

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-83916; File No. SR-OCC-2017-020)

August 23, 2018

Self-Regulatory Organizations; The Options Clearing Corporation; Order Approving Proposed Rule Change, as Modified by Amendment No. 2, Concerning Enhanced and New Tools for Recovery Scenarios

**I. INTRODUCTION**

On December 18, 2017, The Options Clearing Corporation (“OCC”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change SR-OCC-2017-020 (“Proposed Rule Change”) pursuant to Section 19(b) of the Securities Exchange Act of 1934 (“Exchange Act”),<sup>1</sup> and Rule 19b-4<sup>2</sup> thereunder concerning enhanced and new tools for recovery scenarios.<sup>3</sup> The Proposed Rule Change was published for comment in the Federal Register on December 26, 2017.<sup>4</sup> On January 25, 2018, the Commission designated a longer period of time

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Notice infra note 4, 82 FR 61107.

<sup>4</sup> Securities Exchange Act Release No. 82531 (Dec. 19, 2017), 82 FR 61107 (Dec. 26, 2017) (SR-OCC-2017-020) (“Notice”). On December 8, 2017, OCC also filed a related advance notice (SR-OCC-2017-809) (“Advance Notice”) with the Commission pursuant to Section 806(e)(1) of Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, entitled the Payment, Clearing, and Settlement Supervision Act of 2010 and Rule 19b-4(n)(1)(i) under the Exchange Act. 12 U.S.C. 5465(e)(1) and 17 CFR 240.19b-4(n)(1)(i), respectively. The Advance Notice was published in the Federal Register on January 23, 2018. Securities Exchange Act Release No. 82513 (Jan. 17, 2017), 83 FR 3244 (Jan. 23, 2018) (SR-OCC-2017-809).

The Financial Stability Oversight Council designated OCC a systemically important financial market utility on July 18, 2012. See Financial Stability Oversight Council 2012 Annual Report, Appendix A, available at <http://www.treasury.gov/initiatives/fsoc/Documents/2012%20Annual%20Report.pdf>. Therefore, OCC is required to comply with the Payment, Clearing and Settlement Supervision Act and file advance notices with the Commission. See 12 U.S.C. 5465(e).

for Commission action on the Proposed Rule Change.<sup>5</sup> On March 22, 2018, the Commission published an order to institute proceedings to determine whether to approve or disapprove the Proposed Rule Change.<sup>6</sup>

On July 11, 2018, OCC filed Amendment No. 1 to the Proposed Rule Change.<sup>7</sup> On July 12, 2018, OCC filed Amendment No. 2 to the Proposed Rule Change.<sup>8</sup> Therefore, the Proposed Rule Change, as modified by Amendment No. 2, reflects the changes proposed. Notice of Amendments No. 1 and 2 to the Proposed Rule Change was published for public comment in the Federal Register on August 2, 2018.<sup>9</sup> Comments received on the Proposed Rule Change are discussed below.<sup>10</sup> This order approves the Proposed Rule Change as modified by Amendment No. 2 (“Amended Proposed Rule Change”).

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<sup>5</sup> Securities Exchange Act Release No. 82585 (Jan. 25, 2018), 83 FR 4526 (Jan. 31, 2018) (File No. SR-OCC-2017-020).

<sup>6</sup> Securities Exchange Act Release No. 82926 (Mar. 22, 2018), 83 FR 13171 (Mar. 27, 2018) (File No. SR-OCC-2017-020).

<sup>7</sup> In Amendment No. 1, OCC made certain changes to clarify the use of the recovery tools and to improve the overall transparency regarding the use of the recovery tools.

<sup>8</sup> Amendment No. 2 superseded and replaced Amendment No. 1 in its entirety, due to technical defects in Amendment No. 1.

<sup>9</sup> Securities Exchange Act Release No. 83725 (Jul. 27, 2018), 83 FR 37839 (Aug. 2, 2018) (“Notice of Amendment”).

<sup>10</sup> The letters are available at: <https://www.sec.gov/comments/sr-occ-2017-022/occ2017020.htm>.

## II. DESCRIPTION OF THE AMENDED PROPOSED RULE CHANGE<sup>11</sup>

The Amended Proposed Rule Change concerns proposed changes 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 and, if necessary, allocate uncovered losses following the default of a Clearing Member as well as provide for additional financial resources. Each of the proposed tools is contemplated to be deployed by OCC in an extreme stress event that has placed OCC into a recovery or orderly wind-down scenario. The proposed changes include modifying OCC's powers of assessment, introducing a framework for requesting voluntary payments to the Clearing Fund, and establishing OCC's authority to extinguish open positions (i.e., conduct tear-ups) as well as authorizing OCC's Board of Directors ("Board") to re-allocate losses from tear-ups.

### A. Proposed Changes to OCC Powers of Assessment

OCC maintains a Clearing Fund comprised of required contributions from Clearing Members, and OCC has authority to use the Clearing Fund, by a proportionate charge or otherwise, to cover certain losses suffered by OCC.<sup>12</sup> When an amount is paid out of a Clearing Member's required contribution to the Clearing Fund, the Clearing Member is generally required to promptly make good any deficiency in its required contribution to the Clearing Fund from

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<sup>11</sup> 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>12</sup> See OCC By-Laws, Article VIII. For example, under Section 5 of Article VIII of the OCC By-Laws, when a Clearing Member defaults, OCC will pay for the resulting losses or expenses by first applying other funds available to OCC in the accounts of the defaulting Clearing Member and then applying the defaulting Clearing Member's required contribution to the Clearing Fund. If the losses and expenses exceed those amounts, then OCC will charge the amount of the remaining deficiency on a proportionate basis against all non-defaulting Clearing Members' required contributions to the Clearing Fund.

such payment.<sup>13</sup> Generally, this requirement to promptly make good on any deficiency arising from the default of a Clearing Member has been referred to as an “assessment” by OCC against a Clearing Member; however, as further described below, OCC is making clarifying changes to a Clearing Member’s obligation to contribute to the Clearing Fund, including defining and delineating between a Clearing Member’s obligation to answer “assessments” charged by OCC under certain circumstances described further below and a Clearing Member’s obligations where OCC seeks to effect a “replenishment” of the Clearing Fund.

