

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-87673; File No. SR-OCC-2019-807)

December 6, 2019

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of No Objection to Advance Notice Related to Proposed Changes to The Options Clearing Corporation's Rules, Margin Policy, Margin Methodology, Clearing Fund Methodology Policy, and Clearing Fund and Stress Testing Methodology to Address Specific Wrong-Way Risk

**I. INTRODUCTION**

On October 10, 2019, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") advance notice SR-OCC-2019-807 ("Advance Notice") pursuant to Section 806(e)(1) of Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, entitled Payment, Clearing and Settlement Supervision Act of 2010 ("Clearing Supervision Act")<sup>1</sup> and Rule 19b-4(n)(1)(i)<sup>2</sup> under the Securities Exchange Act of 1934 ("Exchange Act")<sup>3</sup> to revise OCC's Rules, margin policy and methodology, Clearing Fund policy, and Clearing Fund and stress testing methodology to adopt new margin charges and other risk measures to address the specific wrong-way risk presented by certain cleared positions.<sup>4</sup> The Advance Notice was published for public comment in the Federal Register on November 12, 2019,<sup>5</sup> and the Commission has received no comments regarding the changes

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

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

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

<sup>4</sup> See Notice of Filing infra note 5, at 84 Fed. Reg. 61114.

<sup>5</sup> Securities Exchange Act Release No. 87476 (Nov. 6, 2019), 84 Fed. Reg. 61114 (Nov. 12, 2019) (File No. SR-OCC-2019-807) ("Notice of Filing"). On October 10, 2019, OCC also filed a related proposed rule change (SR-OCC-2019-010)

proposed in the Advance Notice.<sup>6</sup> The Commission is hereby providing notice of no objection to the Advance Notice.

## II. BACKGROUND<sup>7</sup>

As a central counterparty (“CCP”), OCC is exposed to its Clearing Members’ positions. To the extent that the value of a Clearing Member’s positions is positively correlated with the creditworthiness of the Clearing Member, OCC faces specific wrong-way risk (“SWWR”).<sup>8</sup> OCC proposes changes to address such SWWR. Specifically OCC proposes to: (1) adopt a new SWWR margin add-on charge for OCC’s margin methodology (“SWWR Add-on”); (2) introduce stress test scenarios to measure the SWWR, to the extent not addressed in margin, of cleared positions involving Clearing Member-issued exchange-traded notes (“ETNs”); and (3) impose restrictions on stock

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with the Commission pursuant to Section 19(b)(1) of the Exchange Act and Rule 19b-4 thereunder (“Proposed Rule Change”). 15 U.S.C. 78s(b)(1) and 17 CFR 240.19b-4, respectively. In the Proposed Rule Change, which was published in the Federal Register on October 29, 2019, OCC seeks approval of proposed changes to its rules necessary to implement the Advance Notice. Securities Exchange Act Release No. 87387 (Oct. 23, 2019), 84 Fed. Reg. 57890 (Oct. 29, 2019). The comment period for the related Proposed Rule Change filing closed on November 19, 2019.

<sup>6</sup> Since the proposal contained in the Advance Notice was also filed as a proposed rule change, all public comments received on the proposal are considered regardless of whether the comments are submitted on the Proposed Rule Change or the Advance Notice.

<sup>7</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>8</sup> SWWR arises when an exposure to a participant is highly likely to increase when the creditworthiness of that participant is deteriorating. See Securities Exchange Act Release No. 78961 (September 28, 2016), 81 Fed. Reg. 70786, 70816, n. 317 (October 13, 2016) (S7-03-14) (“Covered Clearing Agency Standards”).

lending activity cleared by OCC.<sup>9</sup>

#### **A. SWWR Margin Add-on**

As a general matter, OCC uses its System for Theoretical Analysis and Numerical Simulations (“STANS”) methodology for calculating Clearing Member margin requirements. OCC also incorporates add-on charges to address risks not otherwise addressed by its STANS methodology.<sup>10</sup> OCC proposes to adopt a new margin add-on to address SWWR at the Clearing Member account level (i.e., the SWWR Add-on). The SWWR Add-on would address SWWR presented by cleared positions involving equities and ETNs issued by a Clearing Member and its affiliates and would comprise three components: (1) “SWWR Equity Charge,” (2) “SWWR ETN Charge,” and (3) “SWWR Residual.” Each of these components is discussed below.

