

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-58158; File No. SR-OCC-2007-20)

July 15, 2008

Self-Regulatory Organizations; The Options Clearing Corporation; Order Granting Approval of a Proposed Rule Change Relating to the System for Theoretical Analysis and Numerical Simulations

I. Introduction

On December 14, 2007, The Options Clearing Corporation (“OCC”) filed with the Securities and Exchange Commission (“Commission”) proposed rule change SR-OCC-2007-20 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”).¹ Notice of the proposal was published in the Federal Register on February 12, 2008.² No comment letters were received. For the reasons discussed below, the Commission is granting approval of the proposed rule change.

II. Description

The proposed rule change permits the incorporation of certain forms of securities deposited as margin collateral into OCC’s System for Theoretical Analysis and Numerical Simulations (“STANS”) risk management methodology. The purpose of the proposed rule change is to more accurately measure the risk in clearing members’ accounts and thereby permit OCC to set margin requirements that more precisely reflect that risk. In connection with this rule change, it is also necessary to include additional flexibility in determining the amount of replacement collateral required when securities deposited as margin are withdrawn. In addition, because OCC believes that certain existing concentration limits and requirements regarding minimum share prices are no longer appropriately applied to securities that are underlying

¹ 15 U.S.C. 78s(b)(1).

² Securities Exchange Act Release No. 57270 (February 5, 2008), 73 FR 8098.

securities or to fund shares that track an index that is an underlying index for covered contracts, OCC is eliminating such requirements with respect to such securities.

Overview of Rule Changes. OCC will incorporate certain common stocks and ETFs (defined as “fund shares” in Article I of OCC’s By-Laws) into the STANS margin calculation process.³ STANS is a large-scale Monte Carlo-based risk management methodology used to measure risk associated with portfolios of cleared contracts. Currently, these forms of securities when deposited as collateral to satisfy margin requirements are priced on a nightly basis and are assigned a value equal to their end-of-day market price minus the haircut applicable to that form of collateral, an amount that varies according to asset type. While this method of valuing collateral has generally served OCC well in the past, it does not take into account the potential risk-reducing impact that the deposited collateral might have on a clearing member’s portfolio. Under the rule change, cleared options positions and underlying securities in the forms indicated above will be analyzed as a single portfolio using STANS, thus providing a more accurate valuation of securities deposited as collateral in relation to the other positions in the account. The rule change will align risk management techniques utilized to manage market risk of options portfolios with those used to value margin deposits. There are two primary benefits expected from the rule change. First, margin requirements will be based on the risk of the combined portfolio that includes both cleared contracts and deposited collateral, thereby allowing the relevant intercorrelations of cleared contracts and deposited collateral to be taken into consideration rather than treating securities deposited as collateral as having fixed values. Second, the coverage provided by a particular asset class (e.g., shares of IBM common stock)

³ For a description of STANS, refer to Securities Exchange Act Release No. 53322 (February 15, 2006) 71 FR 9403 (February 23, 2006) (File No. SR-OCC-2004-20).

will be based on the historical volatility of that particular asset rather than by taking a flat “haircut” rate across a much broader class of assets (e.g., 30% haircut for common stock). For the period from August 16, 2007, to September 10, 2007, OCC staff computed margin requirements for all existing accounts according to this proposed approach. The result showed an average daily reduction in risk margin requirements of approximately \$1.2 billion, or 5 %, as compared to OCC’s current approach. At the same time that average daily collateral requirements will be reduced, the STANS calculations will also measure and compensate for added risk arising where risks are positively correlated rather than offsetting.

OCC is also adding an exception to collateral minimum price and concentration limits with respect to certain securities deposited as collateral. Currently, eligible collateral securities deposited with OCC must (1) have a market value greater than \$10 per share and (2) be traded on a national securities exchange, the Nasdaq Global Market, or the Nasdaq Capital Market. Additionally, the aggregate value of margin attributed to a single security cannot exceed 10% of a clearing member’s total margin requirement. These criteria were designed to limit deposits to liquid, readily marketable securities and to avoid concentrations of deposits in a single security. OCC is adding an exception to these eligibility and concentration requirements for securities that are deliverable upon exercise of a contract cleared by OCC or, in the case of ETFs, that track an index underlying cleared contracts whether or not the particular ETF is an underlying security. OCC believes that this exception will permit and encourage the use of collateral that closely hedges related options positions. The exception will apply only to the approximately 2,800 exchange-listed equity securities that currently underlie listed options. Thus, OCC’s existing minimum value and concentration restrictions will continue to apply to the approximate 7,200 exchange-listed equity securities that do not underlie listed options.

OCC is also making a minor amendment to the current requirement that the aggregate value of margin attributed to a single security cannot exceed 10% of the total margin requirement in an account. The amendment will base the calculation on the clearing member's actual margin deposits rather than the clearing member's total margin requirement in the account. Thus, the requirement as amended will limit the value given to deposits in any single security to no more than 10% of the market value of a member's aggregate margin deposits in the account. This test is very similar in purpose and effect to the current test, but OCC believes it will be much easier to administer than the current test when collateral is included in STANS.

In addition, OCC will need a different means for addressing substitutions of collateral where a security that has been valued in STANS is being replaced during the business day. STANS performs multiple portfolio revaluations during the business day using current prices of collateral and cleared contracts. While the revaluations include updated positions in cleared contracts reflecting intraday trading activity, they do not at present include updated collateral positions reflecting withdrawals and substitutions. In addition, it is operationally too intensive, given the complexity of the STANS methodology and the frequency of substitution requests, to recalculate the STANS requirement for each such collateral withdrawal/deposit. Although OCC intends ultimately to make further systems changes to address these issues in more efficient ways, OCC has developed an approach that provides the necessary protection to the clearing system by taking a conservative view of the estimated impact that a withdrawal/deposit would have on the member's requirement.