Currently, a Clearing Member’s obligation to make good its required contribution to the Clearing Fund is not subject to any pre-determined limit. However, a Clearing Member may limit the amount of its liability to contribute to the Clearing Fund by winding-down its clearing activities and terminating its membership. To do so, a Clearing Member must provide written notice to OCC that it is terminating its membership by no later than the fifth business day after application of the proportionate charge.<sup>14</sup> This termination would limit the Clearing Member’s obligation to meet a future assessment to an additional 100 percent of the amount of its then-required Clearing Fund contribution. Thus, terminating clearing membership is the only means by which a Clearing Member can currently limit its liability for amounts due to the Clearing Fund. OCC proposed three changes to modify its existing authority to assess proportionate charges against Clearing Members’ required contributions to the Clearing Fund: (1) a cooling-off

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<sup>13</sup> See OCC By-Laws, Article VIII, Section 6.

<sup>14</sup> In addition to providing the written notice, to effectively terminate membership, a Clearing Member must satisfy two other conditions. First, after submitting the written notice, the Clearing Member cannot submit for clearance any opening purchase transaction or opening written transaction or initiate a Stock Loan through any of the Clearing Member’s accounts. Second, the Clearing Member has to close out or transfer all of its open positions with OCC, in each case as promptly as practicable after giving written notice. See OCC By-Laws, Article VIII, Section 6.

period and cap on assessments; (2) termination of clearing membership during a cooling-off period; and (3) replenishment of resources following a cooling-off period.

#### 1. Cooling-Off Period and Cap on Assessments

The proposal would introduce a minimum fifteen calendar day “cooling-off” period that automatically begins when OCC imposes a proportionate charge related to the default of a Clearing Member against non-defaulting Clearing Members’ Clearing Fund contributions. During a cooling-off period, the aggregate liability for a Clearing Member would be capped at 200 percent of its then-required contribution to the Clearing Fund. The cooling-off period would be extended if one or more specific events related to the default of a Clearing Member (as set forth in OCC’s By-laws)<sup>15</sup> occur(s) during that fifteen calendar day period and results in one or more proportionate charges against the Clearing Fund. Such an extension would run until the earlier of (i) the fifteenth calendar day from the date of the most recent proportionate charge resulting from that subsequent event, or (ii) the twentieth day from the date of the proportionate charge that initiated the cooling-off period.

Once the cooling-off period ends, each remaining Clearing Member would be required to replenish the Clearing Fund in the amount necessary to meet its then-required contribution. Any remaining losses or expenses suffered by OCC as a result of any events that occurred during that

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<sup>15</sup> Specifically, a cooling-off period would automatically begin after a proportionate charge arises in response to: (i) any Clearing Member failure to discharge duly any obligation on or arising from any confirmed trade accepted by OCC, (ii) any Clearing Member (including any Appointed Clearing Member) failure to perform any obligations (including its obligations to the correspondent clearing corporation) under or arising from any exercised or assigned option contract or any other contract or obligation issued or guaranteed by OCC or in respect of which it is otherwise liable, (iii) any Clearing Member failure to perform any obligation to OCC in respect of the stock loan and borrow positions of such Clearing Member, or (iv) OCC suffered any loss or expense upon any liquidation of a Clearing Member’s open positions. See OCC By-Laws, Article VIII, Section 5(a)(i)-(iv).

cooling-off period could not be charged against the amounts Clearing Members have contributed to replenish the Clearing Fund upon the expiration of the cooling-off period. However, after the end of a cooling-off period, the occurrence of another specified event that results in a proportionate charge against the Clearing Fund would trigger a new cooling-off period.

## 2. Membership Termination during a Cooling-Off Period

As noted above, to limit its liability to replenish the Clearing Fund, a Clearing Member currently must provide written notice of its intent to terminate its clearing membership by no later than the fifth business day after a proportionate charge. OCC's proposal would extend the time frame for a Clearing Member to provide such notice of termination, which would allow the terminating Clearing Member to avoid liability to replenish the Clearing Fund after the cooling-off period. Specifically, to terminate its status as a Clearing Member and not be liable for replenishment at the end of a cooling-off period, a Clearing Member would be required to:

(i) notify OCC in writing of its intent to terminate by no later than the last day of the cooling-off period, (ii) not initiate any opening purchase or opening writing transaction, and, if the Clearing Member is a Market Loan Clearing Member or a Hedge Clearing Member, not initiate any Stock Loan transaction through any of its accounts, and (iii) close-out or transfer all open positions by no later than the last day of the cooling-off period. If a Clearing Member fails to satisfy all of these conditions by the end of a cooling-off period, it would not have completed all of the requirements necessary to terminate its status as a Clearing Member, and therefore, it would remain subject to its obligation to replenish the Clearing Fund after the cooling-off period ends.

