SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-74302; File No. SR-OCC-2014-23]

Self-Regulatory Organizations; The Options Clearing Corporation; Order Approving Proposed Rule Change to Clarify that OCC would not Treat a Futures Transaction that is an Exchange-for-Physical or Block Trade as a Non-Competitively Executed Trade if the Exchange on which Such Trade is Executed has Provided OCC with Representations that it Has Policies or Procedures Requiring that Such Trades be Executed at Reasonable Prices and that Such Price is Validated by the Exchange

February 19, 2015

On December 19, 2014, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change File No. SR-OCC-2014-23 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder.[2] The proposed rule change was published for comment in the Federal Register on January 6, 2015.[3] The Commission did not receive any comments on the proposed rule change. This order approves the proposed rule change.

I. Description

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 Securities Exchange Act Release No. 73961(December 30, 2014), 80 FR 568 (January 6, 2015) (SR-OCC-2014-23).

OCC is modifying its By-Laws to add an interpretation and policy to Section 7 of Article XII of its By-Laws to clarify that OCC will not treat a futures transaction that is an exchange-for-physical ("EFP")[4] or block trade in futures ("Block Trade")[5] as a non-competitively executed trade, and therefore subject to delayed novation, if the exchange on which the EFP or Block Trade is executed has provided OCC with representations that it has rules, policies or procedures requiring that such trades be executed at reasonable prices and that such prices are validated by the exchange.

Background

According to OCC, under OCC's By-Laws, the novation of confirmed trades (*i.e.*, transactions in options, futures, or other "cleared contracts" effected through an exchange and submitted to OCC for clearing) occurs at the "commencement time" for such transactions.[6] The "commencement time" for most confirmed trades is when daily position reports are made available to clearing members.[7] However, transactions in certain cleared products and certain types of transactions, including non-competitively

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4 According to OCC, an EFP is a transaction between two parties in which a futures contract on a commodity or security is exchanged for the actual physical good.

5 According to OCC, a block trade is a trade involving a large number of shares being traded at an arranged price between parties, outside of the open markets, in order to lessen the impact of such a large trade being made public.

6 Cleared Contracts and Commencement Time are defined terms set forth in Article 1, Section 1 of OCC's By-Laws.

7 *See* OCC's By-Laws Article VI, Section 5. According to OCC, in a practical sense, however, most trades are novated upon proper submission to OCC for clearing since OCC's By-Laws, with limited exception, do not permit OCC to reject any confirmed trade due to the failure of the purchasing clearing member to pay any amount due to OCC at or before the settlement time. *See also* Securities Exchange Act Release No. 65990 (December 16, 2011), 76 FR 79731 (December 22, 2011) (SR-OCC-2011-17).

executed EFPs and Block Trades, have delayed commencement times that are tailored to address risks specific to such products or transactions,[8] including, but not limited to, those risks presented by off-market transactions.

When OCC began clearing EFPs and Block Trades, it established that the commencement time for such transactions is expressly conditioned upon the receipt by OCC of variation payments due from purchasing and selling clearing members because EFPs and Block Trades could be executed away from the market and be executed at other than market prices. These factors were viewed as creating heightened exposure to OCC if a clearing member defaults on a trade executed at an off-market price and, as a result, Article XII, Section 7 of OCC's By-Laws establishes that the commencement time for an EFP or Block Trade is the time of the first variation payment after the trade is reported to OCC (typically 9:00 a.m. Central Time the following business day).[9] OCC delays its novation of these non-competitively executed futures trades because OCC is bound to pay the first variation settlement amount to the counterparty once novation has occurred, and if the agreed-upon price at which the trade is entered differs from the competitive market price, there is an increased likelihood that OCC may experience a loss if it is required to close out a defaulting purchaser's position. Accordingly, OCC does not novate, and thereby become a counterparty to, a non-competitively executed trade if OCC fails to receive the first variation payment when due.

EFP and Block Trades Subject to Price Checks

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8 *Id.*

9 *See* Securities Exchange Act Release No. 44727 (August 20, 2001), 66 FR 45351 (August 28, 2001) (SR-OCC-2001-07).