##### *1. SWWR Equity Charge*

The proposed SWWR Equity Charge is based on the assumption that, when a Clearing Member defaults, the value of any equity security issued by the Clearing Member or its affiliates would fall to zero. For purposes of calculating the SWWR Equity Charge, OCC would value a Clearing Member’s positions accordingly (i.e., all

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<sup>9</sup> OCC also proposes clarifying and conforming changes to the Clearing Fund Methodology Policy (“CFM Policy”) and Stress Testing and Clearing Fund Methodology Description (“Methodology Description”).

<sup>10</sup> See e.g. Securities Exchange Act Release No. 86119 (Jun. 17, 2019), 84 Fed. Reg. 29267 (Jun. 21, 2019) (approving implementation of an add-on charge “to guard against potential shortfalls in margin requirements that may arise due to the costs of liquidating the portfolio of a defaulted Clearing Member.”)

stocks, single stock futures, call options, and put options would be valued at zero).<sup>11</sup> Any potential gain from the SWWR positions would be excluded by defining the minimum SWWR Equity Charge as zero. OCC stated that the purpose of the SWWR Equity Charge would be to provide protection from the risk of potential market exposure to products based on a Clearing Member Group's own equity in a default or bankruptcy scenario.<sup>12</sup>

## 2. *SWWR ETN Charge*

The SWWR ETN Charge would be designed to address the risk that the value of open positions related to uncollateralized ETNs issued by a Clearing Member or its affiliates would be correlated with the Clearing Member's credit quality. Similar to the SWWR Equity Charge, the SWWR ETN Charge assumes that a degradation in the value of securities issued by a Clearing Member or its affiliates would occur concurrently with the Clearing Member's default. The SWWR ETN Charge, however, would not assume a complete loss of value for the relevant securities (*i.e.*, ETNs issued by the Clearing Member or its affiliates). OCC states that such uncollateralized ETNs are generally equivalent to unsecured senior debt.<sup>13</sup> OCC, in turn, proposes to utilize an industry standard recovery rate assumption designed to reflect potential losses to ETN positions for the purpose of setting the SWWR ETN Charge component of the SWWR Add-on.

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<sup>11</sup> Because the SWWR arising from equities issued by a Clearing Member or its affiliates would be fully covered as part of margins, OCC proposes to remove such positions from Clearing Fund calculations under OCC's Clearing Fund methodology and would revise its Methodology Description accordingly.

<sup>12</sup> See Notice of Filing, 84 Fed. Reg. at 61116.

<sup>13</sup> See Notice of Filing, 84 Fed. Reg. at 61117.

### 3. *SWWR Residual*

The SWWR Residual would ensure that implementation of the SWWR Add-on would not reduce a Clearing Member's overall margin requirements.<sup>14</sup> To determine the SWWR Residual, OCC would first calculate a "base margin" under on OCC's current methodology (*i.e.*, not assuming any specific degradation in the value of securities issued by a Clearing Member or its affiliates). Next, OCC would calculate a "residual margin," which would represent the Clearing Member's margin requirement for only those positions unaffected by the SWWR Equity Charge and SWWR ETN Charge. Finally, the SWWR Residual would be the difference between the residual margin and the base margin; however, OCC would adjust the value of the SWWR Residual if the sum of the SWWR Equity Charge, SWWR ETN Charge, and SWWR Residual would otherwise reduce a Clearing Member's margin requirement.

