

## Chapter 13

# SROs, Marketplaces and Clearing Agencies

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### 13.3 Clearing Agencies

#### 13.3.1 OSC Notice and Request for Comment – The Options Clearing Corporation – Application for Exemption from Recognition as a Clearing Agency

##### OSC NOTICE AND REQUEST FOR COMMENT

##### THE OPTIONS CLEARING CORPORATION

##### APPLICATION FOR EXEMPTION FROM RECOGNITION AS A CLEARING AGENCY

#### A. Background

The Options Clearing Corporation (OCC) has applied (Application) to the Commission for an order pursuant to section 147 of the *Securities Act* (Ontario) (Act) to exempt OCC from the requirement to be recognized as a clearing agency in subsection 21.2(0.1) of the Act. Among other factors set out in the Application, the exemption is being sought on the basis that OCC is subject to an appropriate regulatory and oversight regime in its home jurisdiction of the United States (U.S.) by the Securities and Exchange Commission and the Commodity Futures Trading Commission.

OCC was organized under the laws of the state of Delaware and was founded in 1973. It currently clears and settles transactions in options and futures made on U.S. securities and futures exchanges, and stock loans.

In reviewing the Application, staff followed the process and assessed the Application against the criteria set out in OSC Staff Notice 24-702 *Regulatory Approach to Recognition and Exemption from Recognition of Clearing Agencies* (Staff Notice).

#### B. Draft Order

In the Application, OCC describes how it addresses each of the criteria set forth in Appendix A to the Staff Notice. Subject to comments received, staff propose to recommend to the Commission that it grant OCC an exemption order with terms and conditions in the form of the proposed draft order (Draft Order).

The Draft Order requires OCC to comply with various terms and conditions, including relating to:

1. Regulation of OCC
2. Filing requirements
3. Submission to jurisdiction and agent for service
4. Information sharing

#### C. Comment Process

The Commission is publishing for public comment the Application and Draft Order. We are seeking comment on all aspects of the Application and Draft Order.

You are asked to provide your comments in writing, via e-mail and delivered on or before **September 22, 2012** addressed to the attention of the Secretary of the Commission, Ontario Securities Commission, 20 Queen Street West, Toronto, Ontario, M5H 3S8, e-mail: [comments@osc.gov.on.ca](mailto:comments@osc.gov.on.ca).

The confidentiality of submissions cannot be maintained as comments received during the comment period will be published.

Questions may be referred to:

Timothy Baikie  
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August 17, 2012

Ontario Securities Commission  
20 Queen Street West  
Suite 1903  
Toronto, Ontario  
Canada M5H 3S8

**Attention: Timothy Baikie, Senior Legal Counsel, Market Regulation**

Dear Mr. Baikie:

**Re: The Options Clearing Corporation Application for Relief**

We are Canadian counsel to The Options Clearing Corporation (“OCC”) in connection with this amended application to the Ontario Securities Commission (“OSC”) (i) for an exemption from section 21.2(0.1) of the *Securities Act* (Ontario) (“OSA”) pursuant to section 147 of the OSA relating to OCC’s business as a clearing agency with respect to options, futures, options on futures and stock loan transactions as more fully described herein, and (ii) for a further variation of the March 1, 2011 interim order pursuant to section 144 of the OSA to extend the termination date to the earlier of (a) November 30, 2012, and (b) the effective date of a subsequent order exempting OCC from the requirement to be recognized as a clearing agency pursuant to section 21.2(0.1) of the OSA.

### **PART I INTRODUCTION**

#### **1. OCC Services to Ontario Residents**

OCC currently has five (5) direct OCC clearing members that have a head office or principal place of business in Ontario (collectively, “Ontario Clearing Members”). Additionally, OCC currently has one (1) approved clearing bank with a head office or principal place of business in Ontario. As an OCC approved clearing bank, the bank provides settlement services for exchange transactions on behalf of the five (5) Ontario Clearing Members. Such services may include, but not be limited to, the payment and release of margin, payment and rebate of fees, and the payment and withdrawal of option premiums.

