

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-56991; File No. SR-OCC-2007-15)

December 19, 2007

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change Relating to Cleared Contracts Carried in a Proprietary Account

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ notice is hereby given that on October 23, 2007, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which items have been prepared primarily by OCC. OCC filed the proposed rule change pursuant to Section 19(b)(3)(A)(i) of the Act² and Rule 19b-4(f)(1)³ thereunder so that the proposal was effective upon filing with the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The proposed rule change would clarify that existing provisions of OCC's By-laws and Rules constitute a "cross-margining or similar arrangement" for purposes of the United States Bankruptcy Code with respect to cleared contracts carried in any proprietary account at OCC to the extent that commodity contracts and securities contracts are permitted to be carried in such account.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

¹ 15 U.S.C. 78s(b)(1).

² 15 U.S.C. 78s-1(b)(3)(A)(i).

³ 17 CFR 240.19b-4(f)(1).

In its filing with the Commission, OCC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. OCC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of such statements.⁴

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

The purpose of the proposed rule change is to add Interpretation and Policy .02 to Section 3 of Article VI of OCC's By-laws to clarify that OCC's existing By-laws and Rules constitute "a cross-margining agreement or similar arrangement" for purposes of the United States Bankruptcy Code with respect to cleared contracts carried in any proprietary account at OCC to the extent that commodity futures and futures options (collectively "commodity contracts") are permitted to be carried in such account along with securities options and other securities (collectively "securities contracts").⁵ Where such positions are permitted to be so commingled, margin is calculated under Chapter VI of OCC's Rules based on the net risk of all such cleared contracts whether they are securities contracts or commodity contracts. "Proprietary accounts" within the scope of Interpretation and Policy .02 include (i) a firm account, (ii) a separate market-maker's account for which the market-maker is a clearing member or a proprietary market-maker trading for his own account, (iii) a combined market-maker's account confined to the exchange transactions of market-makers who are clearing members or proprietary market-

⁴ The Commission has modified parts of these statements.

⁵ Security futures carried in a proprietary account would be considered to be both securities contracts and commodity contracts for purposes of this rule filing.

makers trading for their own accounts, (iv) an OCC proprietary X-M account, or (v) a proprietary futures professional account. Under OCC's By-laws, all such proprietary accounts must be confined to the transactions of the clearing member itself and of such other persons as are not required to be treated as "customers" of the clearing member either under the definition in Commodity Futures Trading Commission ("CFTC") Regulation 1.3(k)⁶ or under Commission Rules 8c-1,⁷ 15c2-1,⁸ or 15c3-3,⁹ or Commission staff interpretations or no-action letters thereunder.¹⁰

⁶ 17 CFR 1.3(k).

⁷ 17 CFR 240.8c-1.

⁸ 17 CFR 240.15c2-1.

⁹ 17 CFR 240.15c3-3.

¹⁰ Article VI, Section 3(a) of OCC's By-laws provides that a "firm account . . . shall be confined to (i) the Exchange transactions in cleared securities other than security futures of such Clearing Member's non-customers [which is defined in terms of rules under the Securities Exchange Act of 1934], (ii) the Exchange transactions in (x) futures other than security futures and (y) futures options of persons whose transactions are not required to be treated as the transactions of futures customers, and (iii) the Exchange transactions in security futures of persons whose transactions are not required to be treated as the transactions either of securities customers or of futures customers." The term "futures customer" is defined in Article I of OCC's By-Laws as "a person whose positions are carried by a futures commission merchant . . . in a futures account required to be segregated under Section 4d of the Commodity Exchange Act and regulations of the Commodity Futures Trading Commission thereunder." Article VI, Section 3(c) provides that a proprietary combined market-makers' account is confined to transactions of "proprietary Market-Makers," which is defined to include "any participant, as such, in an account that is not required to be segregated under Section 4d of the Commodity Exchange Act." A "separate Market-Maker's account" under Section 3(b) is similarly limited to a "proprietary Market-Maker." An "OCC Proprietary X-M account (together with the corresponding proprietary X-M account at a participating futures clearing organization)" is defined in the applicable cross-margining agreements to be an account of a person whose account is a "proprietary account" within the meaning of Section 1.3(y) of CFTC regulations. Finally, a "proprietary futures professional account" is defined in Article I of the By-laws to be an account of a futures professional that is not a futures customer. Accordingly, all of these accounts are defined in terms that exclude any person whose property is required to be segregated under Section 4d of the CEA. Moreover, a futures commission merchant is itself obligated to carry the positions of futures customers in CFTC segregated accounts and would be in violation of that

Section 4d of the Commodity Exchange Act (“CEA”)¹¹ and CFTC regulations thereunder require that futures and futures options traded on a “designated contract market” and carried for the account of a “customer” as defined in CFTC Regulation 1.3(k) must be segregated by the carrying futures commission merchant (“FCM”) from funds or positions that are “proprietary” to the carrying FCM. Although Section 4d and the CFTC regulations permit the property of separate customers of the same FCM to be commingled at the clearinghouse in segregated customer accounts, CFTC Regulation 1.22 provides that “[c]ustomer funds shall not be used to carry trades or positions of the same commodity and/or option customer other than in commodities or commodity options traded through the facilities of a [CFTC-designated] contract market.”¹² Accordingly, OCC carries trades and positions of commodity customers in separate segregated funds accounts in compliance with the CFTC’s regulations and except in accordance with specific cross-margining orders of the CFTC does not commingle these funds with the funds of securities options customers.