Given the products cleared by OCC and the composition of its clearing membership, OCC determined that a minimum 15-calendar day cooling-off period, rolling up to a maximum of 20 calendar days, is likely to be a sufficient amount of time for OCC to manage the ongoing

default(s) and take necessary steps in furtherance of stabilizing the clearing system. Further, based on its conversations with Clearing Members, OCC believes that the proposed cooling-off period is likely to be a sufficient amount of time for Clearing Members (and their customers) to orderly reduce or rebalance their positions, in an attempt to mitigate stress losses and exposure to potential initial margin increases during the stress event.<sup>16</sup> OCC also believes the proposed cooling-off period, coupled with the other proposed changes to OCC's assessment powers, is likely to provide Clearing Members with an adequate measure of stability and predictability as to the potential use of Clearing Fund resources, which would, according to OCC, remove the existing incentive for Clearing Members to withdraw following a proportionate charge (*i.e.*, to avoid facing potentially unlimited liability for replenishing the Clearing Fund).

### 3. Replenishment and Assessment

The proposal would clarify the distinction between “replenishment” of the Clearing Fund and a Clearing Member’s obligation to answer “assessments” charged by OCC. In this context, the term “replenish” (and its variations) would refer to a Clearing Member’s standing duty, following any proportionate charge against the Clearing Fund, to return its Clearing Fund contribution to the amount required from such Clearing Member for the month in question. The term “assessment” (and its variations) would refer to the amount, during any cooling-off period, that a Clearing Member would be required to contribute to the Clearing Fund in excess of the amount of the Clearing Member’s pre-funded required Clearing Fund contribution.

#### B. Proposed Authority to Request Voluntary Payments

OCC proposed new Rule 1011 to provide a framework for receipt of voluntary payments in a circumstance where a Clearing Member has defaulted and OCC has determined that it may

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<sup>16</sup> See Notice of Amendment, 83 FR at 37847.

not have sufficient resources to satisfy its obligations and liabilities resulting from such default.<sup>17</sup> OCC would initiate a call for voluntary payments by issuing a notice inviting all non-defaulting Clearing Members to make payments to the Clearing Fund in addition to any amounts they are otherwise required to contribute pursuant to Rule 1001 (“Voluntary Payment Notice”). The Voluntary Payment Notice would specify the terms applicable to any voluntary payment, including but not limited to, that any voluntary payment may not be withdrawn once made, that no Clearing Member shall be obligated to make a voluntary payment, and that OCC shall retain full discretion to accept or reject any voluntary payment.

In the event that OCC eventually obtains additional financial resources from the defaulting Clearing Member, OCC would give priority to repayment of Clearing Members that made Voluntary Payments. Specifically, if OCC subsequently recovers from the defaulted Clearing Member or the estate of the defaulted Clearing Member, OCC would seek to first compensate all non-defaulting Clearing Members that made voluntary payments.<sup>18</sup> If the amount recovered from the defaulted Clearing Member were less than the aggregate amount of voluntary payments, non-defaulting Clearing Members that made voluntary payments each would receive a

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<sup>17</sup> OCC’s determination would be made notwithstanding availability of remaining resources under Rules 707 (addressing the treatment of funds in a Clearing Member’s X-M accounts); 1001 (addressing the size of OCC’s Clearing Fund and the amount of a Clearing Member’s contribution); 1104-1107 (concerning the treatment of the portfolio of a defaulted Clearing Member); and 2210 and 2211 (concerning the treatment of Stock Loan positions of a defaulted Clearing Member).

<sup>18</sup> As discussed further in Section II.C.1 below, OCC’s proposed authority with respect to Voluntary Payments and Voluntary Payments would work together to establish a hierarchy of repayment in the event that OCC subsequently recovers from the defaulted Clearing Member. Under proposed rules 1011(b) and 1111(a)(ii), OCC would first seek to compensate those non-defaulting Clearing Members who had submitted Voluntary Payments and, thereafter, to the extent funds remained, OCC would then seek to compensation those non-defaulting Clearing Members who had participated in the Voluntary Tear-Up.



percentage of the amount recovered that corresponds to that Clearing Member's percentage of the total amount of voluntary payments received.

C. Proposed Authority to Conduct Voluntary Tear-Ups and Partial Tear-Ups

OCC proposed new Rule 1111 to establish a framework to extinguish positions of a suspended or defaulted Clearing Member on a voluntary basis ("Voluntary Tear-Up") or on a mandatory basis ("Partial-Tear Up") and, in certain extreme circumstances, to allocate any uncovered losses in the event that OCC does not have sufficient financial resources to conduct the tear-up. A Voluntary Tear-Up, if provided, would precede a Partial-Tear Up, and any Partial Tear-Up would take into account any positions extinguished as part of a Voluntary Tear-Up. Further, Rule 1111(h) would provide that no action or omission by OCC pursuant to, and in accordance with, Rule 1111 shall constitute a default by OCC, provided that Rule 1111(h) would not apply where OCC pays Clearing Members a pro rata amount of the applicable Tear-Up price because OCC does not have adequate resources to pay the full Tear-Up price.

OCC's use of both Voluntary and Partial Tear-Up would be subject to certain prerequisites. First, any tear-up would occur after one or more failed auctions pursuant to Rule 1104 or 1106. Second, any tear-up would occur after OCC has determined that it may not have sufficient resources to satisfy its obligations and liabilities resulting from such default.<sup>19</sup>

OCC represented that it would initiate its tear-up process on a date sufficiently in advance of the exhaustion of its financial resources such that OCC would expect to have adequate remaining resources to cover the amount it must pay to extinguish the positions of Clearing

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<sup>19</sup> As with Voluntary Payments, this determination would be made notwithstanding availability of remaining resources under Rules 707, 1001, 1104-1107, 2210, and 2211. See note 17 supra.