#### **B. SWWR Stress Test Scenarios**

As noted above, the proposed SWWR ETN Charge would not assume a complete loss of value for ETNs issued by a Clearing Member or its affiliates. The SWWR Add-on, in turn, would not generate margin requirements designed to cover a scenario in which the recovery rate for such ETNs would be zero. To address such a scenario, OCC proposes to introduce new scenarios into the set of stress tests that OCC uses to test the sufficiency of its financial resources ("SWWR Sufficiency Scenarios"). To construct the SWWR Sufficiency Scenarios, OCC would revise certain of its existing stress test

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<sup>14</sup> OCC noted that where a customer of a Clearing Member has net short positions referencing that Clearing Member's issued equities, such positions may actually present "right-way risk," whereby the position would result in a gain or margin credit for that account as the credit quality of the Clearing Member deteriorates. See Notice of Filing, 84 Fed. Reg. at 61117, n. 20.

scenarios by assuming a value of zero for ETNs issued by a Clearing Member or its affiliates. OCC stated that the introduction of SWWR Sufficiency Scenarios would enable OCC to more accurately measure its credit risks as they relate to SWWR and better test the sufficiency of its overall financial resources as well as to call for additional resources as appropriate.<sup>15</sup> OCC believes, therefore, it would have sufficient financial resources to cover the SWWR associated with SWWR ETN positions if such positions were to be liquidated for less than the assumed recovery rate.<sup>16</sup>

### **C. Stock Lending Restrictions**

Through its stock loan programs,<sup>17</sup> OCC novates stock loan transactions and becomes the lender to each Borrowing Clearing Member and the borrower to each Lending Clearing Member. OCC is exposed to SWWR in such programs when a Clearing Member lends equity securities or ETNs issued by the Clearing Member or its affiliates. To mitigate such risks, OCC proposes prohibiting Clearing Members from

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<sup>15</sup> See Notice of Filing, 84 Fed. Reg. at 61117. OCC's current rules authorize OCC to call for additional resources based on the results of stress scenarios used to test the sufficiency of OCC's financial resources. See Securities Exchange Act Release No. 83735 (Jul. 27, 2018), 83 Fed. Reg. 37855 (Aug. 2, 2018) (SR-OCC-2018-008). OCC's rules also authorize adjustments to OCC's monthly Clearing Fund sizing process based on the results of stress scenarios used to test the sufficiency of OCC's financial resources. OCC believes, however, that SWWR is more appropriately charged to the Clearing Member presenting the risk. See Notice of Filing, 84 Fed. Reg. at 61118. Based on that belief, OCC proposes to revise the CFM Policy such that the results of the SWWR Sufficiency Scenarios would not be used to adjust OCC's monthly Clearing Fund sizing.

<sup>16</sup> See Notice of Filing, 84 Fed. Reg. at 61117.

<sup>17</sup> OCC operates programs for clearing stock loan transactions initiated either bilaterally between market participants or through anonymous matching by a Loan Market. See Notice of Filing, 84 Fed. Reg. at 61115-16.

lending equity securities or ETNs issued by the Clearing Member or its affiliates within OCC's stock loan programs. OCC does not believe that the proposed prohibition would have a material impact on Clearing Members because Clearing Members do not typically lend their own equity securities, and borrowers do not typically accept equity securities issued by their lending counterparty.<sup>18</sup> Further, market participants are able to engage in, and would continue to be able to engage in, securities lending on an uncleared basis outside of OCC.<sup>19</sup>

OCC proposes to implement the prohibition on Clearing Members lending their own securities only on a going-forward basis. The proposal would not affect stock lending activity cleared by OCC before the implementation of the prohibition. Existing stock loan transaction would, however, be subject to the SWWR Add-on described above.

### **III. COMMISSION FINDINGS AND NOTICE OF NO OBJECTION**

Although the Clearing Supervision Act does not specify a standard of review for an advance notice, the stated purpose of the Clearing Supervision Act is instructive: to mitigate systemic risk in the financial system and promote financial stability by, among other things, promoting uniform risk management standards for systemically important financial market utilities ("SIFMUs") and strengthening the liquidity of SIFMUs.<sup>20</sup>

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<sup>18</sup> See Notice of Filing, 84 Fed. Reg. at 61116.

<sup>19</sup> The proposed restrictions on lending activity cleared by OCC would not prevent Clearing Members from lending equities or ETNs issued by the Clearing Member or any affiliate outside of OCC.

<sup>20</sup> See 12 U.S.C. 5461(b).

