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need for risk management showcases occ strength

Clearing has become a hot topic in the news over the last several months. Many commentators say the use of clearinghouses could have helped contain some of the economic turmoil associated with over-the-counter (OTC) derivatives trading.

Regulators around the world are examining ways to bring central counterparty clearing to OTC products. During this period of heightened interest in clearinghouses, OCC was profiled in a feature article in the Financial Times on February 2.

While it is the risk management function of central counterparty clearing that has drawn the increased attention of late, this has always been the focus of OCC.

OCC was the first clearinghouse worldwide to receive a 'AAA' credit rating from Standard & Poor's because of its ability to fulfill obligations as the counterparty for exchange-traded derivatives. OCC has received this rating — S&P's highest rating — every year since 1993.

A three-tiered backup system supports OCC's guarantee of performance for all the products it clears. This system consists of rigorous initial and ongoing membership standards, prudent margin requirements and a substantial clearing fund.

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This system begins at the application stage when OCC evaluates a potential new member by assessing its operational capability, the experience and competence of its personnel, and its financial condition — which must meet minimum capital and credit requirements. Once accepted, OCC monitors the ongoing financial condition of its members with regular financial reporting requirements. The member's financial condition is also evaluated on a daily basis in relation to its outstanding positions.

The second level of defense against clearing member default is a clearing member's margin deposits. Margin can be cash, government securities, equity securities, money market fund shares and other eligible forms of collateral deposited with OCC.

All obligations and non-cash margin deposits are marked to market daily. OCC haircuts the value of securities held as margin to provide a cushion against price fluctuations. In the mid-1980s, OCC was the first clearing organization in the world to develop a margin system based on options price theory and modern portfolio theory. In 2006, this methodology was replaced by STANS, a proprietary risk management system that leverages large-scale Monte Carlo simulations to forecast price moves and correlations to determine a clearing member's margin requirement.

Lastly, member contributions to the clearing fund, which must be cash or government securities, are available to cover potential losses in the event that a defaulting member's margin and clearing fund deposits are inadequate or not immediately available to fulfill the member's outstanding obligations. Only once in the nearly 36-year history of OCC, in connection with the 1987 market break, has the clearing fund been tapped to cover a default, and in that case it was a small amount drawn from the general pool.

The fund amounts fluctuate based on market conditions and open interest. Over the last six months, margin deposits held by OCC have ranged from a high of $116 billion last October to $31 billion at the end of January, while the clearing fund has seen levels from $3 billion to $6 billion at the November peak.

upcoming symbology milestones

On April 26, representatives of the Options Symbology Initiative (OSI) will host a panel discussion at the SIFMA Operations Conference in Hollywood, Florida. The session will be open to all conference attendees and the focus will be on Symbology certification and testing.

OSI has several upcoming milestones that clearing members should note. Below is a timeline that outlines these essential dates. For more information on dates regarding scripted industry testing and consolidation events, please visit www.optionsclearing.com/initiatives and click on the link for Symbology.

Finalized test scripts have been published by the OSI Committee on the Symbology section of OCC's web site. Participants can download these scripts by visiting http://www.optionsclearing.com/initiatives/symbology, then clicking on the quick link for OSI Testing. Certification testing with OCC and the exchanges is scheduled to be completed by participants prior to scripted industry testing in September 2009. Clearing members who have questions regarding testing should contact OSI_Testing@theocc.com.

industry insight

nasdaq omx group vice president adam s. nunes

In this third installment of interviews with industry leaders from OCC's participant exchanges, OCC News sits down with Adam Nunes, Vice President, Head of U.S. Options, NASDAQ OMX Group, Inc. Mr. Nunes shared with OCC News the background on how NASDAQ made its transition into the options market and where the organization fits in as the newest exchange.

How did you get started in financial services, and then more specifically in the options industry?

I started in the financial services industry as an analyst in NASDAQ's economic research department in late 2000. Prior to that, I worked at Economists Inc., an economic consulting firm that had done some work for NASDAQ in the past. As far as the options industry goes, I moved from my initial role in economic research through NASDAQ's transaction services group where I basically had a strategy role in product functionality, policy and new initiatives. One of the new initiatives that I had proposed was to start an options exchange. I was tasked with bringing the exchange to fruition and with running it after that.

What prompted NASDAQ to expand into the options business?