Members and customers.<sup>20</sup> The holders of torn-up positions would be assigned a price, and OCC would draw on its remaining financial resources to extinguish the torn-up positions at the assigned price. Although OCC does not intend, in the first instance, for its tear-up process to serve as a means of loss allocation, OCC recognizes that circumstances may arise such that, despite its best efforts, OCC may not have adequate remaining financial resources to extinguish torn-up positions at the full assigned price, resulting in the allocation of uncovered losses by the tear-up process. As further described below, a Clearing Member allocated an uncovered loss would then have an unsecured claim against OCC for the value of the difference between the pro rata amount paid to the Clearing Member and the full amount the Clearing Member should have received.

#### 1. Voluntary Tear-Up

As noted above, a Voluntary Tear-Up would provide an opportunity to holders of certain positions opposite a defaulting Clearing Member to voluntarily extinguish those positions. Although the Risk Committee of OCC's Board of Directors ("Risk Committee") approval is not necessary to commence a Voluntary Tear-Up, the Risk Committee would be responsible for determining the scope of a Voluntary Tear-Up. Proposed Rule 1111(c) would provide discretion to the Risk Committee when determining the appropriate scope, but the discretion would be subject to, and limited by, certain conditions, i.e., that the determination should be (i) based on then-existing facts and circumstances, (ii) be in furtherance of the integrity of OCC and the

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<sup>20</sup> Specifically, OCC stated that it anticipated that it would determine the date on which to initiate Partial Tear-Ups by monitoring its remaining financial resources against the potential exposure of the remaining unauctioned positions from the portfolio(s) of the defaulted Clearing Member(s).

stability of the financial system, and (iii) take into consideration the legitimate interests of Clearing Members and market participants.

Once the Risk Committee has determined the scope, OCC would initiate the call for Voluntary Tear-Ups by issuing a notice (“Voluntary Tear-Up Notice”) to inform all non-defaulting Clearing Members of the opportunity to participate in a Voluntary Tear-Up.<sup>21</sup> The Voluntary Tear-Up Notice would specify the terms applicable to any Voluntary Tear-Up, including, but not limited to, that no Clearing Member or customers of a Clearing Member shall be obligated to participate in a Voluntary Tear-Up, and that OCC shall retain full discretion to accept or reject any Voluntary Tear-Up.

Clearing Members and their customers that participated in a Voluntary Tear-Up and incurred losses would have a claim to amounts subsequently recovered from a defaulted Clearing Member (or the estate of the defaulted Clearing Member). The claim would be junior to Clearing Members who made a voluntary payment to the Clearing Fund, and OCC would satisfy the claims on a pro-rata basis.

## 2. Partial Tear-Up

Under proposed Rule 1111(b), OCC’s Board would be responsible for the decision to conduct a mandatory Partial Tear-Up. The Risk Committee would then be responsible for determining the appropriate scope of the Partial Tear-Up, subject to the conditions in Rule 1111(c) discussed above.

The proposed rule would also provide the Board with the discretion to conduct a mandatory Partial Tear-Up to extinguish the remaining open positions of any defaulted Clearing

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<sup>21</sup> Because OCC does not know the identities of Clearing Members’ customers, OCC would depend on each Clearing Member to notify its customers with positions in scope of the Voluntary Tear-Up of the opportunity to participate in such tear-up.

Member or customer of such defaulted Clearing Member(s) (“Remaining Open Positions”) and/or any related open positions necessary to mitigate further disruptions to the markets affected by the Remaining Open Positions (“Related Open Positions”). The open positions subject to tear-up opposite to the Remaining Open Positions and the Related Open Positions would be designated in accordance with the methodology in Rule 1111(e). Specifically, for Remaining Open Positions, the aggregate amount in the identical Cleared Contracts and Cleared Securities would be designated on a pro-rata basis to non-defaulting Clearing Members that have an open position in such Cleared Contract or Cleared Security. For Remaining Open Positions, all open positions in Cleared Contracts and Cleared Securities identified in the scope of the Partial Tear-Up would be extinguished.

After the scope of the Partial Tear-Up is determined, OCC would initiate the Partial Tear-Up process by issuing a notice (“Partial Tear-Up Notice”). The Partial Tear-Up Notice would: (i) identify the Remaining Open Positions and Related Open Positions designated for tear-up, (ii) identify the Tear-Up Positions, (iii) specify the termination price (“Partial Tear-Up Price”) for each position to be torn-up, and (iv) list the date and time, as determined by the Risk Committee, that the Partial Tear-Up will occur (“Partial Tear-Up Time”).

Rule 1111(f) would provide that, to determine the Partial Tear-Up Price, OCC would use its discretion, acting 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. Rule 1111(f) further specifies that OCC may consider the same information

set forth in subpart (c) of Section 27, Article VI of OCC's By-Laws.<sup>22</sup> OCC stated that it is likely to use the last established end-of-day settlement price, in accordance with its 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) would 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. For example, OCC represented that it 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 stated it would consider these circumstances in determining whether use of the discretion that would be afforded under proposed Rule 1111(f) might be warranted.<sup>23</sup>

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<sup>22</sup> Section 27, Article VI addresses the valuation of positions that may be subject to close-out netting in the event of OCC's insolvency or default. Specifically, it states that in determining a close-out amount, OCC may consider any information that it deems relevant, including, but not limited to, any of the following factors: (i) prices for underlying interests in recent transactions, as reported by the market or markets for such interests; (ii) quotations from leading dealers in the underlying interest, setting forth the price (which may be a dealing price or an indicative price) that the quoting dealer would charge or pay for a specified quantity of the underlying interest; (iii) relevant historical and current market data for the relevant market, provided by reputable outside sources or generated internally; and (iv) values derived from theoretical pricing models using available prices for the underlying interest or a related interest and other relevant data.

<sup>23</sup> See Letter from Joseph P. Kamnik, Sr. Vice President and CRO, OCC, to Brent Fields, Secretary, Commission, at 5 (Jul. 9, 2018) ("OCC Letter").

