THE OPTIONS CLEARING CORPORATION
ONE N. WACKER DRIVE, SUITE 500, CHICAGO, ILLINOIS 60606

WILLIAM H. NAVIN
EXECUTIVE VICE PRESIDENT, GENERAL COUNSEL, AND SECRETARY
TEL 312.322.1817 FAX 312.322.1836
WNAVIN@THEOCC.COM

February 14, 2011

Via Electronic Mail

Ms. Elizabeth A. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090
rule-comments@sec.gov

Re: S7-44-10 Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 Applicable to All Self-Regulatory Organizations

Dear Ms. Murphy:

This letter is submitted by The Options Clearing Corporation ("OCC") in response to the Commission's recent release (the "Release")[1] requesting comment on proposed rules (the "Proposed Rules") implementing a new process by which a registered clearing agency may submit for review a security-based swap that the clearing agency plans to accept for clearing (each, an "SBS Submission") as mandated by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[2] and the Securities Exchange Act of 1934, as amended by Dodd-Frank (the "Exchange Act"). The Proposed Rules address requirements for the notice the clearing agency must provide to its members of such SBS Submission and the procedure by which the Commission may stay the mandatory clearing requirement. The Proposed Rules would amend the Commission's existing Rule 19b-4 and Form 19b-4 and add new Rules 3Ca-1 and 3Ca-2.

[1] 75 FR 82490 (Dec. 30, 2010).
[2] Pub. L. 111-203.

OCC Background

Founded in 1973, OCC is currently the world's largest clearing organization for financial derivatives. OCC is the only clearing organization that is registered with the Commission as a securities clearing agency pursuant to Section 17A of the Exchange Act and with the Commodity Futures Trading Commission ("CFTC") as a derivatives clearing organization ("DCO") pursuant to Section 5b of the Commodity Exchange Act, as amended by Dodd-Frank (the "CEA"). OCC clears securities options, security futures and other securities contracts subject to the Commission's jurisdiction, and commodity futures and commodity options subject to the CFTC's jurisdiction. OCC clears derivatives for all nine U.S. securities options exchanges and five futures exchanges.[3]

Executive Summary of Comments

OCC commends the Commission for its very detailed and thoughtful Release, which we know was produced under great time pressure and with many competing demands on the staff's time. We believe that the Release and the Commission's Proposed Rules will provide much needed guidance for market participants in complying with the clearing mandate of Dodd-Frank. We especially want to applaud the Commission's proposal to adapt the basic structure and procedures of existing Rule 19b-4 and Form 19b-4 to permit clearing agencies to comply simultaneously with (1) the existing requirement to file proposed rule changes with the Commission; (2) the new requirements of Title VII to file SBS Submissions; and (3) the new requirements of Title VIII to file "Advance Notices" of rule changes and other events that could materially affect the nature or level of risk presented by the clearing agency. The Commission's proposal will permit clearing agencies to comply as efficiently as possible with the overlapping regulatory filing requirements by dealing with all three filing requirements that may be triggered by introduction of a single new product or service in a single filing.

OCC supports the adoption of the Proposed Rules, subject to the comments set forth below. Our comments consist primarily of requests for clarification of specific items as well as suggestions that certain provisions be either revised or interpreted so as to achieve the regulatory purpose in the most efficient manner possible, taking into consideration the demands on the resources of the clearing agency in preparing a submission and the Commission staff in reviewing it.

Security-Based Swap Submissions

Security-Based Swap Submissions Not Requiring Associated Rule Changes

The Commission states in the Release that "[i]n circumstances where no proposed rule change filing would be required, such as a case where a clearing agency's rules already permit it to clear the security-based swap in question, EFFS and Form 19b–4 still would be used for the

[3] The participating options exchanges are BATS Options Exchange, C2 Options Exchange, Inc., Chicago Board Options Exchange, Inc., International Securities Exchange, NASDAQ OMX BX, Inc., NASDAQ OMX PHLX, Nasdaq Options Market, NYSE Amex Options, and NYSE Arca Options. OCC clears futures products traded on CBOE Futures Exchange, NYSE Liffe U.S., NASDAQ OMX Futures Exchange and ELX Futures, as well as security futures contracts traded on OneChicago.

[SBS] Submission."[4] It is not clear to us under what circumstances an SBS Submission would be required to be made by a clearing agency that already has Commission-approved rules permitting it to clear the security-based swap in question. Given that the terms of cleared contracts are ordinarily set forth in the rules of the clearing agency and that a contract generally falls within or outside the definition of a security-based swap depending on the terms of the contract (as well as the nature of the underlying interest), it seems to us that an SBS Submission would always need to include rules specifying the terms of the security-based swap proposed to be cleared. And if the clearing agency already has such rules in place, what would trigger the requirement of another SBS Submission? We would appreciate clarification in this regard.