OCC initiates no direct contact with Canadian clients of Ontario Clearing Members. OCC does not have any office or maintain other physical installations in Ontario or any other Canadian province or territory.

OCC currently offers a wide range of clearing products to the Ontario-resident clearing members described above, including the following:

- (i) Options on equity securities (including exchange-traded funds);
- (ii) Options on stock indices (including volatility indices);
- (iii) Foreign currency options;
- (iv) Interest rate options (cash settled options on the yields of United States (“U.S.”) Treasury securities);
- (v) Credit default options;
- (vi) Interest rate futures;
- (vii) Security futures, including single stock futures and narrow - based stock index futures;
- (viii) Broad-based stock index, volatility and variance futures;
- (ix) Options on commodity futures; and
- (x) Stock loan transactions.

## 2. Background to the Application

On January 10, 2011, OCC applied for an order from the OSC for an exemption on an interim basis from the requirement to be recognized as a clearing agency. The OSC granted the order on March 1, 2011, and subsequently varied the order on August 19, 2011 to extend the termination date to the earlier of (i) September 1, 2012, and (ii) the effective date of a subsequent order exempting OCC from the requirement to be recognized as a clearing agency pursuant to section 21.2(0.1) of the OSA. OCC currently carries on business in Ontario pursuant to the March 1, 2011 interim order, as varied on August 19, 2011.

OCC submitted this application to the OSC for (i) relief pursuant to section 147 of the OSA exempting OCC from the requirement to be recognized as a clearing agency pursuant to section 21.2(0.1) of the OSA, and (ii) for a further variation of the March 1, 2011 interim order pursuant to section 144 of the OSA to extend the termination date to the earlier of (a) November 30, 2012, and (b) the effective date of a subsequent order exempting OCC from the requirement to be recognized as a clearing agency pursuant to section 21.2(0.1) of the OSA. Part III of this application explains how OCC meets the relevant criteria for recognition and exemption for clearing agencies set out in Appendix A to OSC Staff Notice 24-702 – *Regulatory Approach to Recognition and Exemption from Recognition of Clearing Agencies*.

## PART II BACKGROUND

### 1. Regulatory Oversight of OCC

#### A. United States

Founded in 1973, OCC is the world's largest equity derivatives clearing organization (“DCO”). OCC is a corporation organized under the laws of the state of Delaware. OCC is registered as a derivatives clearing agency under Section 17A of the U.S. *Securities Exchange Act of 1934*, as amended (“**Exchange Act**”) and as a DCO under section 7a-1 of the U.S. *Commodity Exchange Act* (“**CEA**”). OCC has been designated by the U.S. Financial Stability Oversight Council (“**FSOC**”) as a “systematically important” financial market utility under Title VIII of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (“**Dodd-Frank**”).

In the U.S., OCC operates under the jurisdiction of both the Securities and Exchange Commission (“**SEC**”) and the Commodity Futures Trading Commission (“**CFTC**”). Under the SEC’s jurisdiction, OCC clears or is qualified to clear transactions in “standardized options,” as defined in SEC regulations. These include options on common stocks and other equity issues, stock indices (including volatility, variance, and strategy-based indices), foreign currencies, interest rate composites, and credit default options. Credit default options relate to the credit risk presented by one or more specified debt securities (i.e., reference obligation(s)), of one or more specified issuers or guarantors (i.e., each a reference entity), and are automatically exercised and pay a fixed cash settlement amount if a credit event is confirmed for one or more reference obligations of a reference entity prior to expiration of the option. Under SEC jurisdiction, OCC also clears futures on single equity issues and narrow-based stock indices (“**security futures**”). As a registered DCO under CFTC jurisdiction, OCC offers clearing and settlement services for transactions in commodity futures (i.e., futures other than security futures) and options on commodity futures. OCC also intends to clear OTC derivatives beginning in late 2012 or in the first quarter of 2013.