Every Partial Tear-Up position would be automatically terminated at the Partial Tear-Up Time, without the need for any further step by any party to the position. Upon termination, either OCC or the relevant Clearing Member would be obligated to pay to the other party the applicable Partial Tear-Up Price. The corresponding open position would be deemed terminated at the Partial Tear-Up Price. In the event that, given the amount of remaining resources, OCC would not be able to pay the full Partial Tear-Up Price, OCC would pay each torn-up Clearing Member a pro-rata amount of the applicable Partial Tear-Up Price based on the amounts of such resources remaining. Those Clearing Members would then have an unsecured claim against OCC for the value of the difference between the pro rata amount and the Partial Tear-Up Price.

### 3. Re-Allocating Losses from Tear-Up

The proposed changes would provide OCC with means to re-allocate losses, costs, and expenses associated with the tear-up process. First, the proposal would amend Article VIII of the By-Laws to provide OCC discretion to use remaining Clearing Fund contributions to re-allocate losses imposed on non-defaulting Clearing Members and customers from tear-up. Second, in connection with a Partial Tear-Up, proposed Rule 1111(g) would provide the Board with discretion to re-allocate losses, costs, and fees imposed upon non-defaulting Clearing Members and their customers among all non-defaulting Clearing Members to the extent that such losses, costs, and fees can be reasonably determined by OCC (“Special Charge”). The Special Charge would correspond to each non-defaulting Clearing Member’s proportionate share of the variable amount of the Clearing Fund at the time of the Partial Tear-Up. The Special Charge would be distinct and separate from a Clearing Member’s obligation to satisfy Clearing Fund assessments during a cooling-off period and, therefore, not subject to the cap on assessments.

### III. DISCUSSION AND COMMISSION FINDINGS

Section 19(b)(2)(C) of the Exchange Act 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 Exchange Act and the rules and regulations thereunder applicable to such organization.<sup>24</sup> After carefully considering the Amended Proposed Rule Change, the Commission believes the proposal is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to OCC. More specifically, the Commission finds that the Amended Proposed Rule Change is consistent with Section 17A(b)(3)(F) of the Exchange Act<sup>25</sup> and Rules 17Ad-22(e)(2)(i), (iii), and (v), (e)(4)(viii) and (ix), (e)(13), and (e)(23)(i) and (ii) thereunder.<sup>26</sup>

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

Section 17A(b)(3)(F) of the Exchange Act requires that the rules of a clearing agency be designed to, among other things, promote the prompt and accurate clearance and settlement of securities transactions, assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible, and, in general, to protect investors and the public interest.<sup>27</sup>

OCC is the sole registered clearing agency for the U.S. listed options markets. In general, OCC maintains equal and opposite obligations on cleared positions (commonly referred

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<sup>24</sup> 15 U.S.C. 78s(b)(2)(C).

<sup>25</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>26</sup> 17 CFR 240.17Ad-22(e)(2)(i), (iii), and (v), (e)(4)(viii) and (ix), (e)(13), and (e)(23)(i) and (ii).

<sup>27</sup> 15 U.S.C. 78q-1(b)(3)(F).

to as a matched book). In an extreme loss event caused by a Clearing Member default, re-establishing a matched book as quickly as possible is essential because it would allow OCC to continue clearing and settling securities transactions as a central counterparty. In addition, allocating uncovered losses is important in such an event because it would allow OCC to provide further certainty to Clearing Members, their customers, and other stakeholders about how it addresses such losses and avoid a disorderly resolution to such an event. Thus, taken together, the Commission believes that the new and amended authority granted to OCC specific to the context of extreme loss events and described in the Amended Proposed Rule Change should provide OCC with the ability to re-establish a matched book, allocate uncovered losses if necessary, and limit OCC's potential exposure to losses from such an event, all of which would be essential to OCC's ability to continue promptly and accurately clearing securities transactions in the event that an extreme market event places OCC in a recovery scenario.

Further, the Commission believes that the proposed changes would provide a reasonable amount of clarity and specificity to Clearing Members, their customers, and other stakeholders about the potential tools that would be expected to be available to OCC if such an event occurred, and the consequences that might arise from OCC's application of such tools. Because of this increased clarity and specificity, OCC's Clearing Members, their customers, and other stakeholders should have more information regarding their potential exposure and liability to OCC in an extreme loss event. Accordingly, the Commission believes that the proposed changes should allow Clearing Members, their customers, and other stakeholders to better evaluate the risks and benefits of clearing transactions at OCC because the proposed changes result in those parties having more information and specificity regarding the actions that OCC could take in response to an extreme loss event. To the extent that Clearing Members, their customers, and



other stakeholders are able to use this increased clarity and specificity to better manage their potential exposure and liability in clearing transactions at OCC, such parties should be able to mitigate the likelihood that such tools could surprise or otherwise destabilize them. For these reasons, the Commission believes that the proposed rules providing for such clarity and specificity are designed, in general, to protect investors and the public interest.

It is important for OCC to implement measures, including measures designed to facilitate OCC's ability to address risks and obligations arising in the specific context of extreme loss events, that enhance OCC's ability to address losses and to avoid threatening its ability to safeguard securities and funds within OCC's custody or control. OCC's proposed modified assessment powers would impose a cap on a Clearing Member's potential liability to replenish the Clearing Fund following a particular default event and extend the timeframe during which a Clearing Member must determine whether to terminate its membership and avoid further losses. Taken together, the Commission believes that these tools are reasonably designed to provide OCC with sufficient financial resources to cover default losses and ensure that OCC can take timely actions to contain losses and continue meeting its obligations in the event of a Clearing Member default. Similarly, the Commission believes that these changes would provide Clearing Members and their customers with greater certainty and predictability regarding the amount of losses they must bear as a result of a Clearing Member default. For these reasons, the Commission believes that the Amended Proposed Rule Change is designed to assure the safeguarding of securities and funds in OCC's custody or control.