According to OCC, in the time since OCC adopted Article XII, Section 7 of its By-Laws, the Commodity Futures Trading Commission ("CFTC") has adopted Regulation 1.73, which requires clearing futures commission merchants ("FCMs") to establish certain risk controls, including risk based limits for bilaterally executed transactions and for Block Trades.[10] In light of this requirement and other proposed regulatory developments that may affect EFPs and Block Trades,[11] certain futures exchanges requested that OCC review its By-Laws regarding delayed novation of these trades to reassess the impact of the recently implemented rules, supported by policies and procedures, which require the exchanges' market participants to execute s EFPs and Block Trades at reasonable prices that are verified by the exchange. These rules, policies and procedures leverage risk controls implemented by FCMs, as applicable. OCC undertook such a review of its practices with respect to delayed novation of EFPs and Block Trades, and determined that it is appropriate to novate these trades when daily position reports are made available, provided that the exchange that submitted such trades

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[10] *See* 17 CFR 1.73. According to OCC, Regulation 1.73 requires FCMs to: 1) establish risk-based limits in the proprietary account and in each customer account based on position size, order size, margin requirements, or similar factors; 2) screen orders for compliance with the risk-based limits; and 3) monitor for adherence to the risk based limits intra-day and overnight.

[11] According to OCC, the CFTC has proposed regulations requiring Designated Contract Markets (*i.e.*, futures exchanges) to determine whether or not the price of a block trade is fair and reasonable considering: 1) the size of the block trade, 2) the price and size of other block trades in any relevant markets at the applicable time, and 3) the circumstances of the market or the parties to the block trade. *See* proposed CFTC Regulation 38.503. 75 FR 80572, 80592. *See also* proposed Appendix B of part 38 of the CFTC's proposed regulations concerning Core Principle 9. 75 FR 80572, 80630. The CFTC has also proposed to adopt similar regulations concerning EFP trades. *See* proposed CFTC Regulation 38.505. 75 FR 80572, 80593.

to OCC represents to OCC that the exchange has in place rules, policies and procedures to verify the reasonableness of the transaction price of EFPs and Block Trades it submits to OCC for clearance and settlement, and that such price is validated by the exchange.

OCC has determined that EFPs and Block Trades that are subject to price reasonability checks do not present the same settlement risks discussed above in relation to non-competitively executed EFPs and Block Trades. Specifically, should a clearing member that executed a reasonably priced EFP or Block Trades fail to pay its first variation payment to OCC on the trade, OCC anticipates it will liquidate the futures positions at the prevailing market price and obtain sufficient funds, or OCC will already have sufficient funds in its clearing fund, to pay or reimburse itself for the first variation settlement to the counterparty to the trade. This is the same risk management methodology OCC currently uses for other competitively executed trades in cleared contracts that OCC accepts for clearance and settlement on a daily basis.

Accordingly, OCC is amending Article XII, Section 7, of its By-Laws by adding an interpretation and policy to exclude EFPs and Block Trades from the delayed novation and to provide for the treatment of these trades as competitively executed trades, provided that the s EFPs and Block Trades are reported by an exchange that represents to OCC that it performs a price reasonableness check on the trade, and that such price is validated by the exchange.

Verification of Exchange Rules, Policies and Procedures Related to Price Reasonableness

Before permitting an exchange to submit EFPs and Block Trades that will not be subject to delayed novation, OCC will require an exchange to provide OCC with a

certification that the exchange has rules, policies or procedures as they relate to verifying the reasonableness of the price of the EFP and Block Trade. Specifically, OCC will require an exchange to certify that its rules, policies or procedures provide that the price at which a EFP or Block Trade is executed must be fair and reasonable in light of: (i) the size of the EFP or Block Trade; (ii) the prices and sizes of other transactions in the same contract at the relevant time; and (iii) the prices and sizes of transactions in other relevant markets, including, without limitation, the underlying cash market or related futures markets, at the relevant time.[12] An exchange will also have to certify that its rules, policies or procedures require one or both parties to an EFP or Block Trade to report the trade details of the trade to the exchange within a reasonable period of time (*i.e.*, within 10 minutes of the time of execution or, if the EFP or Block Trade is executed outside of regular trading hours, within 15 minutes of the commencement of trading on the next business day). OCC believes that it is appropriate to rely on price reasonableness checks performed by exchanges trading futures because they are self-regulatory organizations subject to regulatory oversight, including routine examinations. Moreover, OCC will presume that all EFPs and Block Trades submitted by an exchange that represents that it has price reasonableness rules, policies or procedures in place will submit to OCC EFPs and Block Trades that have undergone a price reasonableness check.