First, prior to August 2006, we were actually not an exchange. In 2006, we fully separated from the National Association of Securities Dealers, Inc. (NASD), now the Financial Industry Regulatory Authority (FINRA), and became a full fledged stock exchange. That was one of the pieces that we needed in place to be an options exchange — to actually be an exchange. The second piece was our acquisition of Buy-Net. The technology that we acquired provided us with a trading platform that was robust from a reliability standpoint as well as from a message traffic standpoint. Having a system that was robust enough to operate in the U.S. options industry — an industry with exceptional message traffic — put us in a good place. The third piece was the move to penny pricing. It provided an opportunity for a price-time exchange, which at the time was what our technology was geared up to do, making it relatively easy to come into the market and be successful.

As the first electronic stock market, NASDAQ has been a leader in technological innovation for nearly 40 years. What is NASDAQ's strategy for leveraging this experience to grow its options business and what unique offerings help differentiate NASDAQ from what is currently available in the marketplace?

I think you need to look at our options strategy. One of the key underpinnings of our strategy is having a price-time exchange through the NASDAQ Options Market (NOM) and a pro-rata exchange model through NASDAQ OMX PHLX.

What we are working towards right now is having the technology that drives both to be uniform, so we are currently going through the process of re-platforming the PHLX system onto NASDAQ technology, a transition that we expect to complete over the summer. From a technical standpoint, this is a challenge because it is a very different market structure and model than what we have used in the past. However, when we look at applying our platform across different market structures, it is key to what NASDAQ OMX is doing as a whole.

We are working to scale out the platform across asset classes and geographies so if you look at what we are doing in options, it is part of a larger goal that we have as an organization. Our plan is to get the leverage and savings of a single platform across both market structures. In viewing the ability for each of these to grow, there are going to be larger turns at work, but it is really going to come down to investor choice as far as which one grows more.

The launch of NASDAQ Options Market increased the number of options exchanges to seven last year but we now appear to be entering a period of flat to declining volume. How might this new environment impact competition and will there be enough business for all these exchanges?

As far as volume is concerned, frankly, it has held up relatively well. We don't know what's coming, but as far as our philosophy on the ability of volume to support seven exchanges if it were to go flat or decline, it really depends. Our view across our businesses is that we need to provide our exchange systems with extreme efficiency. We don't just strive to obtain that efficiency when volume is in question, we strive to do it all the time. To the extent that we are succeeding, which I believe we have been, puts you in a position where you can withstand potential downturns better than a firm that is not operating at peak efficiency all the time. So when I look at the PHLX business and the NOM business, we can still run them attractively in markets with flat to down volume.

With the recent acquisition of PHLX, NASDAQ is now in the position of providing two different market structure models. Do you see one model eventually dominating, and therefore NASDAQ is in a position to succeed either way, or is this more a matter of providing customers a choice to participate in the marketplace in the manner best suited to them?

It's more of the latter. Long term, I don't know which way it will go. Certainly in both the short and medium term, we will see both models co-existing. The balance of market share from one to another may shift, but I don't see it shifting too dramatically. What we really see is that there is demand for both models. We have a very broad, diverse base of customers and we want to be able to serve all of them. Having both models allows us to do that.

We're able to offer functionality that is focused on different participant types from one model to the other. When we look at new functionality there are times where that will lend itself very well to NOM. There are times where it really doesn't make sense there, but makes more sense with PHLX. We are trying to cater each exchange to really be the best at what it is and provide the best service to the firms that choose to use it.

Now that NASDAQ has been a part of the options industry for about a year, are things easier or harder than you thought they would be?

As far as what we've learned this year, there are a few things that really went the way we had anticipated. Our ability to come up with and operate in a stable way and the performance of our technology has more or less been what we expected. We had high expectations for that, so we provided a stable operating system and sub-millisecond response times.

Frankly, the impact of the penny pilot has been less than what we expected. When I look at our growth and market share, that's been more or less in line, though I think we have a long way to go.

What is also worth noting is that a year ago, NASDAQ had zero options exchanges. NOM was really on the cusp of being launched and while we had announced the deal with PHLX, it had yet to be closed. Within that year, we've actually come a long way from doing the initial leg work to getting the options exchange up and running to now having NOM just under 3% market share and completing the PHLX acquisition. We have come a long way in integrating it all.

oic continues to broaden global horizons

Efforts by The Options Industry Council (OIC) to seek out new international alliances that will further raise the awareness of options has yielded favorable results. Recently, OIC entered into educational cooperatives with overseas counterparts in Dubai and Tokyo.

In January, OIC signed a content sharing agreement with the Tokyo Stock Exchange, Inc. (TSE), providing Japanese investors with access to OIC's vast array of educational resources geared towards understanding the options product. To kick-off this initiative, TSE hosted a three-city road show in Tokyo, Nagoya and Osaka. The events featured presentations by OIC President Gina McFadden along with NYSE Arca Options Senior Director and OIC instructor Paul Finnegan, drawing in more than 500 investors across all three cities.