Additionally, OCC's proposed authority to conduct tear-ups would provide OCC with a mechanism for restoring a matched book and, in the event that OCC did not have sufficient financial resources to pay the full Partial Tear-Up Price, allocate losses to the non-defaulting

Clearing Members. The Commission recognizes that a tear-up would result in termination of positions of non-defaulting Clearing Members. However, because under the proposed rules OCC would only be able to use its tear-up authority after it has conducted an auction pursuant to its Rules and when OCC has determined that it may not have sufficient financial resources to meet its obligations, a tear-up would only arise in an extreme stress scenario. Use of tear-up in such circumstances could potentially return OCC to a matched book quickly, thereby containing its losses and avoiding OCC's and its Clearing Members' exposure to additional losses. OCC's proposal would also address the determination of the Partial Tear-Up Price. Specifically, OCC would determine a Partial Tear-Up Price by using its discretion, acting 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. The Commission believes that OCC's proposed authority to conduct tear-ups could facilitate its ability to return to a matched book quickly and, in an extreme event, allocate losses. This, in turn, could help ensure that OCC is able to continue providing its critical clearing functions by facilitating the timely containment of default losses and liquidity pressures, thereby helping to prevent OCC from failing in such an event, and is therefore consistent with promoting the prompt and accurate clearance and settlement of securities transactions.

One commenter states that the Partial Tear-Up Price should be determined objectively and not on a discretionary basis.<sup>28</sup> In the OCC Letter, OCC states that, in the event that it has to

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<sup>28</sup> See Letter from Jacqueline H. Mesa, Sr. Vice President of Global Policy, Futures Industry Association, to Brent Fields, Secretary, Commission, at 2; available at

determine a Partial Tear-Up Price, OCC anticipates that it is likely to use the last established end-of-day settlement price, in accordance with its existing practices concerning pricing and valuation, but notes that discretion may be necessary in the circumstances likely to be associated with an extreme loss event necessitating a tear-up where the end-of-day closing price may be stale or unavailable.<sup>29</sup> Further, the Commission notes that, under OCC’s proposed rule, OCC would not have unfettered discretion to determine the appropriate price. Rather, OCC’s discretion would be limited by two conditions. Specifically, in the event that OCC uses its discretion to determine a Partial Tear-Up Price, it will be required under OCC’s proposed rule to do so (i) in good faith and (ii) in a commercially reasonable manner.<sup>30</sup> The Commission believes that this discretion, as limited by the two specified conditions, is appropriate given that it is not possible to know the precise circumstances likely to be associated with an extreme loss event necessitating a tear-up, and, therefore, the limited discretion provided for in the proposed rule may be appropriate in such circumstances. The Commission also notes that, in the event that OCC is using its authority to conduct a Partial Tear-Up, OCC would provide notification to the Commission and other regulators.<sup>31</sup> Accordingly, the Commission does not believe that this aspect of the proposal is inconsistent with the Exchange Act.

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<https://www.sec.gov/comments/sr-occ-2017-022/occ2017020.htm> (Jan. 16, 2018) (“FIA Letter”).

<sup>29</sup> See OCC Letter at 5. According to OCC, 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. See id.

<sup>30</sup> See also id. at 5.

<sup>31</sup> See Securities Exchange Act Release No. 83918 (Aug. 23, 2018) at note 19 (SR-OCC-2017-021).

Finally, OCC's proposal would also introduce methods of re-allocating losses after a tear-up. First, the revised By-Laws would allow OCC discretion to use remaining Clearing Fund contributions to re-allocate losses imposed on non-defaulting Clearing Members and their customers from a tear-up. Second, the revised Rules would provide the Board with the discretion to re-allocate losses among all non-defaulting members via a Special Charge, to the extent that such losses can be reasonably determined. As such, the Commission believes that these tools, and the associated governance, are designed to give OCC the ability to re-allocate the losses in a fair and equitable manner after an extreme market event, and, in general, to protect investors and the public interest.

One commenter states that the power to impose the Special Charge in connection with a Partial Tear-Up potentially could impose costs onto non-defaulting Clearing Members that did not have an opposing position from a defaulting Clearing Member. According to the commenter, the Special Charge could, in effect, be another assessment against all Clearing Members, which could create unquantifiable and unmanageable risks to Clearing Members. Moreover, the commenter states that the discretion afforded the Board may result in the Special Charge being capriciously applied. For these reasons, the commenter believes that the costs associated with a Partial Tear-Up should not be transferrable to unaffected Clearing Members.<sup>32</sup>

Under the terms of the proposed rule, the Special Charge could only be used when the losses, costs, and fees imposed upon non-defaulting Clearing Members and their customers directly resulting from a Partial Tear-Up reasonably can be determined by OCC. Further, if it were used, the Special Charge would correspond to each non-defaulting Clearing Member's proportionate share of the Clearing Fund at the time of the Partial Tear-Up. Thus, the

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<sup>32</sup> See FIA Letter at 2.

Commission does not believe that OCC would be permitted under the proposed rule to engage in unlimited assessments because the amount of the Special Charge must be subject to a reasonable determination, and the Special Charge would then correspond to the non-defaulting Clearing Member's proportionate share of the Clearing Fund. These aspects of the Special Charge should help ensure that OCC does not apply the tool capriciously and that the Board would use the Special Charge in these delineated circumstances, i.e., when the amount of the losses was reasonably determinable. For these reasons, the Commission does not believe that the Special Charge is inconsistent with the Exchange Act.

