OCC THE FOUNDATION FOR SECURE MARKETS

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July 9, 2018

VIA EMAIL

Brent J. Fields, Secretary
U.S. Securities and Exchange Commission
100 F. Street, N.E.
Washington, DC 20549-1090

Re: File No. SR-OCC-2017-20; Notice of Filing of a Proposed Rule Change Concerning Enhanced and New Tools for Recovery Scenarios

Dear Mr. Fields:

The Options Clearing Corporation ("OCC") respectfully submits this response letter in connection with the proposed revisions to OCC's Rules and By-Laws to enhance OCC's existing tools to address the risks of liquidity shortfalls and credit losses and to establish new tools by which OCC could re-establish a matched book following a default (the "Proposed Rule Change"). The tools included in the Proposed Rule Change are contemplated to be deployed by OCC only in an extreme stress event that has placed OCC into a recovery or orderly wind-down scenario.

The Securities and Exchange Commission ("SEC" or "Commission") issued a notice of the filing of the Proposed Rule Change on December 19, 2017, and requested comments.[1] The SEC received one comment letter, which was from the Futures Industry Association ("FIA").[2] On January 25, 2018, the SEC issued a notice of designation of a longer period for SEC action on the Proposed Rule Change.[3] On March 22, 2018, the SEC issued an order instituting proceedings to determine whether to approve the Proposed Rule Change and requested written comments.[4] No further comments were submitted. OCC is providing this letter in response to FIA's comments, which focused on: (1) the

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1 *See* Notice of Filing of a Proposed Rule Change Concerning Enhanced and New Tools for Recovery Scenarios, Release No. 34-82351 (SR-OCC-2017-20) (Dec. 19, 2017) (the "Notice of Filing").

2 Letter from Jacqueline H. Mesa, Senior Vice President of Global Policy, FIA, dated January 16, 2018, to Brent J. Fields, Secretary, Commission ("FIA Letter").

3 *See* Notice of Designation of Longer Period for Commission Action on Proposed Rule Change Concerning Enhanced and New Tools for Recovery Scenarios, Release No. 34-82585 (SR-OCC-2017-20) (Jan. 25, 2018).

4 *See* Order Instituting Proceedings to Determine Whether to Approve or Disapprove the Proposed Rule Concerning Enhanced and New Tools for Recovery Scenarios, Release No. 34-82926 (SR-OCC-2017-20) (March 22, 2018).

200% cap on assessments associated with replenishment of the Clearing Fund and (2) partial tear-ups, each of which OCC addresses below.

I. Proposed 200% Cap on Clearing Fund Assessments

The Proposed Rule Change would revise the existing assessment powers in Section 6 of Article VIII of OCC's By-Laws to establish, among other things, a rolling cooling-off period that would be triggered by the payment of a proportionate charge against the Clearing Fund, during which period the aggregate liability of a clearing member to replenish the Clearing Fund (inclusive of assessments) would be 200% of the clearing member's required contribution as of the time immediately preceding the triggering proportionate charge.

FIA commented that OCC "should provide an explanation as to how the cap level of 200% [regarding assessments in a cooling-off period] was determined and why [OCC] considers 200% appropriate, rather than a lower cap level."[5]

OCC appreciates the comment received from FIA requesting further explanation of the proposed 200% cap on assessments and offers the following explanation in response:

In evaluating potential assessment caps, OCC conducted analyses relating to OCC's ability to have sufficient financial resources *inclusive of OCC's proposed assessment powers* to withstand extreme market conditions on a "Cover-2" basis under various scenarios, such as the stock market crash of 1987.[6] At the time of these analyses, OCC determined that, under such scenarios, it would be in a position to meet its clearing obligations so long as OCC was able to use (1) the financial resources on hand in the Clearing Fund and (2) the full funding of two assessments (*i.e.*, 200%) from non-defaulting clearing members. Thus, OCC determined that a 200% cap would help provide OCC with sufficient financial resources to withstand stressed losses under an unprecedented loss scenario and enhance OCC's ability to re-establish a matched book.[7]

In order to measure OCC's proposed 200% assessment cap relative to other central counterparty clearing organizations ("CCPs"), OCC also reviewed assessment caps set by other CCPs. OCC noted a range of assessment caps from 100% of a clearing member's guaranty fund contribution per

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5 FIA Letter at 2.

6 For the avoidance of doubt, the referenced analyses concerning the sufficiency of OCC's financial resources on a "Cover-2" basis under various scenarios (such as the stock market crash of 1987) were *inclusive* of OCC's pre-funded financial resources (*i.e.*, Clearing Fund) and OCC's proposed assessment powers (*i.e.*, two times assessments).