In addition to exchanges implementing rules, policies or procedures regarding the price reasonableness checks for EFPs and Block Trades, exchanges may continue to use

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[12] For example, according to OCC, OneChicago LLC ("OCX") Rule 417 governs EFP and Block Trades executed on OCX and provides that such trades be executed on a designated trading platform that will automatically verify that EFPs and Block Trades were executed at competitive prices by price verification software for price reasonableness.

their existing authority to notify OCC pursuant to Article VI, Section 7(c) of OCC's By-Laws, to disregard any EFP or Block Trade submitted to OCC that was executed at an unreasonable price. The notification will be delivered to OCC along with other trades "busted" by an exchange, in accordance with an operational process that currently occurs every day before daily position reports are distributed. Such trades could not be properly cleared under amended Article XII, Section 7, but instead would fall within the non-competitively executed category and therefore be subject to delayed novation. Taken together, OCC believes that these measures appropriately protect OCC in the event OCC receives a EFP or Block Trade at an unreasonable price. Moreover, OCC and the exchanges will continue to maintain an ongoing dialogue about operational matters, which OCC will use to confirm the continued application of price reasonableness controls.

II. Discussion and Commission Findings

Section 19(b)(2)(C) of the Act[13] directs the Commission to approve a proposed rule change of a self-regulatory organization if it finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to such organization.

The Commission finds that the proposed rule change is consistent with Section 17A(b)(3)(F) of the Act[14] which requires the rules of a clearing agency to, among other things, assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible. OCC is amending Article XII,

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[13] 15 U.S.C. 78s(b)(2)(C).

[14] 15 U.S.C. 78q-1(b)(3)(F).

Section 7, to include a new policy and interpretation setting forth the specific criteria a futures exchange must meet in order for EFPs and Block Trades to not be subject to the delayed novation times set forth in Article XII of OCC's By-Laws. Specifically the exchange must provide OCC with a certification that the exchange has rules, policies or procedures as they relate to verifying the reasonableness of the price of the EFP and Block Trade. OCC's proposal, as approved, does not affect the novation time for any securities transactions.

OCC has determined that EFPs and Block Trades that are subject to price reasonability checks do not present the same settlement risks as those executed on exchanges without price reasonability checks, and as such has determined that OCC's requirement that exchanges certify price reasonableness policies and procedures are sufficiently appropriate to mitigate the risks associated with non-competitively executed trades. In addition, in the event a clearing member fails to its first variation payment to OCC on an EFP or Block Trade that was executed on an exchange with price reasonability checks, OCC will employ the same risk management methodology used for all other competitively executed trades accept for clearing at OCC, which should in turn reduce settlement risks that could expose OCC to loss if it is required to close out a defaulting purchaser's EFP or Block Trade position. Combining OCC's price reasonableness requirements for exchanges and OCC's ability to liquidate futures positions or use its clearing fund to management risks associated with non-payment of premiums for those trades accepted for clearance and settlement, OCC should have sufficient risk management controls in place in to assure the safeguarding of securities and funds which are in the custody of control of OCC or for which it is responsible.

III. Conclusion

On the basis of the foregoing, the Commission finds that the proposal is consistent with the requirements of the Act and in particular with the requirements of Section 17A of the Act[15] and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[16] that the proposed rule change File No. SR-OCC-2014-23 be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[17]

Brent J. Fields,
Secretary.

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

16 15 U.S.C. 78s(b)(2).

17 17 CFR 200.30-3(a)(12).