Therefore, the Commission believes that the proposed rule changes would promote the prompt and accurate clearance and settlement of securities transactions, assure the safeguarding of securities and funds in OCC's custody and control, and, in general, protect investors and the public interest, consistent with Section 17A(b)(3)(F) of the Exchange Act.<sup>33</sup>

B. Consistency with Rule 17Ad-22(e)(2)(i), (iii), and (v), Rule 17Ad-22(e)(4)(viii) and (ix), Rule 17Ad-22(e)(13), and Rule 17Ad-22(e)(23)(i) and (ii) Under the Exchange Act

1. Governance

Rule 17Ad-22(e)(2) requires, in relevant part, that OCC establish, implement, maintain, and enforce written policies and procedures reasonably designed to provide for governance arrangements that are clear and transparent; support the public interest requirements of Section 17A of the Exchange Act applicable to clearing agencies, and the objectives of owners and participants; and specify clear and direct lines of responsibility.<sup>34</sup>

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<sup>33</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>34</sup> 17 CFR 240.17Ad-22(e)(2)(i), (iii), and (v).

The proposal, taken together with existing OCC Rules, specifies the governance that would apply to use of each of the recovery tools. Specifically, with respect to the modified powers of assessment, the cooling-off period would commence automatically upon a number of events specified in the By-Laws. The use of Voluntary Payments and either Voluntary or Partial Tear-Up cannot occur unless OCC has determined that it may not have sufficient resources available to satisfy its obligations after a default. In addition, the proposal specifies the applicable decision-making body that would be responsible for determining whether to conduct a tear-up. Specifically, for a Voluntary Tear-Up, OCC would be able to make that determination, and for a Partial Tear-Up, which is mandatory, Board action is required. The Risk Committee would be responsible for determining the scope of the tear-ups, and any such determinations must take into account certain considerations. Only the Board may elect to impose a Special Charge to reallocate losses, costs, and fees from a Partial Tear-Up.

Thus, key decisions by OCC in connection with the use of its proposed recovery tools are subject to specific governance processes. These requirements include the involvement of the Risk Committee in determining the scope and pricing for any Partial Tear-up and specifically require Board approval with respect to instituting Partial Tear-Up and authorizing the Special Charge. Accordingly, the Commission believes that the governance process for using the recovery tools is clear and transparent and provides clear and direct lines of responsibility by addressing decision making in the use of recovery tools, thereby supporting the public interest requirements of Section 17A of the Exchange Act applicable to clearing agencies, and the

objectives of owners and participants, and therefore the Commission believes that the proposed rule change is consistent with Rule 17Ad-22(e)(2)(i), (iii), and (v).<sup>35</sup>

## 2. Allocation of Credit Losses Exceeding Available Resources

Rule 17Ad-22(e)(4)(viii) requires, in relevant part, that OCC establish, implement, maintain, and enforce written policies and procedures reasonably designed to address allocation of credit losses OCC may face if its collateral and other resources are insufficient to fully cover its credit exposures.<sup>36</sup> OCC's proposal includes three new recovery tools addressing the allocation of credit losses in the event that OCC determined that, notwithstanding the availability of any remaining resources under the other resource rules, OCC may not have sufficient resources to satisfy its obligations and liabilities following a default. First, Rule 1009 would provide a framework for OCC to receive Voluntary Payments in addition to their required contribution to the Clearing Fund to address a shortfall. Second, Rule 1111 would provide a framework for Clearing Members and their customers to participate in a Voluntary Tear-Up. Third, Rule 1111 would provide the Board with the discretion to conduct a mandatory Partial Tear-Up. This tool could be used, if necessary in the event that OCC determines that its resources are inadequate to pay the applicable Partial Tear-Up Price, to allocate losses by allowing OCC to pay each relevant Clearing Member a pro rata amount of the applicable Partial Tear-Up Price based on the amount of such resources remaining. In addition, the modified powers of assessment would continue to allow OCC to use the Clearing Fund to address credit losses in the event of a member default.

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<sup>35</sup> 17 CFR 240.17Ad-22(e)(2)(i), (iii), and (v).

<sup>36</sup> 17 CFR 240.17Ad-22(e)(4)(viii).

Thus, the Commission believes that these additional recovery tools are reasonably designed to provide OCC with means to address allocation of credit losses that it may face if its collateral and other resources are insufficient to fully cover its credit exposures. Further, the Commission believes that these tools should address fully any credit losses that OCC may face as a result of any individual or combined default among its Clearing Members. Therefore, the Commission believes that these aspects of the proposed changes are consistent with Rule 17Ad-22(e)(4)(viii).<sup>37</sup>

### 3. Replenishment of Financial Resources Following a Default

Rule 17Ad-22(e)(4)(ix) requires, in relevant part, that OCC establish, implement, maintain, and enforce written policies and procedures reasonably designed to describe OCC's process to replenish any financial resources it may use following a default or other event in which use of resources is contemplated.<sup>38</sup>

The proposed changes to OCC's assessment powers would include the addition of a minimum fifteen-day cooling-off period that would be automatically triggered by a proportionate charge to the Clearing Fund arising from a Clearing Member default. At the end of the cooling-off period, a remaining Clearing Member (i.e., a Clearing Member that did not choose to terminate its membership during the cooling-off period) would be obligated to replenish the Clearing Fund.

The Commission recognizes that by placing a cap on its assessment power during the cooling-off period, these revisions would effectively limit the amount of financial resources available to OCC from its Clearing Fund during that period. However, the Commission believes

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<sup>37</sup> 17 CFR 240.17Ad-22(e)(4)(viii).