The derivatives contracts traded on U.S. exchanges, of which OCC is also the nominal “issuer”, are sold by regulated foreign market participants worldwide. OCC is primarily regulated by the SEC and CFTC in the U.S. OCC is not subject to regulatory oversight by any other foreign securities or futures regulatory authority in any jurisdiction outside the U.S., including in the United Kingdom, Continental Europe, and Australia, or by any other Canadian provincial or territorial securities regulatory authority.

OCC is registered as a clearing agency with the SEC and as a DCO with the CFTC. The Exchange Act establishes conditions that registered clearing agencies must satisfy relating to, among other things, the clearing agency’s capacity to promptly and accurately clear and settle transactions, safeguarding of funds and securities, enforcement of the clearing agency’s rules, equitable allocation of fees and charges among participants, and avoiding any unnecessary burden on competition. Similarly, the CEA establishes core principles with which registered DCOs must comply relating to, among other things, financial resources, appropriate admission and eligibility standards for participants, risk management, timely completion of settlements, ensuring the safety of funds and enforcement of the DCO’s rules.

OCC is subject to examination by both the SEC and CFTC, and virtually all OCC rule changes are filed with both regulatory agencies. However, because the overwhelming majority of OCC’s business relates to clearing securities, the CFTC historically has deferred to the SEC as the lead regulator except in connection with matters specifically related to the clearing of transactions in commodity futures, options on such futures or other products subject to the CFTC’s jurisdiction and compliance with the CEA and the CFTC’s regulations thereunder. Following OCC’s designation by FSOC as a “systematically important” financial market utility, the SEC is now OCC’s supervisory agency.

**B. Canada**

In Canada, OCC has received exemptions or relief from the following Canadian jurisdictions:

Alberta	The Alberta Securities Commission has designated OCC as an “acceptable clearing corporation” for purposes of Alberta Securities Commission Blanket Order 91-503 <i>Over-the-Counter Derivatives Transactions and Commodity Contracts</i> .
British Columbia	The British Columbia Securities Commission has issued BC Instrument 21-501 <i>Recognition of exchanges, self-regulatory bodies, and jurisdictions</i> , which recognizes certain U.S. exchanges for which OCC clears.
Manitoba	The Manitoba Securities Commission has granted an order (Order No. 5575) for an exemption from the application of section 37 of <i>The Securities Act</i> (Manitoba) with respect to any options cleared by OCC and that currently trade or may trade on a U.S. exchange.
New Brunswick	The New Brunswick Securities Commission has granted an order (Order No. 2005-80306) for an exemption from the application of sections 45 and 71 of the <i>Securities Act</i> (New Brunswick) with respect to trades in any options, futures and options on futures cleared by OCC that currently, or may in the future, trade on any or all of certain prescribed U.S. exchanges.
Newfoundland and Labrador	The Prince Edward Island Director of Securities has designated OCC as a “Recognized Clearing Organization” for purposes of Blanket Order No. 26.
Nova Scotia	The Nova Scotia Securities Commission issued a ruling on July 20, 2005 that sections 31 and 58 of the <i>Securities Act</i> (Nova Scotia) shall not apply to trades in any options, futures and commodity options cleared by OCC that currently, or may in the future, trade on any or all of certain prescribed U.S. exchanges, provided that each trade is conducted through a Nova Scotia dealer.
Ontario	The Ontario Securities Commission has granted an interim order exempting OCC from the requirement in subsection 21.2(0.1) of the OSA to be recognized as a clearing agency.
Prince Edward Island	The Prince Edward Island Registrar of Securities has issued a ruling on July 30, 2005 that sections 2 and 8 of the <i>Securities Act</i> (Prince Edward Island) shall not apply to trades in any options, futures and commodity options cleared by OCC that currently, or may in the future, trade on any or all of certain prescribed U.S. exchanges, provided that each trade is conducted through a Prince Edward Island dealer.
Quebec	The Autorité des marchés financiers has issued a decision (Decision No. 2010-PGD-0206) granting an exemption from the qualification and authorization requirements concerning the creation or marketing of derivatives pursuant to the <i>Derivatives Act</i> (Quebec) (“QDA”).
Saskatchewan	The Saskatchewan Financial Services Commission has issued General Ruling/Order 11-901 <i>Recognition Order</i> , which recognizes certain U.S. exchanges for which OCC clears.