Section 805(a)(2) of the Clearing Supervision Act<sup>21</sup> authorizes the Commission to prescribe regulations containing risk-management standards for the payment, clearing, and settlement activities of designated clearing entities engaged in designated activities for which the Commission is the supervisory agency. Section 805(b) of the Clearing Supervision Act<sup>22</sup> provides the following objectives and principles for the Commission’s risk-management standards prescribed under Section 805(a):

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

Section 805(c) provides, in addition, that the Commission’s risk-management standards may address such areas as risk-management and default policies and procedures, among other areas.<sup>23</sup>

The Commission has adopted risk-management standards under Section 805(a)(2) of the Clearing Supervision Act and Section 17A of the Exchange Act (the “Clearing Agency Rules”).<sup>24</sup> The Clearing Agency Rules require, among other things, each

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<sup>21</sup> 12 U.S.C. 5464(a)(2).

<sup>22</sup> 12 U.S.C. 5464(b).

<sup>23</sup> 12 U.S.C. 5464(c).

<sup>24</sup> 17 CFR 240.17Ad-22. See Securities Exchange Act Release No. 68080 (October 22, 2012), 77 Fed. Reg. 66220 (Nov. 2, 2012) (S7-08-11). See also Covered Clearing Agency Standards, 81 Fed. Reg. 70786. The Commission established an effective date of December 12, 2016 and a compliance date of April 11, 2017 for the Covered Clearing Agency Standards. OCC is a “covered clearing agency” as defined in Rule 17Ad-22(a)(5). The Commission established an effective date of December 12, 2016 and a compliance date of April 11, 2017 for the Covered Clearing Agency Standards. OCC is a “covered clearing agency” as defined in Rule 17Ad-22(a)(5).

covered clearing agency to establish, implement, maintain, and enforce written policies and procedures that are reasonably designed to meet certain minimum requirements for its operations and risk-management practices on an ongoing basis.<sup>25</sup> As such, it is appropriate for the Commission to review advance notices against the Clearing Agency Rules and the objectives and principles of these risk management standards as described in Section 805(b) of the Clearing Supervision Act. As discussed below, the Commission believes the changes proposed in the Advance Notice are consistent with the objectives and principles described in Section 805(b) of the Clearing Supervision Act,<sup>26</sup> and in the Clearing Agency Rules, in particular Rules 17Ad-22(e)(4) and (6).<sup>27</sup>

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

The Commission believes that the proposal contained in OCC's Advance Notice is consistent with the stated objectives and principles of Section 805(b) of the Clearing Supervision Act. Specifically, as discussed below, the Commission believes that the changes proposed in the Advance Notice are consistent with promoting robust risk management in the area of credit risk, promoting safety and soundness, reducing systemic risks, and supporting the stability of the broader financial system.<sup>28</sup>

First, the Commission believes that the adoption of the SWWR Add-on would be consistent with the promotion of robust risk management at OCC. To the extent that the value of a Clearing Member's positions is positively correlated with the creditworthiness

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<sup>25</sup> 17 CFR 240.17Ad-22.

<sup>26</sup> 12 U.S.C. 5464(b).

<sup>27</sup> 17 CFR 240.17Ad-22(e)(4) and 17 CFR 240.17Ad-22(e)(6).

<sup>28</sup> 12 U.S.C. 5464(b).

of the Clearing Member, OCC faces SWWR. OCC's current margin methodology does not incorporate a specific component designed to address SWWR for cleared positions. As described above, the proposed SWWR Add-on would address SWWR arising out of equities and ETNs issued by the relevant Clearing Member or its affiliates underlying a Clearing Member's cleared positions. Further, the SWWR Add-on would be designed to avoid any unintended reduction in margin requirements resulting from "right-way risk" in a Clearing Member's accounts.<sup>29</sup> Adopting an add-on charge to address a risk not captured elsewhere in OCC's margin methodology would provide for more comprehensive management of OCC's risks, consistent with the promotion of robust risk management.

