</sup> Notably, the Commission stated that a covered clearing agency should consider whether a link has a well-founded legal basis, in all relevant jurisdictions, that

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<sup>60</sup> 17 CFR 240.17Ad-22(e)(7).

<sup>61</sup> 17 CFR 240.17Ad-22(e)(20).

<sup>62</sup> 17 CFR 240.17Ad-22(a)(8).

<sup>63</sup> *See* Covered Clearing Agency Standards, 81 FR at 70841.

supports its design and provides adequate protection to the covered clearing agencies involved in the link.<sup>64</sup>

As described above, the Accord is a contractual arrangement between NSCC and OCC that governs the processing of E&A Activity, which consists of settlement obligations arising out of certain products cleared by OCC. The Accord, therefore, is a link for the purposes of Rule 17Ad-22(e)(20). The specific legal basis for the Accord to conform to a T+1 settlement cycle was discussed above in section III.B. Likewise, Section III.C. discussed the ways the Accord provides adequate protection to both OCC and NSCC by introducing the GSP, enhancing information sharing between OCC and NSCC, and ensuring that OCC and NSCC have the tools and information they need to monitor the potential liquidity need posed by the GSP.

For the reasons discussed in those sections, the Accord between OCC and NSCC has a well-founded legal basis that supports its design and provides adequate protection to the covered clearing agencies involved in the Accord. Accordingly, the proposed changes to the Accord are consistent with Rule 17Ad-22(e)(20) under the Exchange Act.<sup>65</sup>

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<sup>64</sup> *Id.*

<sup>65</sup> 17 CFR 240.17Ad-22(e)(20).

#### **IV. CONCLUSION**

IT IS THEREFORE NOTICED, pursuant to Section 806(e)(1)(I) of the Clearing Supervision Act, that the Commission DOES NOT OBJECT to Advance Notice (SR-OCC-2023-801) as modified by Partial Amendment No. 1 and Amendment No. 2, and that OCC is AUTHORIZED to implement the proposed changes as of the date of this notice or the date of an order by the Commission approving proposed rule change SR-OCC-2023-007, whichever is later.

By the Commission.

**Sherry R. Haywood,**

*Assistant Secretary.*