



DIVISION OF
TRADING AND MARKETS

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

January 23, 2014

Mr. James E. Brown
Executive Vice President,
General Counsel and Secretary
The Options Clearing Corporation
1 North Wacker Drive, Suite 500
Chicago, IL 60606

Re: Request for No-Action Relief with Respect to Cleared Over-the-Counter Options for Purposes of Rules 15c3-1 and 15c3-1a

Dear Mr. Brown:

In your November 7, 2013 letter, you request assurance that the staff of the Division of Trading and Markets (“Division”) will not recommend enforcement action to the Securities and Exchange Commission (“Commission”) against broker-dealers with respect to certain provisions of Rules 15c3-1 and 15c3-1a¹ as applied to cleared over-the-counter options issued by a securities clearing agency registered under Section 17A of the Securities Exchange Act of 1934² (“OTC Options”), under the facts and representations set forth in your letter.

OCC OTC Options

The Options Clearing Corporation (“OCC”) proposed, and the Commission approved, a rule change to establish a legal and operational framework for OCC to provide central clearing of OTC Options on the S&P 500 Index.³ OCC may propose to clear OTC options on other indices and on individual equity securities in the future, subject to Commission approval of one or more additional rule filings.

¹ 17 CFR 240.15c3-1 and 15c3-1a.

² 15 U.S.C. 78q-1.

³ See Securities Exchange Act Release No. 67835 (Sept. 12, 2012), 77 FR 57602 (Sept. 18, 2012), (SR-OCC-2012-14); see also Securities Exchange Act Release No. 68434 (Dec. 14, 2012), 77 FR 75243 (Dec. 19, 2012) (approving proposed rule change). OCC also filed, and received accelerated approval of, a proposed rule change to reflect enhancements in its system for theoretical analysis and numerical simulations as applied to longer-tenor options. Securities Exchange Act Release No. 70719 (Oct. 18, 2013), 78 FR 63548 (Oct. 24, 2013), (SR-OCC-2013-16).

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You state that the OTC Options are more like listed options, particularly exchange-traded standardized equity index options called FLEX Options that allow for customization of certain terms, than they are like bilateral options. Similar to FLEX Options, OTC Options referencing the S&P 500 Index will allow for customization of a limited number of terms. Transactions in OTC Options will not be exchange-traded, but instead will be bilateral trades submitted to OCC for clearance through one or more providers of trade affirmation services. OTC Options will be carried in a clearing member's OCC clearing accounts, with proprietary positions carried in the clearing member's firm account, and customer positions in its securities customers' account. Positions in OTC Options will be margined at OCC in the omnibus customers' account on the same basis as listed options.

OCC expects to clear OTC Options subject to the same basic rules and procedures used for the clearance of listed index options, with such modifications as are necessary to reflect the unique characteristics of OTC Options.⁴ OCC rules will require that counterparties to OTC Options be eligible contract participants and that the transactions be cleared through an OCC clearing member that is registered with the Commission as a broker-dealer or one of the small number of clearing members that are "non-U.S. securities firms," as defined in OCC's By-Laws. OCC is not requiring clearing members to meet any different financial standards for clearing OTC Options, other than those to which they are presently subject. However, clearing members must be specifically approved by OCC to clear OTC Options through the submission of a business expansion request and completion of an operational review. Clearing members that carry customer positions in OTC Options will be subject to all OCC rules governing OCC-cleared options generally, as well as all applicable rules of the Commission and of any self-regulatory organization ("SRO") of which they are a member, including the Financial Industry Regulatory Authority, Inc. ("FINRA").

Exercise of an OTC Option will result in delivery of cash on the business day following exercise in exactly the same manner as cash is delivered in connection with exercise settlement of listed index options. The exercise-settlement amount of an OTC Option will be equal to the difference between the current value of the underlying index and the exercise price of the OTC Option, times the notional value that determines the size of the OTC Option. In the case of an OTC Option on the S&P 500 Index, the multiplier will be fixed at 1.⁵ Accordingly, as described below, OCC is requesting that OTC options be treated as listed options for certain purposes under Rules 15c3-1 and 15c3-1a.

⁴ OCC's Bylaws will define the term "OTC option" to mean an option contract, "with variable terms that are negotiated bilaterally between the parties to such transaction...and that is affirmed through the facilities of an OTC Trade Source and submitted to [OCC] for clearing as a confirmed trade." See Securities Exchange Act Release No. 68434 (Dec. 14, 2012), 77 FR 75243 (Dec. 19, 2012) (approving proposed rule change).

⁵ This differs from listed options, for which the multiplier is fixed at 100.