Independent Validation of Margin Methodology and Financial Resources

The Commission has solicited comment on whether "a clearing agency, in connection with each submission *or in some circumstances* [should] be required to include an independent validation of its margin methodology and its ability to maintain sufficient financial resources."[5] We believe a clearing agency should have an ongoing internal process for validating its internal risk models. The validation process should be independent of the internal models' development, implementation, and operation. It should be permissible for the review personnel to be employed by the clearing agency. The key is that the employees performing the independent validation are not biased in their assessment due to their involvement in the development, implementation, and operation of the risk models. This "independent validation" approach is well established and accepted in the U.S. banking area, where it is applied in the context of reviewing banks' internal risk models. We further recommend that the independent evaluation include evaluation of empirical evidence and documentation supporting the methodologies used, important model assumptions and their limitations, adequacy and robustness of empirical data used in parameter estimation and model calibration, and evidence of a model's strengths and weaknesses. This approach is consistent with a recent U.S. Treasury rulemaking proposal that would apply to a bank's review of its internal risk models.[6]

Details Required in Security-Based Swap Submissions

The Proposed Rules identify a potentially very large amount of data to be provided in an SBS Submission. For example, the Release states that "[i]n describing the security-based swap, or any group, category, type or class of security-based swaps, that a clearing agency plans to accept for clearing, the clearing agency *could include* the relevant product specifications, including copies of any standardized legal documentation, generally accepted contract terms, standard practices for managing and communicating any life cycle events associated with the security-based swap and related adjustments, and the manner in which the information contained in the confirmation of the security-based swap trade is transmitted."[7] This statement appears to be guidance and not a mandate, and we believe that it is important for the Commission staff to exercise judgment and flexibility in determining what information will actually be required in the context of a particular SBS Submission. Continuing the example above, the text of a clearing

[4] 75 FR at 82494.
[5] 75 FR at 82497 (emphasis added). The CFTC recently solicited comment to similar questions in a notice of proposed rulemaking entitled "Risk Management Requirements For Derivatives Clearing Organizations." 76 FR 3698 (January 20, 2011), at 3705.
[6] 76 FR 1890 (January 11, 2011), at 1897.
[7] 76 FR at 82495 (emphasis added).

agency's rules would ordinarily set forth all material terms of the particular security-based swap, and the Item 3 description in the Form 19b-4 would ordinarily provide an explanation of any provision not obvious on the face of the rule. The explanation would include the reasoning behind the rule, which might include reference to existing market practices. In the case of OCC, we anticipate that the practices for managing and communicating any life cycle events, adjustments, and the manner in which the information contained in the confirmation of the security-based swap trade is transmitted would be covered either in rules applicable to both listed and over-the-counter products, including security-based swaps, or, in some cases, in rules generally applicable to over-the-counter products. A new SBS Submission should be required to state which provisions of existing rules are applicable and to address the other enumerated factors only to the extent of any different provisions applicable to the new product.

In addition, as the Commission is aware, the over-the-counter derivatives market relies heavily on standardized documentation and definitional booklets prepared by ISDA. In certain cases a clearing agency may have rules that incorporate ISDA terms by reference or state that determinations made by an ISDA committee will apply to the security-based swaps that it clears. In such instances, consideration should be given to clarifying that, to the extent that such an incorporated rule is changed not through any action of the clearing agency but through the action of ISDA or other external authority, such an event would not constitute a rule change or necessitate an additional SBS Submission.

The Proposed Rules would also require that an SBS Submission include quantitative and qualitative information to assist the Commission in its consideration of the five factors listed in Exchange Act Section 3C(b)(4)(B). While we appreciate that the five factors are specified by statute, we believe that in many instances one or more of the factors would require at most a very cursory mention in a particular SBS Submission. For example, Proposed Rule 19b-4(o)(3)(ii)(A) would require that an SBS Submission include "[i]nformation that will assist the Commission in the quantitative and qualitative assessment of the factors specified in Section 3C of the [Exchange] Act, including, but not limited to. . . [t]he existence of significant outstanding notional exposures, trading liquidity and *adequate pricing data*[.]" For security-based swaps that have a delta of one and are priced off an exchange-traded public security, we believe that little, if anything, needs to be said about the adequacy of pricing data, as such data is readily and publicly available and already received by OCC in connection with clearing and margining listed options. Similarly, we believe very little would need to be said concerning the "credit support infrastructure" (including the "methods to address and communicate requests for, and posting of, collateral")[8] used to clear a security-based swap to the extent that the clearing agency intends to rely on its existing credit support infrastructure, which would have previously been described to the Commission and about which the Commission will already have extensive knowledge and experience when dealing with established clearing agencies. As the Commission is aware, OCC uses its STANS system to margin all cleared products based on the net risk of the positions in a Clearing Member account, and OCC anticipates that security-based swaps and over-the-counter securities options cleared by OCC will be cleared using the same basic margin system, clearing fund requirements and risk management procedures that are used for clearing listed options. There would be no more need to redescribe these same systems in procedures in an SBS Submission than in any other new product rule filing submitted by OCC.