<sup>38</sup> 17 CFR 240.17Ad-22(e)(4)(ix).



that these proposals would provide greater certainty and predictability regarding Clearing Members' maximum liability to the Clearing Fund. Moreover, in light of the proposed cap on OCC's assessment powers during the cooling-off period, OCC has authority under Rule 603 to call for additional initial margin from Clearing Members to ensure that OCC maintains sufficient financial resources to meet its requirements under Rule 17Ad-22(e)(4)(iii). Finally, at the end of a cooling-off period, a Clearing Member would be required to replenish the Clearing Fund in the amount necessary to meet its then-required contribution

In light of the foregoing discussion, the Commission believes that the provisions related to OCC's assessment powers, taken together with the other components of OCC's default management procedures and recovery rules, which are reasonably designed to allow OCC to replenish its financial resources following a default or other event in which use of such resources is contemplated, are consistent with Rule 17Ad-22(e)(4)(ix).<sup>39</sup>

One commenter states that OCC should provide an explanation of its determination to set the cap on the powers of assessment at 200 percent during a cooling-off period.<sup>40</sup> In the OCC Letter, OCC provided an explanation of the internal analysis that it conducted to reach the 200 percent determination.<sup>41</sup> Specifically, OCC stated that it considered its ability to have sufficient financial resources inclusive of its proposed assessment powers to withstand extreme market conditions on a "Cover-2" basis under various scenarios, and that OCC determined that, under such scenarios, it would be able to meet its clearing obligations so long as it was able to use (1) the financial resources on hand in the Clearing Fund, and (2) the full funding of two assessments

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<sup>39</sup> 17 CFR 240.17Ad-22(e)(4)(ix).

<sup>40</sup> See FIA Letter at 1-2.

<sup>41</sup> See OCC Letter at 2-3.

(i.e., 200 percent) from non-defaulting Clearing Members.<sup>42</sup> Moreover, OCC stated that it reviewed the caps that other CCPs impose upon their own assessment powers and determined that the 200 percent cap is generally aligned with other assessment caps.<sup>43</sup> Based on review of the analysis provided by OCC and the caps of other CCPs,<sup>44</sup> the Commission believes that the 200 percent cap in the proposed changes is consistent with Rule 17Ad-22(e)(4)(ix).

#### 4. Authority to Take Timely Action to Contain Losses and Liquidity Demands and Continue to Meet Obligations

Rule 17Ad-22(e)(13) requires, in relevant part, that OCC 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.<sup>45</sup> As described above, OCC's proposal would provide OCC with modified assessment powers and new tools of Voluntary Payments, Voluntary Tear-Ups, and Partial Tear-Ups.

As discussed above, the Commission recognizes that a tear-up would result in termination of positions of non-defaulting Clearing Members. However, because OCC would only be able to use its tear-up authority after it has conducted an auction pursuant to its Rules and

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<sup>42</sup> See id.

<sup>43</sup> See id. at 3.

<sup>44</sup> See, e.g., Self-Regulatory Organizations; ICE Clear Credit LLC; Notice of Filing Amendment No. 1 and Order Granting Accelerated Approval of Proposed Rule Change to Amend the ICE Clear Credit Clearing Rules, as Modified by Amendment No. 1, Relating to Default Management, Clearing House Recovery and Wind-Down, Exchange Act Release No. 79750 (Jan. 6, 2017), 82 FR 3831 (Jan. 12, 2017) (SR-ICC-2016-013) (approving a proposed rule change including, among other things, a 300 percent cap on non-defaulting participants' liability during a cooling-off period).

<sup>45</sup> 17 CFR 240.17Ad-22(e)(13).

when OCC has determined that it may not have sufficient financial resources to meet its obligations, a tear-up would only arise in an extreme stress scenario. Further, use of tear-up in such circumstances could potentially return OCC to a matched book quickly, thereby containing its losses.

The Commission believes that these tools are designed to provide greater certainty to Clearing Members seeking to estimate the potential risks and losses arising from their use of OCC, while enabling OCC to promptly return to a matched book. The Commission believes that returning to a matched book pursuant to these provisions in the context of OCC's default management and recovery facilitates OCC's operational capacity to timely contain losses and liquidity demands while continuing to meet its obligations. Thus, the Commission believes that the proposed changes are consistent with Rule 17Ad-22(e)(13).<sup>46</sup>

#### 5. Public Disclosure of Key Aspects of Default Rules

Rules 17Ad-22(e)(23)(i) and (ii) require, in relevant part, that OCC establish, implement, maintain, and enforce written policies and procedures reasonably designed to provide for the public disclosure of all relevant rules and material procedures, including key aspects of default rules and procedures, as well as sufficient information to enable participants to identify and evaluate the risks, fees and other material costs they incur by participating in OCC.<sup>47</sup> The Commission believes that the proposed changes address key aspects of OCC's default rules and procedures, thereby providing Clearing Members with a better understanding of the potential risks and costs they might face in an extreme event where OCC may use its proposed recovery tools, including the potential use of the Special Charge. Accordingly, the Commission believes

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<sup>46</sup> Id.

<sup>47</sup> 17 CFR 240.17Ad-22(e)(23)(i) and (ii).

that OCC has disclosed these key aspects of its default rules and procedures, consistent with Rule 17Ad-22(e)(23)(i) and (ii).<sup>48</sup>

#### IV. CONCLUSION

On the basis of the foregoing, the Commission finds that the Amended Proposed Rule Change is consistent with the requirements of the Exchange Act, and in particular, with the requirements of Section 17A of the Exchange Act<sup>49</sup> and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Exchange Act,<sup>50</sup> that the Proposed Rule Change (SR-OCC-2017-020), as modified by Amendment No. 2, be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>51</sup>

Eduardo A. Aleman  
Assistant Secretary

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<sup>48</sup>

Id.

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In approving this Amended 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).

<sup>50</sup>

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

<sup>51</sup>

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