In Alberta, British Columbia and Saskatchewan, exchange-traded security futures, broad-based stock index futures and options thereon are covered by the definition of “exchange contracts” under their respective securities legislation. In addition, registered dealers in each of these provinces are permitted to trade exchange-traded futures and options on futures provided that such futures and options are listed on a “recognized exchange” and the registered dealer provides clients with the specified risk disclosure document. As a result, OCC is not required to register with any of the securities commissions of these provinces or prepare and file any documentation in connection with OCC’s U.S. clearing activities in respect of exchange-traded security futures, broad-based stock index futures and options thereon that it intends to clear for Canadian registered dealers. However, OCC has received relief from the securities commissions of these provinces with respect to updating the list of “recognized exchanges” that they each maintain.

In New Brunswick, Nova Scotia, Prince Edward Island and Newfoundland and Labrador, the securities legislation of these provinces either does not regulate the trading of exchange-traded futures contracts and options on futures contracts or does not recognize OCC as a recognized clearing corporation for the purposes of clearing these products. However, OCC has

received exemptions from the obligations contained in the securities legislation of each of these provinces in respect of OCC's clearing activities for Canadian dealers.

In Manitoba and Ontario, exchange-traded futures contracts and options on futures contracts are covered by the definition of "commodity futures contract" and "commodity futures option" under their respective commodities futures legislation. Additionally, physically-settled securities futures, cash-settled security futures and broad-based stock index futures and options may be considered to be securities, and therefore subject to the securities legislation of these provinces. OCC has received exemptions from the registration and prospectus requirements under the securities legislation of Manitoba and Ontario with respect to security futures, broad-based index futures, options on security futures and options on broad-based index futures.

In Quebec, the QDA governs transactions involving both over-the-counter and exchange-traded derivatives, which includes Canadian and non-Canadian listed futures, options on futures and security options, and imposes a qualification requirement on a person, other than a recognized regulated entity, who creates or markets a derivative before the derivative is offered to the public. OCC has received an exemption from certain requirements of the QDA in connection with its business and operations as a clearing house, subject to conditions.

## **2. Ownership of OCC**

OCC is owned equally by the following five (5) participant securities exchanges that trade options, all of which are currently registered with the SEC:

- (i) Chicago Board Options Exchange;
- (ii) International Securities Exchange;
- (iii) NYSE Amex (formerly the American Stock Exchange);
- (iv) NYSE Arca (formerly the Pacific Stock Exchange); and
- (v) NASDAQ OMX PHLX (formerly the Philadelphia Stock Exchange).

Prior to becoming a participant securities exchange, each of the options exchanges above was registered as a national securities exchange under the Exchange Act, and (i) had effective rules for the trading of option contracts in accordance with the provisions of the Exchange Act and the rules and regulations of the SEC thereunder, (ii) had purchased the number of shares of the common stock of OCC set forth in Article VIIA, Section 2 of OCC's By-Laws, (iii) had executed a stockholders agreement as described in Article VIIA, Section 3 of OCC's By-Laws, and (iv) had furnished OCC with such information OCC requested concerning the operations, the management, the rules and the membership of such exchange and such other information as OCC required to amend or make current any registration statement of OCC filed with the SEC or other regulatory authority.

Until 2002, options exchanges that wished to have OCC clear for them were required to purchase stock in OCC. In 2002, the SEC approved a rule change eliminating that requirement.

