

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-70719; File No. SR-OCC-2013-16)

October 18, 2013

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change Amending OCC's By-Laws and Rules to Reflect Enhancements in OCC's System for Theoretical Analysis and Numerical Simulations as Applied to Longer-Tenor Options

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² notice is hereby given that on October 10, 2013, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by OCC.³ The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons and to approve the proposed rule change on an accelerated basis.

I. Clearing Agency's Statement of the Terms of Substance of the Proposed Rule Change

The proposed rule change would provide for enhancements in OCC's margin model for longer-tenor options (*i.e.*, those options with at least three years of residual tenor) and to reflect those enhancements in the description of OCC's margin model in OCC's Rules.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ OCC also filed the proposed change as an advance notice under Section 806(e)(1) of Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act titled the Payment, Clearing, and Settlement Supervision Act of 2010 ("Payment, Clearing and Settlement Supervision Act"). 12 U.S.C. 5465(e)(1). The Commission issued a notice of no objection to the advance notice on October 17, 2013. See Securities Exchange Act Release No. 70709 (October 17, 2013) (SR-OCC-2013-803).

II. Clearing Agency's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, OCC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. OCC has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

(A) Clearing Agency's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

The purpose of this proposed rule change is to provide for enhancements in OCC's margin model for longer-tenor options (*i.e.*, those options with at least three years of residual tenor) and to reflect those enhancements in the description of OCC's margin model in OCC's Rules. OCC also proposes to make changes to the description of OCC's margin model to clarify that description.

On August 30, 2012, OCC submitted a rule change with respect to OCC's proposal to clear certain over-the-counter options on the S&P 500 Index ("OTC Options").⁴ The OTC Options Rule Filing, as amended, added a statement appearing before Section 6 of Article XVII of OCC's By-Laws that "THE BY-LAWS IN THIS SECTION (OTC INDEX OPTIONS) ARE INOPERATIVE UNTIL FURTHER NOTICE BY THE CORPORATION" to clarify that OCC would not commence clearing OTC Options until the changes being made to OCC's margin model for longer-tenor

⁴ The proposal to clear OTC Options was approved on December 14, 2012. *See* Securities Exchange Act Release No. 68434 (December 14, 2012), 77 FR 75243 (December 19, 2012) (SR-OCC-2012-14).

options, as provided in this rule change, were put in place, notwithstanding whether the OTC Options Rule Filing had already been approved. OCC is now proposing to remove this statement from Section 6, which will allow OCC to commence clearing of OTC Options on the S&P 500 Index.

Additional information concerning OCC's proposal to clear OTC Options is included in the OTC Options Rule Filing. As described in the OTC Options Rule Filing, OCC intends to use its STANS margin system to calculate margin requirements for OTC Options on the same basis as for exchange-listed options cleared by OCC. However, OCC is proposing to implement enhancements to its risk models for all longer-tenor options (including OTC Options) in order to better reflect certain risks of longer-tenor options. The changes described herein would apply to all longer-tenor options cleared by OCC and would be implemented before OCC begins clearing OTC Options.

Margin Enhancements for Longer-Tenor Options

The proposed rule change includes daily OTC quotes, variations in implied volatility and valuation adjustments in the modeling of all longer-tenor options under STANS, thereby enhancing OCC's ability to set margin requirements through the use of risk-based models and parameters⁵ and encouraging clearing members to have sufficient financial resources to meet their obligations to OCC.⁶ The proposed rule change would not affect OCC's safeguarding of securities and funds in its custody or control because though it may change margin requirements in respect of certain longer-tenor options, it does not change the manner in which margin assets are pledged. In addition, the

⁵ 17 CFR 240.17Ad-22(b)(2).

⁶ 17 CFR 240.17Ad-22(d)(2).

proposed rule change allows OCC to enhance its risk management procedures and controls related to longer-tenor options in accordance with the Commission's clearing agency standards.

OCC calculates clearing-level margin using STANS, which determines the minimum expected liquidating value of each account using a large number of projected price scenarios created by large-scale Monte Carlo simulations. OCC is proposing to implement enhancements to the STANS margin calculation methodology with respect to longer-tenor options and to amend Rule 601 to reflect these enhancements as well as to make certain clarifying changes in the description of STANS in Rule 601. The specific details of the calculations performed by STANS are maintained in OCC's proprietary procedures for the calculation of margin and coded into the computer systems used by OCC to calculate daily margin requirements.

OCC has proposed at this time to clear only OTC Options on the S&P 500 index and only such options with tenors of up to five years. However, OCC currently clears FLEX Options with tenors of up to fifteen years. While OCC believes that its current risk management practices are adequate for current clearing activity, OCC proposes to implement risk modeling enhancements with respect to all longer-tenor options.