"Partnering with TSE on this initiative provided a unique opportunity for OIC to present itself to the Japanese market as a resource for options education," said Gina McFadden. "This level of exposure is not only great for OIC, but for the U.S. options industry as a whole."

It was also in January that OIC entered into a licensing agreement with NASDAQ Dubai to develop an options education program for investors and financial advisors in the Middle East. In addition to its work with the exchange, the NASDAQ Dubai Academy will also use OIC content to conduct seminars that will further explain equity options to Middle Eastern audiences.

"OIC has experienced continued worldwide investor interest in the U.S. equity options market," said Gina McFadden. "Working with NASDAQ Dubai to bring options education to the Middle East is a natural extension of OIC's mission to inform investors and their financial advisors about the benefits and risks of equity options."

In 2008, OIC established cooperative agreements with exchanges in Canada, Poland and Thailand. With these additional agreements in Dubai and Tokyo, OIC continues to forge ahead in creating and building upon its international relationships.

occ and quadriserv collaborate to bring transparency to securities lending market

In January, OCC joined with Quadriserv, Inc. in efforts to provide transparency and efficiency to the securities lending industry. Due to OCC's successful track record on its Stock Loan/Hedge program, Quadriserv approached OCC to be the central guarantor of transactions coming through Quadriserv's AQS Securities Lending Marketplace™. The AQS platform is an automated market that provides trade matching, price discovery and market data services. With OCC now serving as the central clearinghouse for these transactions, it will be a first within the stock loan industry.

For OCC clearing members, there will be no added interruptions, delays or system updates in regards to their current stock loan transactions. From the Quadriserv perspective, AQS provides a fully electronic marketplace through a web-based portal to match lenders and borrowers, resulting in those matches now being cleared by OCC. For matched AQS transactions, OCC guarantees daily mark-to-market payments and the return of loaned securities and collateral and, to the extent margin has been collected, dividend equivalent and rebate payments. From the clearing member perspective, the biggest benefit for participating in the program is OCC's 'AAA' credit rating and the potential for margin requirement reductions due to increased stock loan activity.

Currently, OCC and AQS are conducting a pilot program with a limited focus group of Quadriserv customers using live transactions. The pilot program, which started earlier this year, will continue through the summer prior to launching the system to Quadriserv's entire client base.

options volume walks line between growth and decline

The old adage of what goes up, must come down rings true in most circumstances and options are no exception. In 2008, we witnessed new volume milestones including surpassing the 3 billion contract mark on October 20 and trading more than 30 million contracts on September 18. Also notable was that options premium, which came in at $1.9 trillion, increased 43 percent over 2007.

Despite record annual volume for the past six consecutive years, however, the recent economic downturn as evidenced by the deleveraging of many hedge funds has begun to reverberate through the options market.

Volume declined for consecutive months in November (21 percent), December (7 percent) and January (28 percent). Is this a sign of things to come? Not necessarily. This past January still ranks as the second highest January by volume in history. February averaged 13.2 million contracts a day — up by 1 million compared to last February's average daily volume. March volume has continued the upward upward trend with 346,037,577 options contracts traded, a nearly 23 percent increase over last March.

Options volume is holding up relatively well averaging 14.1 million contracts per day, which is on par with 2008's year-end daily average.

While the current facts and figures show promise that options may be able to successfully navigate today's turbulent market conditions, the full impact that this economy will have on trading volume in 2009 remains to be seen.

occ cares

Every year, OCC identifies two charities that can benefit from the company's community outreach efforts. Maywood Fine Arts Association and Dallas Southwest Kids were the 2008 beneficiaries. Collectively, OCC raised more than $32,000 in contributions for both organizations.

Maywood Fine Arts Association provides low cost arts education and outreach programs for thousands of children and adults in Maywood, Illinois and surrounding communities. Over the past year, OCC collected nearly $25,000 in donations providing Maywood Fine Arts sufficient funding for renovations. Two restrooms in the center are currently being refurbished with updates to the center's dance studio being planned for the near future.

Dallas Southwest Kids is a non-profit organization for abused, neglected and homeless children in Dallas, Texas. Through a variety of fundraising events, OCC employees raised nearly $8,000 in 2008, of which $5,000 went towards purchasing new backpacks and school supplies for 104 children.

Two new charities for 2009 will be selected this spring.

conference date draws near

got an opinion?

Are there topics that you would like to see in future issues of *OCC News* or improvements that will help the publication to better suit your needs? Take our web survey and let us know your thoughts.

Sign on to **www.optionsclearing.com/occnewssurvey** for a brief survey.

Thank you and we look forward to your feedback.

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