In addition to the five (5) stockholder exchanges, OCC also has the following five (5) non-equity participant exchanges, as well as a number of futures exchanges:

- (i) BATS Exchange, Inc.;
- (ii) C2 Options Exchange, Inc.;
- (iii) Nasdaq OMX BX, Inc.;
- (iv) The Nasdaq Stock Market, LLC; and
- (v) BOX Options Exchange, LLC.

Pursuant to OCC's By-Laws, the non-equity participant exchanges are required to hold promissory notes. There is no similar requirement for the stockholder exchanges.

Pursuant to OCC's By-Laws, any securities exchange or securities association registered under the Exchange Act, which (i) has effective rules for the trading of option contracts in accordance with the provisions of the Exchange Act and the rules and regulations of the SEC thereunder, (ii) has purchased a Promissory Note of OCC as required pursuant to Article VIIB, Section 2 of OCC's By-Laws, (iii) has executed a noteholders agreement as described in Article VIIB, Section 3 of OCC's By-Laws, and (iv) has furnished OCC with such information as OCC may reasonably request concerning the operations, the

management, the rules and the membership of such exchange or association and such other information as OCC may require to amend or make current any registration statement of OCC filed with the SEC or other regulatory authority, shall be qualified for participation in OCC as a "Non-Equity Exchange".

OCC currently clears options traded on the U.S. securities exchanges named above, security futures traded on OneChicago, LLC, and commodity futures and in some cases options on commodity futures traded on four (4) U.S. futures exchanges. OCC also clears stock loan transactions executed on a broker-to-broker basis and on AQS, an electronic trading platform regulated by the SEC as an automated trading system and by the U.S. Financial Industry Regulatory Authority ("FINRA") as a broker-dealer.

OCC operates as a not-for-profit industry utility and refunds excess revenues to its members.

### **3. Products Cleared by OCC**

OCC currently clears the products listed in "Part I – Introduction".

New Equity options with standard contract terms are submitted to OCC under the Options Listing Procedures Plan guidelines without oversight by OCC Product Development Staff. All new non-equity options and futures products are evaluated by OCC staff for clearance and settlement by OCC according to the following general guidelines:

**1. Does the product fit within existing Regulatory frameworks?**

Staff will review OCC and Exchange rules, the Options Disclosure Document, and any jurisdictional issues presented by the product.

**2. Does OCC require systemic or processing changes relating to the new product?**

Staff will review OCC risk management systems and policies, clearing, settlement & collateral systems and processes.

**3. Is the clearing community ready to process the product?**

Staff will investigate and required modifications to Clearing Member risk management, clearing, settlement & collateral systems and processes.

The process for reviewing and approving a new product starts with a participant exchange notifying OCC that it would like to list a new product. The exchange will be asked to supply product specifications, draft rule filings, and additional pertinent information on the derivative and the underlying asset. Staff performs an initial review of the materials submitted by the requesting exchange, and may request further information and/or clarification, as needed. OCC Product Development Staff will, at a minimum, consider the following high level areas when analyzing the new product:

- Exchange Capability & Eligibility
- Product Set-Up
  - Underlying Instrument
  - Option Product and Series
  - Futures Product and Contract
- New and replacement Series / futures contract processing
- Product daily pricing issues
  - Option Prices
  - Futures Prices
  - Underlying Prices

- Ability for OCC and Clearing Members to process the product within their automated systems, including the following key clearing functions:
  - Trade Processing & Balancing
  - Post Trade Processing & Balancing
  - Cash transactions and settlement
  - OCC CM Account Capability & Eligibility
  - Position Accounting
  - Window Control
  - Margins & Risk Management
  - Exercise/Assignment and Expiration Processing
  - Delivery Settlement
  - Billing
  - Clearing data transmissions

OCC Product Development staff will review each of these areas, as well as, any other impacts or novel features that the new product may impose and discuss them with the appropriate parties. The process may be interactive with the exchange and potentially other involved parties such as participant banks, vendors, service bureaus, and Clearing Members until all issues are resolved.