7 Since the time these analyses were conducted, OCC has proposed to further modify its Financial Safeguards Framework ("FSF") with respect to the sizing of its Clearing Fund in ways that would further enhance OCC's ability to have sufficient financial resources (inclusive of OCC's proposed assessment powers) to withstand extreme market conditions on a "Cover 2" basis. Specifically, OCC has proposed that (1) the "Sizing Scenarios" for sizing its Clearing Fund be based on the generated statistical down and up shocks for the Standard & Poor's S&P 500 Index (*i.e.*, "SPX") from a 1-in-80 year market event (as opposed to a 1-in-70 year market event, which was originally proposed), and (2) the "Sufficiency Scenarios" for determining whether it is necessary to call for additional Clearing Fund resources (either from margin called from individual clearing member groups or an inter-month re-sizing of the Clearing Fund) include the historical market crash of October 1987 to be covered on a "Cover-1" basis. *See* Securities Exchange Act Release No. 34-83406 (SR-OCC-2018-008) (June 11, 2018).

default occurring within a single cooling-off period[8] to 550% of a clearing member's guaranty fund contribution in the event of multiple clearing member defaults occurring within a single cooling-off period.[9] Against the range of assessment caps observed, OCC believes that its proposed 200% assessment cap is generally in line with other CCPs' assessment caps, including ICE Clear Europe Limited, which currently operates with a per default assessment limit of twice (*i.e.*, 200%) the required guaranty fund contribution for the futures and options and foreign exchange product categories for its clearing members, and other similarly-situated organizations.[10]

II. Partial Tear-Ups

The Proposed Rule Change would also provide OCC, in extraordinary circumstances, with the authority under new Rule 1111 to call for voluntary tear-ups and, if necessary, to require partial tear-ups, of any remaining open positions held by defaulting clearing members, non-defaulting clearing members and/or their customers. In the event that OCC ever needed to conduct voluntary or partial tear-ups, the Proposed Rule Change would provide OCC with discretion to use remaining Clearing Fund resources to compensate non-defaulting clearing members and their customers for any reasonably determinable losses, costs, and fees imposed by a voluntary tear-up or partial tear-up. The Proposed Rule Change also would provide OCC's Board with discretion to re-allocate any reasonably determinable losses, costs, and fees imposed by a partial tear-up through a special charge levied against remaining non-defaulting clearing members.

OCC appreciates FIA's support for multiple aspects of the Proposed Rule Change, including for OCC's proposed use of partial tear-ups as a position rebalancing tool, for OCC's proposed initiation of partial tear-ups at a time when it expects to have sufficient remaining financial resources to obviate the need for haircutting gains, and for OCC's proposed use of remaining Clearing Fund resources to cover the partial tear-up losses.

FIA also offered three comments on OCC's partial tear-up proposal. First, FIA suggested that "it is [not] reasonable nor analytically sound for tear-ups to result in incremental costs of undefined amounts being distributed through assessments, as it effectively enables the Board of OCC to engage in unlimited assessments."[11] Second, FIA argued that where a cleared trade is selected by OCC's

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8 *See* ICE Clear Credit Rule 803(b) (providing that "no Participant shall be liable for Assessment Contributions as a result of charges or applications against the General Guaranty Fund in respect of a single Default of a Participant in an amount exceeding the amount of its Required Contribution and any Specific WWR Guaranty Fund Contribution immediately preceding such Default.").

9 *See* Chicago Mercantile Exchange Rule 802. B.1.v. (providing that each solvent, non-defaulting clearing member is subject to an assessment up to a 550% threshold of such clearing member's "Base Guaranty Fund requirements attributable to all Base Guaranty Fund Product Classes at the time of the default with respect to Losses attributed to all defaulted clearing members during a Base Cooling Off Period.").

10 *See* Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Adopt Clearinghouse Recovery and Wind-Down Rules for its Futures and Options and Foreign Exchange Product Categories, Release No. 34-71450 (File No. SR-ICEEU-2014-03) (Jan. 31, 2014); *see also* Chicago Mercantile Exchange Rule 802.B.1.v. (providing that each solvent, non-defaulting clearing member is subject to an assessment up to a 275% threshold of such clearing member's "Base Guaranty Fund requirements attributable to all Base Guaranty Fund Product Classes at the time of the default with respect to Losses attributed to a single defaulted clearing member.").

11 FIA Letter at 2.

Board for partial tear-up, "the price of the trade should be determined objectively (either by marking to market or an objective best-estimate of market price), not on a discretionary basis."[12] Finally, FIA stated that OCC should ensure that the design and application of partial tear-ups "do not dis-incentivize bidding in default management auctions."[13] OCC will address each of the three comments in turn.