Second, the Commission believes that introduction of the SWWR Sufficiency Scenarios would be consistent with the promotion of robust risk management at OCC. The ETN component of the SWWR Add-on would not address the exposures presented by a complete loss of value for ETNs issued by the Clearing Member or its affiliates. To address the potential credit exposure represented by the value of such ETNs going to zero, OCC proposes to introduce the new SWWR Sufficiency Scenarios described above. OCC would use the SWWR Sufficiency Scenarios to test its total financial resources. Introducing new scenarios to test the sufficiency of OCC's financial resources generally and to address assumptions underlying OCC's margin methodology more specifically (i.e., a non-zero ETN recovery rate), would be consistent with the promotion of robust risk management.

Third, the Commission believes that the collection of resources to address the

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<sup>29</sup> See infra at note 14.

exposures discussed above and the proposed prohibition of certain stock lending activity as described above would be consistent with the promotion of safety and soundness at OCC. The collection of additional financial resources, whether in margin or Clearing Fund contributions, would better enable OCC to manage the potential losses arising out of a Clearing Member default. Prohibiting certain stock loan activity that could generate losses in the event of a Clearing Member default would avoid those potential losses all together. Avoiding or holding resources to address such losses would promote OCC's safety and soundness.

Finally, the Commission believes that the proposal is generally consistent with reducing systemic risk and supporting the broader financial system. As discussed above, OCC proposes to identify and manage SWWR posed by the cleared positions of its Clearing Members. OCC proposes to collect resources to address such risks as margin and, for more extreme scenarios, as Clearing Fund contributions. Additionally, OCC would prohibit stock loan transactions that give rise to SWWR. Prohibiting such activity and collecting additional margin to collateralize exposures created by permitted activity could reduce the probability that OCC would mutualize a loss arising out of the close-out of a defaulted Clearing Member that generated SWWR. While unavoidable under certain circumstances, reducing the probability of loss mutualization during periods of market stress could reduce the transmission of financial risks arising from a Clearing Member default to non-defaulting Clearing Members, their customers, and the broader options market. Further, OCC maintaining additional Clearing Fund contributions would further reduce the potentiality that OCC would need to call for additional resources from Clearing Members in times of market stress. The Commission believes, therefore, that

the proposed changes would be consistent with the reduction of systemic risk and supporting the stability of the broader financial system.

Accordingly, and for the reasons stated above, the Commission believes the changes proposed in the Advance Notice are consistent with Section 805(b) of the Clearing Supervision Act.<sup>30</sup>

**B. Consistency with Rule 17Ad-22(e)(4) under the Exchange Act**

Rule 17Ad-22(e)(4) under the Exchange Act requires, in part, that a covered clearing agency establish, implement, maintain, and enforce written policies and procedures reasonably designed to effectively identify, measure, monitor, and manage its credit exposures to participants and those arising from its payment, clearing, and settlement processes.<sup>31</sup>

As described above, OCC proposes to prohibit each Clearing Member submitting for clearing any stock loan activity involving the lending of equity securities or ETNs issued by such a Clearing Member or its affiliates going forward. Under the proposal, OCC would identify those stock loan transactions presenting SWWR and avoid any potential exposures arising out of such transactions through the proposed prohibition. Further, for those transactions that would not be affected by the prohibition (i.e., existing transactions), OCC proposes to measure, monitor, and manage its exposures through the use of the SWWR Add-on described above and discussed below. Accordingly, the Commission believes that OCC's proposal in the Advance Notice to prohibit certain

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<sup>30</sup> 12 U.S.C. 5464(b).

<sup>31</sup> 17 CFR 240.17Ad-22(e)(4).

stock loan transactions is consistent with Rule 17Ad-22(e)(4) under the Exchange Act.<sup>32</sup>

Rules 17Ad-22(e)(4)(i) and (iii) under the Exchange Act require that a covered clearing agency's policies and procedures meet the requirements of Rule 17Ad-22(e)(4) by maintaining financial resources at the minimum to enable OCC to cover a wide range of foreseeable stress scenarios that include, but are not limited to, the default of the participant family that would potentially cause the largest aggregate credit exposure for OCC in extreme but plausible market conditions.<sup>33</sup> Further, Rule 17Ad-22(e)(4)(vi) under the Exchange Act requires that a covered clearing agency's policies and procedures meet the requirements of Rule 17Ad-22(e)(4) by testing the sufficiency of a covered clearing agency's total financial resources available to meet the minimum financial resource requirements under Rules 17Ad-22(e)(4)(i) through (iii).<sup>34</sup>