OCC will treat margin collateral substitutions and withdrawals in the same manner that substitutions and withdrawals of specific and escrow deposits are treated. In the case of a margin withdrawal or deposit, OCC will incorporate an adjustment factor, based on the historical

volatility of the security, equal to the estimated impact (within the 99% confidence interval) of the security on the projected liquidating value of the account. For example, if a clearing member deposited \$300 in IBM stock and IBM is given a risk adjustment factor of 10%, the deposited stock would be given a value of \$270 ($\$300 \times [100\% - 10\%]$) in intraday excess collateral value to be used against releases to account for the potential negative risk impact of adding the stock to the portfolio. If the clearing member then released \$200 of Google stock and Google is given a risk adjustment factor of 12%, the clearing member would be required to maintain \$224 ($\$200 \times [100\% + 12\%]$) in excess collateral to account for the negative impact of removing Google from the portfolio.

Changes to OCC's Rules to Implement the Foregoing Concepts. OCC's Rule 601, "Margin Requirements," currently states in paragraph (c) that margin assets may be incorporated into the Monte Carlo calculations as an alternative to valuing such assets under Rule 604, "Form of Margin Assets." OCC now proposes merely to add an Interpretation to Rule 601 to indicate that OCC is implementing this alternative to the extent that it will be incorporating common stocks and ETFs into the STANS calculation of expected net liquidating value. Rule 604(b)(4), which governs the deposit of equity and debt issues to satisfy margin requirements, would be amended to provide exceptions to the per share minimum price and concentration limits and to provide that concentration limits will be measured in relation to the aggregate margin on deposit rather than to the margin requirement in an account. Rule 604(b)(4) is also proposed to be amended to reflect the fact that Nasdaq is now registered as a national securities exchange. An Interpretation is proposed to be added to Rule 608, "Withdrawals of Margin," to give OCC the flexibility to adopt the interim method of dealing with collateral withdrawals and substitutions as described above. The proposed changes in Rules 609, "Intraday Margin," and 706(c), "Cross-

Margining Settlement Procedures,” would reflect minor conforming changes and nonsubstantive updates to streamline the rules and add flexibility.

OCC proposes to put all of the foregoing proposed rule changes into effect simultaneously upon appropriate notice to clearing members once systems changes needed for full implementation are in place. The published text of OCC’s Rules would not be modified until that time although this rule change would be published as pending approval or approved but not yet implemented, as the case may be.

III. Discussion

Section 17A(b)(3)(F) of the Act requires, among other things, that the rules of a clearing agency be designed to assure the safeguarding of securities and funds which are in its custody or control or for which it is responsible.⁴ The Commission approved OCC’s STANS risk management methodology for the purpose of calculating clearing member margin in February 2006 and has monitored the results of the methodology through quarterly reports from OCC.⁵ The proposed rule change to include certain common stocks and fund shares deposited by OCC members as margin in the daily STANS risk calculation is consistent with the purpose of the methodology, which is to provide an accurate measure the market risk in a clearing member's account. The proposed rule change also amends OCC’s rules regarding the calculation of concentration limits and collateral substitution to allow OCC to more easily implement the inclusion of margin deposits in the STANS calculation. As noted above, OCC expects to collect approximately 5 percent less margin under the proposed rule change than currently collects.

⁴ 15 U.S.C. 78q-1(b)(3)(F).

⁵ Securities Exchange Act Release No. 53322 (February 15, 2006), 71 FR 9403 (February 25, 2006) (File No. SR-OCC-2004-20).

However, this is because of the increased diversification benefit allowed by the risk measurement under STANS and not because of a decrease in OCC's risk tolerance in calculating margin. Accordingly, because the proposed rule change should not affect the purpose of the STANS methodology to provide OCC with sufficient collateral in the event a member becomes insolvent or otherwise fails to meet its obligations to OCC, it should assure the safeguarding of securities and funds which are in OCC's custody or control or for which it is responsible.

The proposed rule change also adds an exception to the collateral minimum price and concentration limits in OCC's rules for securities that are deliverable upon exercise of a contract cleared by OCC or, in the case of ETFs, that track an index underlying cleared contracts whether or not the particular ETF is an underlying security. The minimum price and concentration limits in OCC's rules are designed to assure that OCC will be able to collect sufficient collateral in the event it needs to liquidate securities deposited as margin. This type of liquidity risk should not apply if the security deposited as margin is deliverable upon exercise of the clearing member's cleared contracts or if the security is an exchange traded fund that tracks an index underlying the clearing member's cleared contracts. Accordingly, the proposed rule change to add this exception to the collateral minimum price and concentration limits should not affect OCC's ability to assure the safeguarding of securities and funds which are in OCC's custody or control or for which it is responsible.

IV. Conclusion

On the basis of the foregoing, the Commission finds that the proposed rule change is consistent with the requirements of the Act and in particular Section 17A of the Act and the rules

and regulations thereunder.⁶

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (File No. SR-OCC-2007-20) be and hereby is approved.

For the Commission by the Division of Trading and Markets, pursuant to delegated authority.⁷

Florence E. Harmon
Acting Secretary

⁶ In approving the proposed rule change, the Commission considered the proposal's impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

⁷ 17 CFR 200.30-3(a)(12).