[8] *See* 75 FR at 82495.

We are encouraged to note that the Commission appears to be in agreement with our views that the statutory factors will not apply in all cases, as the Release indicates that "[e]ach [SBS] Submission would be required to address the [statutory] factors . . . to the extent they are applicable to the security-based swap, the clearing agency and the market."[9] We urge the Commission to encourage the Commission staff to interpret the five factors in a reasonable and flexible manner in reviewing whether an SBS Submission conforms to the requirements of Rule 19b-4 in order to avoid repetition of information already well known to the Commission. SBS Submissions that include large amounts of boilerplate description will not be helpful to the Commission. This is particularly the case with respect to established clearing agencies where the Commission already has extensive knowledge of and experience with the clearinghouse and its procedures.

Where information responsive to the five factors is included in the text of a rule submission, we do not believe reiterating that same information in narrative form to comply with Rule 19b-4(o)(3)(ii) should be necessary and suggest that the Commission clarify this in the final rules. OCC has made a deliberate effort to make its rule filings succinct and informative by not simply repeating information in the Form 19b-4, Item 3 description that is self-evident from the text of the proposed rule.

Clearing Requirement; Anti-Evasion and Rule 3Ca-2

New Exchange Act Section 3C(b)(2) requires the Commission to review all SBS Submissions to determine whether the security-based swap (or group, category, type or class of security-based swaps) proposed to be accepted for clearing by the clearing agency will be required to be cleared. If the Commission determines to impose a clearing requirement, we interpret the statute as contemplating, as is appropriate, that the clearing agency's rules will determine the scope of the class of security-based swaps required to be cleared (although the Commission could impose the clearing requirement on only some sub-class or sub-category of those security-based swaps). Any similar swap with terms that fall outside the scope of the clearing agency's rules could be entered into on a bilateral basis between the parties and not cleared, subject only to the Commission's authority under Section 3C(d) to take action to prevent evasion of the clearing requirement.

Section 3C(d)(1) of the Exchange Act requires the Commission to prescribe rules as determined by the Commission to be necessary to prevent evasion of the mandatory clearing requirement. The Commission states that proposed Rule 3Ca– 2 is intended to prevent evasion of the clearing requirement by specifying that security-based swaps required to be cleared must be submitted for central clearing to a clearing agency that functions as a central counterparty. The proposed rule does not address evasion that could occur if the parties to a security-based swap intentionally include terms in the contract that have no economic purpose other than to cause the contract to fall outside the scope of the clearing agency's rules and therefore outside the clearing requirement. While OCC understands that there may be good economic reasons for parties to customize contracts in ways that would make them sufficiently non-standard as to be unclearable, we were somewhat surprised that the Commission's Proposed Rules do not address the potential for evasion through spurious customization. While OCC believes that the

[9] *Id.*

Commission should be careful not to use its anti-evasion authority in a way that could interfere with economically useful security-based swap transactions, we also believe that the Commission should not ignore the potential for evasion as the Commission and market participants gain experience with the operation of the clearing requirement.

Advance Notices Under Title VIII of Dodd-Frank

Material Rule Changes

Proposed Rule 19b-4(n)(1) requires a clearing agency that has been designated as systemically important to provide 60 days' advance notice to the Commission of "any proposed change to its rules, procedures, or operations that could materially affect the nature or level of risks presented by such designated clearing agency."[10] The Commission is proposing to define "materially affect the nature or level of risks presented" to include "matters as to which there is a reasonable possibility that the change could affect the performance of essential clearing and settlement functions or the overall nature or level of risk presented by the designated clearing agency."[11] The Commission states in the Release that this proposed definition "is designed to include *all changes* that would affect the risk management functions performed by the clearing agency that are related to systemic risk, as well as changes that *could affect* the clearing agency's ability to continue to perform its core clearance and settlement functions."[12] We note that while Dodd-Frank expressly included a materiality requirement, such a requirement is not consistently included in the language of Proposed Rule 19b-4(n) itself, and the Commission's commentary also disregards the statutory provision that only material changes should be subject to the Advance Notice requirement.