As described above and discussed below, the proposed SWWR Add-on is designed to measure and manage OCC's credit exposures to Clearing Members to the extent those exposures arise out of SWWR related to cleared positions. One component of the SWWR Add-on – the SWWR ETN Charge – would not, however, fully cover OCC's potential exposure through margin because it would not assume a complete loss of value for ETNs issued by the Clearing Member or its affiliates. To address the potential credit exposure represented by the value of ETNs issued by the Clearing Member or its affiliates going to zero, OCC proposes to introduce the new SWWR Sufficiency Scenarios described above. OCC would use the SWWR Sufficiency

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<sup>32</sup> 17 CFR 240.17Ad-22(e)(4).

<sup>33</sup> 17 CFR 240.17Ad-22(e)(4)(i) and 17 CFR 240.17Ad-22(e)(4)(iii).

<sup>34</sup> 17 CFR 240.17Ad-22(e)(4)(vi).

Scenarios to test its total financial resources and to call for additional resources as necessary to ensure the resources it holds would be sufficient to enable OCC to cover exposures arising under the relevant stress scenarios. Accordingly, and for the reasons stated above, the Commission believes the changes proposed in the Advance Notice are consistent with Rule 17Ad-22(e)(4)(i), (iii), and (vi) under the Exchange Act.<sup>35</sup>

**C. Consistency with Rule 17Ad-22(e)(6) under the Exchange Act**

Rule 17Ad-22(e)(6)(i) under the Exchange Act requires that a covered clearing agency establish, implement, maintain, and enforce written policies and procedures reasonably designed to cover, if the covered clearing agency provides central counterparty services, its credit exposure to participants by establishing a risk-based margin system that, at a minimum, considers, and produces margin levels commensurate with, the risks and particular attributes of each relevant product, portfolio, and market.<sup>36</sup>

As noted above, OCC faces SWWR to the extent that the value of a Clearing Member's positions is positively correlated with the creditworthiness of the Clearing Member. OCC proposes to cover its exposure to such SWWR posted by its Clearing Members through the introduction of the SWWR Add-on. The SWWR Add-on consists of three components. Two of those components – the SWWR Equity Charge and SWWR ETN Charge – are designed to produce margin levels commensurate with the particular attributes of certain products that OCC clears in terms of the likely recovery available in the event of a default by the issuing Clearing Member. Further, the SWWR Residual

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<sup>35</sup> 17 CFR 240.17Ad-22(e)(4)(i); 17 CFR 240.17Ad-22(e)(4)(iii); 17 CFR 240.17Ad-22(e)(4)(vi).

<sup>36</sup> 17 CFR 240.17Ad-22(e)(6)(i).

would ensure that the introduction of the SWWR Add-on could not inadvertently weaken OCC's current margin methodology due to the potential existence of "right-way risk" in a Clearing Member's accounts.<sup>37</sup> Accordingly, and for the reasons stated above, the Commission believes the adoption of a margin add-on charge designed to cover exposures arising out of SWWR is consistent with Rule 17Ad-22(e)(6)(i) under the Exchange Act.<sup>38</sup>

#### **IV. CONCLUSION**

IT IS THEREFORE NOTICED, pursuant to Section 806(e)(1)(I) of the Clearing Supervision Act, that the Commission DOES NOT OBJECT to Advance Notice (SR-OCC-2019-807) and that OCC is AUTHORIZED to implement the proposed change as of the date of this notice or the date of an order by the Commission approving proposed rule change SR-OCC-2019-010 whichever is later.

By the Commission.

Jill M. Peterson  
Assistant Secretary

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<sup>37</sup> See infra at note 14.

<sup>38</sup> 17 CFR 240.17Ad-22(e)(6)(i).