However, Section 4d and the cited regulations do not apply to accounts that are “proprietary” within the meaning of CFTC Regulation 1.3(y).¹³ There is no prohibition against commingling of proprietary funds of an FCM relating to its futures activities with other proprietary funds of the same FCM at the clearinghouse level. Accordingly, a clearing member may maintain both securities contracts and commodity contracts in any proprietary account to the extent that such inclusion is otherwise consistent with the purposes of the account. The result

obligation by carrying them in any account at OCC that is not such an account.

¹¹ 7 U.S.C. 6d.

¹² 17 CFR 1.22.

¹³ 17 CFR 1.3(y).

is that clearing level margin requirements applicable to any such proprietary account are determined under OCC Rule 601 based upon the net liquidating value of all positions carried in the account. Therefore, the margin that would otherwise be required on positions in securities contracts may be reduced by offsetting positions in commodity contracts and vice versa.

Section 561(b)(2)(A) of the United States Bankruptcy Code (“Code”)¹⁴ contains certain prohibitions against the offset by a party of obligations to a “debtor” (i.e., a person subject to a bankruptcy proceeding under the Code) arising under or in connection with a commodity contract as defined under Section 761(4) of the Code¹⁵ against any claim arising under or in connection with other instruments including securities contracts “except to the extent that the party has positive net equity in its commodity accounts at the debtor.” Section 561(b)(2)(B) of the Code contains a similar prohibition against such offsets applicable to “another commodity broker” having an obligation to the debtor arising under or in connection with a commodity contract entered into on behalf of a “customer of the debtor.”¹⁶ The legislative history of these provisions states, “Subsections 561(b)(2)(A) and (b)(2)(B) limit the depletion of assets available for distribution to customers of commodity brokers.”¹⁷

OCC recently adopted a “close-out netting” rule, set forth in Section 27 of Article VI of OCC’s By-laws.¹⁸ Section 27 is intended to allow clearing members to calculate their credit

¹⁴ 11 U.S.C. 561(b)(2)(A).

¹⁵ 11 U.S.C. 761(4). This very broad “commodity contracts” definition should include commodity futures and futures options and may include security futures as well.

¹⁶ 11 U.S.C. 561(b)(2)(B).

¹⁷ H.R. Rep. No. 109-31, Part 1 at 132 (April 8, 2005).

¹⁸ Securities Exchange Act Release No. 56069 (July 13, 2007), 72 FR 39869 (July 20, 2007) (File No. SR-OCC-2006-19).

exposure to OCC on a net basis for balance sheet and regulatory capital purposes to the extent consistent with customer protection rules under the Act and the CEA. Paragraph (d) of Section 27 effectively permits netting of assets and liabilities within proprietary accounts without limitation as to whether the assets and liabilities in the account arise from securities contracts or commodity contracts. Absent an applicable exception, the prohibition in Section 561(b)(2)(A) could be interpreted to limit such netting and make it unenforceable to the extent that there are both securities contracts and commodity contracts in such accounts.¹⁹ However, an exception to the prohibition in Section 561(b)(2)(A) and Section 561(b)(2)(B) was created for cross-margining arrangements, and that exception is applicable to the close-out netting provided for in Section 27 of Article VI of OCC's By-laws insofar as such netting permits the offset of commodity contracts against securities contracts in proprietary accounts.

Section 561(b)(3)(A) of the Code provides that “no provision of [Section 561(b)(2)(A) or (B)] shall prohibit the offset of claims and obligations that arise under a cross-margining agreement or similar arrangement that has been submitted to the [CFTC] under paragraph (1) or (2) of section 5c(c) of the [CEA] and has not been abrogated or rendered ineffective by the [CFTC].” All of OCC's By-laws and Rules have been submitted under Paragraph (1) or (2) of Section 5c(c) of the CEA, and none has been abrogated or rendered ineffective by the CFTC.

¹⁹ Section 561(b)(2)(B) should not apply to close-out netting in the event of an insolvency of OCC. Section 561(b)(2)(B) would appear to provide in effect that a clearing member may not net an obligation to OCC arising from a commodity contract entered into on behalf of a “customer of the debtor” against amounts owed by OCC to the clearing member arising under a securities contract or other contracts other than commodity contracts. Because OCC would be the debtor, the term “customer of the debtor” would appear to refer to a customer of OCC. OCC does not believe that a clearing member would likely be deemed to have entered into any commodity contract on behalf of any party that would also be deemed to be a customer of OCC for purposes of this provision, and we therefore believe that Section 561(b)(2)(B) should not be interpreted as limiting the enforceability of any provisions of Section 27 of Article VI of OCC's By-laws. In any event, however, Section 561(b)(2)(B) would be overridden by the exception in Section 561(b)(3)(A) as set forth in the proposed Interpretation and Policy.