After all of the above steps have been completed and the exchange has completed its rule making, operational and systems updates, OCC presents new products to its Board for approval to file rules.

#### **4. OCC Members**

OCC has approximately 120 clearing members who are U.S. registered broker-dealers, futures commission merchants and non-U.S. securities firms.

### **PART III APPLICATION OF APPROVAL CRITERIA TO OCC**

#### **1. Governance**

##### **1.1 The governance structure and governance arrangements of the clearing agency ensures:**

##### **1.1 (a) effective oversight of the clearing agency:**

OCC's governance structure dates from 1975, when it was converted from a wholly-owned subsidiary of the Chicago Board Options Exchange ("CBOE") to an industry utility that clears for all U.S. options exchanges. OCC's stock is owned equally by five (5) U.S. options exchanges.

Effective as of March 2012, OCC's board of directors consists of 18 members:

- Nine (9) Member Directors nominated by a seven (7) member Nominating Committee composed of one (1) Public Director and six (6) Clearing Member representatives;
- Five (5) Exchange Directors, appointed by OCC's five (5) stockholder exchanges;
- Three (3) Public Directors unaffiliated with any exchange or broker-dealer; and
- OCC's Chairman, who serves ex officio as OCC's Management Director.

This board structure is supported by charter and by-law provisions and a stockholders' agreement obligating the stockholder exchanges to vote their shares (i) for the candidates for Member Director nominated by the Nominating Committee,

(ii) for the candidates for the following year's Nominating Committee nominated by the current year's Nominating Committee, (iii) for the person nominated by the Chairman, with the approval of the board of directors, for Public Director, and (iv) for OCC's Chairman as Management Director. The Nominating Committee holds irrevocable proxies to vote the exchanges' shares as required by these provisions.

The board has three (3) standing committees: the Performance Committee, the Membership/Risk Committee, and the Audit Committee. The Performance Committee is responsible for evaluating the performance of OCC and its management and overseeing employee compensation and benefits. The Membership/Risk Committee is responsible for overseeing the administration of OCC's membership requirements and risk management systems, and for periodically reviewing such requirements and systems and making recommendations to the board. The Audit Committee is responsible for overseeing management's conduct of OCC's financial reporting process, system of internal control, and auditing and accounting processes.

OCC believes that the board committee structure described above, the industry background and expertise of its Member Directors and Exchange Directors, and its heavily regulated status as both a securities clearing agency regulated by the SEC and a DCO regulated by the CFTC, together ensure effective oversight. OCC expects to be designated by the newly-organized Financial Stability Oversight Council ("FSOC") as a "designated financial market utility," in which case it will also become subject to supervision by the Board of Governors of the Federal Reserve System.

OCC's Management is under the general direction of its Board of Directors. OCC's Board ordinarily holds five (5) regularly scheduled meetings and several special meetings as needed annually to address specific issues. OCC's Board is active and engaged, and specific areas of OCC's activities are subject to the additional oversight of the Performance Committee, the Membership/Risk Committee, and the Audit Committee, whose membership is in each case suited to the functions of the particular committee.

**1.1 (b) the clearing agency's activities are in keeping with its public interest mandate**

OCC's Mission and Values Statement states that:

*"The Options Clearing Corporation is a customer-driven clearing organization that delivers world-class risk management, clearance and settlement services at a reasonable cost; and provides value-added solutions that support and grow the markets we serve."*

The fact that a majority of OCC's directors are drawn from its clearing members is consistent with its mandate as a customer-driven organization. OCC is operated as a nonprofit market utility, refunding any excess profits to its clearing members. Because it is the members who use OCC's services and pay OCC's fees, their representatives on OCC's board have an incentive to ensure that OCC delivers quality clearance and settlement services at a reasonable cost, consistent with its mandate. Because the consequences of any failure of OCC's risk management systems will be borne by clearing members, who support OCC's multibillion dollar clearing fund, OCC's Member Directors have an incentive to ensure that OCC has state-of-the-art risk management systems, also consistent with its mandate. At the same time, OCC's Exchange Directors have an incentive to ensure that OCC properly supports the markets that it serves. OCC's governance structure is thus calculated to ensure that its activities are in keeping with its public interest mandate.