First, OCC disagrees with the premise that the Proposed Rule Change allows OCC's Board to effectively engage in "unlimited" assessments. OCC's staff, the Board and the Board's Risk Committee worked diligently to craft a recovery tools proposal that could satisfy applicable regulatory requirements and result in equitable treatment of clearing members and their customers even in the face of an extraordinary remedy like partial tear-up. A partial tear-up process that does not attempt to re-allocate the losses, costs, and fees imposed by partial tear-up (such losses, costs, and fees hereinafter collectively, "partial tear-up losses")would result in a circumstantial and uneven distribution of losses, which is contrary to the mutualized risk philosophy that otherwise drives central clearing.[14]

Therefore, to better align its partial tear-up process with the philosophy of mutualized risk, the Proposed Rule Change introduces two unique features. First, the Proposed Rule Change would provide OCC with discretion to use remaining Clearing Fund resources to compensate non-defaulting clearing members and their customers for any reasonably determinable losses, costs, and fees imposed by a voluntary tear-up or partial tear-up. Second, the Proposed Rule Change also would provide OCC's Board with discretion to re-allocate any reasonably determinable partial tear-up losses through a special charge levied against remaining non-defaulting clearing members.[15]

As noted in FIA's comment, the amounts of any discretionary special charge levied by OCC's Board for the purpose of re-allocating the partial tear-up losses would not be subject to the proposed assessment cap in the amount of 200% of a clearing member's then-required contribution to the Clearing Fund. However, OCC does not believe that the exclusion of these potential charges from the proposed assessment cap would result in a recovery tool set that exposes clearing members to unlimited assessments. To begin, the proposed authority could only be used if OCC first determined that the partial tear-up losses to be re-allocated are "reasonably determinable." In order for partial tear-up losses to be reasonably determinable, the total amount of any such losses necessarily must be known, finite and by definition limited. Furthermore, the proposed authority would be discretionary, meaning that even if OCC were forced to conduct a partial tear-up and it determined that partial tear-

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12 *Id.*

13 *Id.*

14 Without a means of re-allocating partial tear-up losses, a partial tear-up process would leave such losses resting only with those clearing members and customers who happen to hold positions opposite the un-auctioned positions remaining in the portfolio(s) of the defaulted clearing member(s). Under such a model, partial tear-up losses would necessarily be unevenly distributed across clearing members and customers, based solely on what positions those clearing members and customers happen to hold at the time of the partial tear-up.

15 Proposed Rule 1111(f) makes clear that the proportionate share of any such special charge would be set in an amount corresponding to each such non-defaulting clearing member's proportionate share of the variable amount of the Clearing Fund at the time such partial tear-up is conducted.

up losses were reasonably determinable, OCC's Board ultimately may decide that no special charge be levied.

Second, OCC appreciates FIA's concern about objective determination of partial tear-up price. As is explained in our Proposed Rule Change, OCC anticipates that it is likely to use as its partial tear-up price the last established end-of-day settlement price, in accordance with OCC's existing practices concerning pricing and valuation. However, given that it is not possible to know in advance the precise circumstances that would cause OCC to conduct a tear-up, Rule 1111(f) has been drafted to allow OCC to exercise reasonable discretion, if necessary, in establishing the partial tear-up price by some means other than its existing practices concerning pricing and valuation.[16] Rule 1111(f) would require that OCC, in exercising any such discretion, would act in good faith and in a commercially reasonable manner to adopt methods of valuation expected to produce reasonably accurate substitutes for the values that would have been obtained from the relevant market if it were operating normally, including but not limited to the use of pricing models that use the market price of the underlying interest or the market prices of its components.

Third, OCC agrees with FIA's comment that the design of partial tear-ups should not dis-incentivize participation in auctions of defaulted clearing members' portfolios. OCC believes that its proposed recovery tool set would not dis-incentivize active participation in auctions. Nonetheless, OCC will continue to monitor the bidding participation in auctions in default management exercises.

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OCC believes this responds to each of the issues FIA raises in its letter. Accordingly, OCC respectfully requests that the SEC approve the Proposed Rule Change.

Sincerely,

Joseph P. Kamnik
Senior Vice President and
Chief Regulatory Officer

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16 For example, OCC has observed certain rare circumstances in which a closing price for an underlying security of an option may be stale or unavailable. A stale or unavailable closing price could be the result of a halt on trading in the underlying security, a corporate action resulting in a cash-out or conversion of the underlying security (but that has not yet been finalized), or the result of an ADR whose underlying security is being impacted by certain provisions under foreign laws. OCC would consider the presence of these factors on its end-of-day prices in determining whether use of the discretion that would be afforded under proposed Rule 1111(f) might be warranted.