Daily OTC Indicative Quotes

In general, the market for listed longer-tenor options is less liquid than the market for other options, with less volume and therefore less price information. In order to supplement OCC's pricing data derived from the listed markets, and improve the price discovery process for longer-tenor options, OCC proposes to include in the daily dataset of market prices used by STANS to value each portfolio indicative daily quotations

obtained through a third-party service provider that obtains these quotations through a daily poll of OTC derivatives dealers. A third-party service provider was selected to provide this data in lieu of having the data provided directly by the OTC derivatives dealers in order to avoid unnecessarily duplicating reporting that is already done in the OTC markets.

Variations in Implied Volatility

To date, the STANS methodology has assumed that implied volatilities of option contracts do not change during the two-day risk horizon used by OCC in the STANS methodology. OCC's backtesting of its margin models has identified few instances in which this assumption would have, as a result of sudden changes in implied volatility, resulted in margin deposits insufficient to liquidate clearing member accounts without loss. However, as OCC expects to begin clearing more substantial volumes of longer-tenor options, including OTC Options, it believes that implied volatility shocks may become more relevant due to the greater sensitivity of longer-tenor options to implied volatility. OCC therefore proposes to introduce variations in implied volatility in the modeling of all longer-tenor options under STANS. This will be achieved by incorporating, into the set of risk factors whose behavior is included in the econometric models underlying STANS, time series of proportional changes in implied volatilities for a range of tenors and in-the-money and out-of-the-money amounts representative of the dataset provided by OCC's third-party service provider.

A review of individual S&P 500 Index put and call options positions with varying in-the-money amounts and with four to nine years of residual tenor indicates that the inclusion of modeled implied volatilities tends to result in less margin being held against

short call positions and more margin being held against short put positions. These results are consistent with what would be expected given the strong negative correlation that exists between changes in implied volatility and market returns.

The description of the Monte Carlo simulations performed within STANS in Rule 601 references revaluations of assets and liabilities in an account under numerous price scenarios for “underlying interests.” In order to accommodate the proposed implied volatility enhancements, OCC is proposing to amend this portion of Rule 601 to provide that the scenarios used may also involve projected levels of other variables influencing prices of cleared contracts and modeled collateral. Accordingly, the references to “underlying interests” are proposed to be deleted.

Valuation Adjustment

While historically OCC has not cleared a significant volume of longer-tenor options, OCC anticipates that there will be growth in volume of longer-tenor options, including OTC Options, being cleared with three to five year tenors. Longer-tenor options may represent a larger portion of any clearing member’s portfolio in the future, and OCC has therefore identified a need to model anticipated changes in the value of longer-tenor options on a portfolio basis in order to address OCC’s exposure to longer-tenor options that may have illiquid characteristics. OCC proposes to introduce a valuation adjustment into the portfolio net asset value used by STANS based upon the aggregate sensitivity of any longer-tenor options in a portfolio to the overall level of implied volatilities at three years and five years and to the relationship between implied volatility and exercise prices at both the three- and five-year tenors in order to allow for the anticipated market impact of unwinding a portfolio of longer-tenor options, as well as

for any differences in the quality of data in OCC's third party service provider's dataset, given that month-end data may be subjected to more extensive validation by the service provider than daily data. In order to accommodate the planned valuation adjustment for longer-tenor options, new language would be added to Rule 601 to indicate that the projected portfolio values under the Monte Carlo simulations may be adjusted to account for bid-ask spreads, illiquidity, or other factors.

Clarification of Pricing Model Reference in Rule 601

Rule 601 currently refers to the use of "options pricing models" to predict the impact of changes in values on positions in OCC-cleared contracts. OCC is proposing to amend this description to reflect that OCC currently uses non-options related models to price certain instruments, such as futures contracts and U.S. Treasury securities. This change is not intended to be substantive and simply clarifies the description in Rule 601.

Effect on Clearing Members

The proposed rule change will affect clearing members who engage in transactions in longer-tenor options, and indirectly their customers, by enhancing the STANS margin calculation methodology for these options. The STANS enhancements could increase margin requirements with respect to these positions. However, OCC does not believe that the enhancements will result in significantly increased margin requirements for any particular clearing member, and therefore is not aware of any significant problems that clearing members are likely to have in complying with the proposed rule change.

The proposed rule change is consistent with the purposes and requirements of Section 17A(b)(3)(F) of the Exchange Act [sic] (the “Act”)⁷ because amending OCC’s margin rules to accommodate longer-tenor options will promote the prompt and accurate clearance and settlement of securities transactions and facilitate the safeguarding of funds and securities within OCC’s custody and control. In addition, and in accordance with Rule 17Ad-22(b)(2), the proposed rule change will allow OCC to use risk-based models to set clearing member margin requirements that will limit OCC’s exposure to its clearing members under normal market conditions.⁸ The proposed rule change is not inconsistent with any rules of OCC, including any other rules proposed to be amended.