OCC believes that the statutory objective of reducing systemic risk would be disserved by taking too broad a view of those changes considered material under Title VIII, as the consequence of a change being treated as material will be to prevent systemically important clearing agencies from implementing changes in risk management for up to 2 months, if not longer. Although the statute does not expressly distinguish between changes that tend to increase systemic risk and those that tend to decrease it, we believe that this distinction should be taken into consideration when applying the materiality standard. We urge the Commission to consider limiting the changes for which Advance Notice is required to those changes that are reasonably likely to have a materially adverse effect on the nature or level of risks presented. At a minimum, we urge the Commission to make a practice of working with the Board of Governors of the Federal Reserve System (the "Board"), which has concurrent authority to review a change subject to Advance Notice, to promptly approve such changes in less than 60 days. Under existing rules, OCC may sometimes file risk-reducing changes for immediate effectiveness under the criteria set forth in Rule 19b-4(f), such as provisions allowing immediate effectiveness of rule changes not adversely affecting the safeguarding of funds or securities.[13]

---

[10] We note that this language effectively tracks the language of Section 806(e)(1)(A) of Dodd-Frank, which requires a designated financial market utility to "provide 60 days in advance notice to its Supervisory Agency of any proposed change to its rules, procedures, or operations that could, as defined in the rules of each Supervisory Agency, materially affect the nature or level of risks presented by the designated financial market utility."

[11] Proposed Rule 19b-4(n)(1)(i).

[12] 75 FR at 82501 (emphasis added).

[13] 17 CFR 240.19b-4(f)(4)(i).

The Dodd-Frank goal of reducing systemic risk is not well served by introducing a regime that delays implementation non-controversial improvements.

We believe that clearing agencies subject to Section 806(e) of Dodd-Frank and the Commission should work closely together to create a shared understanding of those changes for which Advance Notice should be required. The Commission states that "as this would be a new requirement, the Commission expects that designated clearing agencies may discuss, at least initially, proposed changes with Commission staff prior to determining if advance notice under Section 806(e) is required to be filed with respect to a proposed change to the clearing agency's rules, procedures or operations."[14] We wholeheartedly agree with and commend the Commission's recognition of the need for cooperation and dialogue in this area.

Advance Notice of Liquidity Arrangements

The Commission has included liquidity arrangements among the list of matters it would consider appropriate for Advance Notice. A clearing agency may rely on a line of credit as a significant source of liquidity; however, providing Advance Notice to the Commission of the terms of the line of credit, which are subject to negotiation with the issuing banks, before those terms are finalized, is impractical. In practice, imposing a 60 day Advance Notice requirement for a systemically important clearing agency to enter into a liquidity arrangement would require the clearing agency to finalize the terms of the liquidity arrangement, file the Advance Notice, and thereafter wait up to 60 days to begin relying on the liquidity arrangement. This could materially increase the risks faced by the clearing agency during the waiting period. Moreover, liquidity arrangements typically have a fixed term (in OCC's case, the term has historically been 364 days); and when they come up for renewal, the terms of the renewal facility, unlike the terms of a clearing agency's own rules, are not within the exclusive control of the clearing agency, nor can they be controlled by the Commission. Requiring an Advance Notice for renewal of a liquidity facility strikes us as impractical as well as inefficient, especially when the amount of the facility is unchanged or even increased. Once again, we encourage the Commission to take the view that clearing agency actions that clearly decrease the risks to which the clearing agency is exposed are outside the Advance Notice requirement. It would, on the other hand, be practical and appropriate to require an Advance Notice for a termination or reduction of a liquidity arrangement at the instance of the clearing agency, but we believe that should be the extent of the requirement,

Forwarding Advance Notices to the Board

Section 806(e)(3) of Dodd-Frank requires a systemically important clearing agency to provide the Board with "a complete copy of any notice, request, or other information it issues, submits, or receives under [Section 806(e)]." The Commission is proposing, via a proposed change to the instructions to Form 19b-4, that this requirement be fulfilled by the clearing agency providing three copies of the relevant materials, in hard copy form.[15] We find it difficult to understand why in the 21st century such submissions should not be made electronically in printable format. Filing materials in paper form is highly inefficient and inconsistent with

[14] 75 FR at 82502.
[15] See 75 FR at 82502.

environmental policy objectives. We encourage the Commission to work with the Board to facilitate the submission of filings pursuant to Section 806(e)(3) in electronic format absent a highly compelling reason to do otherwise.

Conclusion

OCC appreciates the opportunity to comment on the Proposed Rules. We would be pleased to provide the Commission with any additional information or analysis that might be useful in determining the final form of the Proposed Rules.

Sincerely,

William H. Navin
Executive Vice President
And General Counsel

cc: Mary L. Shapiro
Chairman
Securities and Exchange Commission

Kathleen L. Casey
Commissioner

Elisse B. Walter
Commissioner

Luis A. Aguilar
Commissioner

Troy A. Paredes
Commissioner