As commonly understood, a “cross-margining agreement” includes an arrangement under which commodity contracts and securities contracts are margined together as a single portfolio.²⁰ This is precisely what takes place under OCC By-laws and Rules and its Rule 601 in particular in all proprietary accounts to the extent that they contain both securities contracts and commodity contracts.

The original cross-margining program, which was initiated between OCC and ICC in 1988, was limited to proprietary accounts.²¹ In connection with its approval, the Commission stated that “it appears that no statutory, Commission or CFTC rule changes are required to implement a cross-margining system for proprietary accounts.” OCC rule changes were necessary in 1988 in order to implement proprietary cross-margining because OCC and ICC were separate clearing organizations and needed to have special arrangements between them in order to combine securities contracts cleared by OCC and commodity contracts cleared by ICC for margin purposes. However, when OCC itself registered as a derivatives clearing organization under the CEA, cross-margining in proprietary accounts was an automatic consequence of that dual registration. Of course, a rule filing was necessary in order to combine customer positions in security contracts and commodity contracts for margin purposes even where OCC clears both the commodity contracts and the securities contracts. Accordingly, OCC submitted appropriate rule filings to both the Commission and the CFTC and received the necessary approval to create an internal cross-margining program for non-proprietary market

²⁰ Securities Exchange Act Release No. 26153 (October 3, 1988), 53 FR 39561 (October 3, 1988) (File No. SR-OCC-86-17) approving the first cross-margining program between OCC and its commodity clearing affiliate, The Intermarket Clearing Corporation (“ICC”). CFTC approval of that cross-margining program was memorialized in a letter from Jean A. Webb, Secretary, to George S. Hender, President, ICC (June 1, 1988).

²¹ Securities Exchange Act Release No. 26153.

professionals.²² In the case of proprietary cross-margining, however, no such approval is required, and this rule filing is being submitted simply in order to clarify OCC's interpretation of its existing rules.

Since its approval of the first cross-margining program in 1988,²³ the Commission has repeatedly expressed its support for such programs and has found that they are consistent with the Act and in particular with Section 17A of the Act. Indeed, there has been wide support for cross-margining systems over many years. For example, the Report of the Presidential Task Force on Market Mechanisms ("Brady Report") noted that the absence of an effective cross-margining system for futures and securities options markets contributed to payment strains in October 1987. Accordingly, the Brady Report recommended that cross-margining be allowed in order to permit market participants with an investment in futures to receive credit for a hedged investment in stocks or options.²⁴ The President's Working Group on Financial Markets in its Interim Report concurred recommending that the Commission and CFTC not only approve the OCC/ICC cross-margining program but facilitate cross-margining among other clearing agencies.²⁵

The Commission has previously found that cross-margining programs are consistent with clearing agency responsibilities under Section 17A of the Act. In so finding, the Commission noted that cross-margining programs reduce the risk that a clearing member would become

²² The proposed rule change adopted By-Law Article VI, Section 25. Securities Exchange Act Release No. 50509 (Oct. 8, 2004), 69 FR 61289 (October 15, 2004) (File No. SR-OCC-2004-10) and CFTC order issued November 5, 2004.

²³ Securities Exchange Act Release No. 26153.

²⁴ Brady Report at 66 (January 1988).

²⁵ Interim Report of the President's Working Group on Financial Markets, Appendix D at 11 (May 1988).

insolvent in a distressed market and the corresponding risk that one insolvency could lead to multiple insolvencies in a ripple effect and that they therefore enhance the security of the clearing system.²⁶

The proposed rule change is not inconsistent with the rules of OCC including any rule proposed to be amended.

(B) Self-Regulatory Organization's Statement on Burden on Competition

OCC does not believe that the proposed rule change would impose any burden on competition.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

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

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The foregoing rule change has become effective pursuant to Section 19(b)(3)(A)(i) of the Act²⁷ and Rule 19b-4(f)(1)²⁸ promulgated thereunder because the proposal constitutes an interpretation with respect to the meaning, administration, or enforcement of an existing rule of OCC.²⁹ At any time within sixty days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in

²⁶ Securities Exchange Act Release No. 32708 (August 2, 1993) 58 FR 42586 (August 10, 1993) (File No. SR-OCC-93-13).

²⁷ 15 U.S.C. 78s(b)(3)(A)(i).

²⁸ 17 CFR 240.19b-4(f)(1).

furtherance of the purposes of the Act.

IV. Solicitation of Comments

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

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-OCC-2007-15 on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-OCC-2007-15. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00

²⁹ The Commission neither makes any findings nor expresses any opinion with respect to OCC's representations and interpretations regarding the application of the Bankruptcy Code.

pm. Copies of such filing also will be available for inspection and copying at the principal office of OCC. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-OCC-2007-15 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission by the Division of Trading and Markets, pursuant to delegated authority.³⁰

Florence E. Harmon
Deputy Secretary

³⁰ 17 CFR 200.30-3(a)(12).