Treatment of OTC Options under Rules 15c3-1 and 15c3-1a

Paragraph (a)(6)(i) of Rule 15c3-1 allows market makers, specialists, and certain other dealers who meet the conditions of paragraph (a)(6)(ii) to elect to apply paragraph (a)(6)(iii) of Rule 15c3-1, in lieu of the “haircuts” required under paragraph (c)(2)(vi) or Appendix A. Under paragraph (a)(6)(ii) of Rule 15c3-1, paragraph (a)(6) is available only to a dealer who, among other things, “does not effect transactions in options not listed on a registered national securities exchange or facility of a registered national securities association” and “whose market maker or specialist transactions are effected through and carried in a market maker or specialist account cleared by another broker or dealer as provided in paragraph (a)(6)(iv).”⁶ You state that the prohibition against trading in unlisted options could be interpreted to prevent a market maker that wants to qualify for paragraph (a)(6) treatment under Rule 15c3-1 from using OTC Options to hedge its market making activity. You believe that would be an inappropriate result that was not intended when the rule was adopted. Accordingly, OCC is seeking no-action relief from the staff to permit OTC Options to be treated the same as other listed options for purposes of paragraph (a)(6) of Rule 15c3-1 so that marker makers may trade in OTC Options without making themselves ineligible for paragraph (a)(6) capital treatment. You believe this result is consistent with the intended effect of paragraph (a)(6) of Rule 15c3-1.

Because paragraph (a)(6)(iii)(A) of Rule 15c3-1 references paragraph (c)(2)(x) of the rule (relating to broker-dealers carrying accounts of listed options specialists), and because paragraph (c)(2)(x)(A) references listed options, you state corresponding relief also would be required under paragraph (c)(2)(x) of Rule 15c3-1 to define an OTC Option as a “listed option” under paragraph (c)(2)(x)(B)(1) of Rule 15c3-1.

Finally, OCC believes that the OTC Options should be treated the same as listed options for purposes of applying risk-based haircuts under Appendix A to Rule 15c3-1.⁷ A broker-dealer is permitted, pursuant to Appendix A of Rule 15c3-1, to use an approved theoretical options pricing model to calculate capital charges for listed options and related futures and futures options positions.⁸ OCC is seeking relief to permit broker-dealers to apply risk-based haircuts under Appendix A to Rule 15c3-1 to their positions in OTC Options.

⁶ 17 CFR 240.15c3-1(a)(6).

⁷ 17 CFR 240.15c3-1a.

⁸ *Id.*

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Response

Based on the facts and representations set forth in your letter, and without necessarily agreeing with your conclusions and analysis, the Division will not recommend to the Commission that enforcement action be taken pursuant to Exchange Act Rules 15c3-1 or 15c3-1a, if a broker-dealer treats an OTC Option as:

1. An option “listed on a registered national securities exchange or facility of a registered national securities association” for purposes of paragraph (a)(6)(ii) of Rule 15c3-1, when acquired in a market maker or specialist transaction.
2. A “listed option” under paragraph (c)(2)(x)(B)(1) of Rule 15c3-1;⁹ *provided however*, that, for purposes of calculating the required deductions under Appendix A to Rule 15c3-1, the minimum capital charge for each OTC Option under Appendix A to Rule 15c3-1 will be \$0.75, adjusted as appropriate for the size of the OTC Option, not to exceed the market value in the case of long contracts in OTC Options.¹⁰

In addition, in cases where paragraph (g)(7)(B) of FINRA Rule 4210, paragraph (e)(2) of CBOE Rule 12.4, or a comparable SRO rule applies, a broker-dealer must substitute “\$0.75” for “\$.375,” in calculating the amount of margin required; *provided, however*, a broker-dealer may, in lieu of collecting the specified minimum required margin, apply a 100% capital charge when computing its net capital under Rule 15c3-1 in an amount equal to the difference between the margin amount required by this paragraph and the amount of margin collected from the customer for each OTC Option.¹¹

⁹ Appendix A to Rule 15c3-1 defines the term “unlisted option” as “any option not included in the definition of listed option provided in paragraph (c)(2)(x) of § 240.15c3-1.” 17 CFR 240.15c3-1a(a)(1). Consequently, because an OTC Option would be included within the definition of listed option under paragraph (c)(2)(x)(B)(1) of Rule 15c3-1 for purposes of this no-action letter, an OTC Option would also be considered a listed option for purposes of Appendix A to Rule 15c3-1.

¹⁰ Firms entering into OTC Options specify a notional value of the index, in contrast to standardized options for which firms specify a number of contracts. The multiplier for OTC Options is fixed at 1 (*i.e.*, equal to the value of the S&P 500 Index), instead of 100. Therefore, taking as an example an OTC Option on the S&P 500 Index with a \$30 million notional value, assuming that the current level of the S&P 500 index is 1,500, the minimum net capital charge would be equal to: $\$0.75 \times (\$30,000,000/1,500) = \$15,000$.

¹¹ Broker-dealers must still comply with applicable SRO margin rules with respect to OTC Options.

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This position is based strictly on the facts and representations you have made in your letter, and any different facts or representations might require a different response. This position is subject to modification or revocation at any time the staff determines that such modification or revocation is consistent with the public interest or the protection of investors. Furthermore, this response expresses a staff position on enforcement action only and does not purport to express any legal conclusions on the questions presented. The Division expresses no view with respect to any other questions that the proposed activities may raise, including the applicability of any other federal or state laws, or SRO rules.

Sincerely,



Michael A. Macchiaroli
Associate Director

cc: Rudolph Verra, FINRA
Kathryn Moore, FINRA