(B) Clearing Agency’s Statement on Burden on Competition

OCC does not believe that the proposed rule change would impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. With respect to a burden on competition among clearing agencies, OCC does not believe that the proposed rule change would have any impact because OCC is the only registered clearing agency that issues options and provides central counterparty services to the options markets.

OCC does not believe that enhancing OCC’s margin model for longer-tenor options would inhibit access to any of OCC’s services or disadvantage or favor any user of OCC’s services in relationship to any other such user because the model enhancements would apply equally to all clearing members clearing longer-tenor options. Moreover, OCC believes that the proposed rule change would also promote competition among

⁷ 15 U.S.C. 78q-1(b)(3)(F).

⁸ 17 CFR 240.17Ad-22(b)(2).

participants in the longer-tenor options markets. The rule change would enhance OCC's ability to manage risk within OCC's existing structure, and improve OCC's ability to reduce systemic risk to the longer-tenor options market in general as well as reduce inter-dealer counterparty risk in the OTC Options market, allowing for increased participation in this market.

For the foregoing reasons, OCC believes that the proposed rule change is in the public interest, would be consistent with the requirements of the Act applicable to clearing agencies, and would not impose a burden on competition that is unnecessary or inappropriate in furtherance of the purposes of the Act because the changes would enhance OCC's margin methodology for longer-tenor options in ways that help to promote the purposes of the Act and Rule 17Ad-22 thereunder as described above.⁹

(C) Clearing Agency's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were not and are not intended to be solicited with respect to the proposed rule change and none have been received.

III. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or

⁹ 17 CFR 240.17Ad-22.

- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-OCC-2013-16 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-OCC-2013-16. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549 on official business days between the hours of 10:00 am and 3:00 pm. Copies of the filing also will be available for inspection and copying at the principal office of OCC and on OCC's website (<http://www.theocc.com/about/publications/bylaws.jsp>). All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-OCC-2013-16 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

IV. Commission's Findings and Order Granting Accelerated Approval of Proposed Rule Change

Section 19(b)(2)(C) of the Act¹⁰ 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 applicable to such organization. After a careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act, particularly with the requirements of Section 17A of the Act,¹¹ and the rules and regulations thereunder.¹²

Section 17A(b)(3)(F) of the Act¹³ requires the rules of a clearing agency to be designed to, among other things, promote the prompt and accurate clearance and settlement of securities transactions and to 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 finds that OCC's proposed rule change is consistent with these requirements because it amends OCC's margin rules to accommodate longer-tenor options and also includes a non-substantive change to clarify a pricing model reference in OCC Rule 601.

¹⁰ 15 U.S.C. 78s(b)(2)(C).

¹¹ 15 U.S.C. 78q-1.

¹² 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).

¹³ 12 U.S.C. 78q-1(b)(3)(F).

Rule 17Ad-22(b)(2) of the Act,¹⁴ requires, in part, that a registered clearing agency that performs central counterparty services shall establish, implement, maintain and enforce written policies and procedures reasonably designed to use margin requirements to limit its credit exposures to participants under normal market conditions and use risk-based models and parameters to set margin requirements. The proposed change is consistent with this rule because it is designed to enhance STANS, which is a risk-based model OCC uses to set margin requirements to limit OCC's credit exposures to participants under normal market conditions.

Rule 17Ad-22(b)(3) of the Act¹⁵ requires, in part, that a registered clearing agency that performs central counterparty services shall establish, implement, maintain and enforce written policies and procedures reasonably designed to maintain sufficient financial resources to withstand, at a minimum, a default by the participant family to which it has the largest exposure in extreme but plausible market conditions. This proposed change is consistent with this rule because it is designed to enhance STANS, which OCC uses to set margin requirements for longer-tenor options and should therefore help OCC maintain sufficient financial resources to withstand a default by the participant family to which it has the largest exposure in extreme but plausible market conditions.

The Commission finds that, pursuant to Section 19(b)(2)(C)(iii) of the Act,¹⁶ there is good cause to approve the proposed rule change earlier than 30 days after the date of publication of the notice in the Federal Register. Approval of the proposal will allow

¹⁴ 17 CFR 240.17Ad-22(b)(2).

¹⁵ 17 CFR 240.17Ad-22(b)(3).

¹⁶ 15 U.S.C. 78s(b)(2)(C)(iii).

OCC to immediately implement enhancements in its margin model for longer tenor options cleared by OCC, which should in turn facilitate the reduction in risk in the clearance and settlement of these securities.

V. Conclusion

On the basis of the foregoing, the Commission finds the proposed rule change consistent with the requirements of the Act, particularly with the requirements of Section 17A of the Exchange Act,¹⁷ and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁸ that the proposed rule change (SR-OCC-2013-16) be, and it hereby is, approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁹

Kevin M. O'Neill
Deputy Secretary

¹⁷ 15 U.S.C. 78q-1.

¹⁸ 15 U.S.C. 78s(b)(2).

¹⁹ 17 CFR 200.30-3(a)(12).