OCC calculates monthly clearing fees for all Clearing Members and collects fees directly from the Clearing Member. OCC does not have any requirements on how Clearing Members should charge their customers. Likewise, when there are excess profits, OCC refunds the profits to the Clearing Members allocated based on clearing fees collected. OCC does not have any requirements on how the Clearing Members use their refund.

**1.1 (c) fair, meaningful and diverse representation on the governing body (Board) and any committees of the Board, including a reasonable proportion of independent directors**

OCC is engaged in a highly specialized business, and benefits greatly from the industry expertise of its Member Directors and Exchange Directors. However, both the SEC and the CFTC have proposed rules that could require OCC to add a substantial number of independent directors and alter the composition of its Membership/Risk Committee. OCC has filed comment letters with both the SEC and the CFTC regarding the proposed rules in which OCC has identified various concerns that it has with respect to the proposals, in particular the requirements relating to independent directors (in the case of the SEC) or public directors (in the case of the CFTC) as they apply to a not-for-profit, market utility such as OCC. While OCC would prefer that the SEC and CFTC modify the proposed rules in the manner set forth in OCC's comment letters, OCC will of course comply with the rules that are ultimately adopted as applicable.

OCC's comment letter to the SEC can be found at <http://www.sec.gov/comments/s7-27-10/s72710-76.pdf>. OCC's comment letter to the CFTC is included as Appendix II to the SEC comment letter.



**1.1 (d) a proper balance among the interests of the owners and the different entities seeking access (participants) to the clearing, settlement and depository services and facilities (settlement services) of the clearing agency**

As was noted above, five (5) of OCC's eighteen (18) directors are appointed by stockholders and nine (9) by participants. OCC believes that this strikes an appropriate balance between the interests of owners and participants.

Section 17A(b)(3)(C) of the Exchange Act prohibits the SEC from registering a clearing agency unless the SEC determines that:

*"The Rules of the clearing agency assure a fair representation of its shareholders (or members) and participants in the selection of its directors and administrators of its affairs."*

This requirement is very similar to the OSC's criterion 1.1(d). The SEC has determined that OCC's Rules satisfy its registration requirements, including Section 17A(3)(C).

In order to address the requirement of fair representation, OCC's charter and by-laws require that nine (9) of OCC's eighteen (18) directors be directors, senior officers, principals, or general partners of clearing member organizations. Candidates for Member Director must be nominated either by the Nominating Committee, which is composed of one (1) Public Director and six (6) Clearing Member representatives, or by a petition signed by a specified number of clearing members.

The Nominating Committee is composed of seven (7) members, consisting of one (1) Public Director and six (6) members who represent clearing member organizations ("Non-Director Members"). The Public Director member serves for a term of three (3) years. The six (6) Non-Director Members are divided into two (2) equal classes elected for staggered two (2) year terms. Prior to each annual meeting of stockholders, the Nominating Committee nominates a slate of nominees for election to the class of Member Directors and to the class of Nominating Committee members whose terms expire at that meeting. In selecting such nominees, the Nominating Committee seeks to achieve balanced representation among Clearing Members, giving due consideration to the various business activities of different categories of Clearing Members and their geographical distribution. No person who is associated with the same Clearing Member Organization as a member of the Nominating Committee may be nominated by the Nominating Committee for a position as a Member Director or a Non-Director Member of the Nominating Committee for the ensuing year.

Clearing Members also have the right to nominate additional candidates for Member Director by filing a petition signed by a specified number of clearing members.

Each director is obligated as a matter of corporate law to act in good faith to promote the interests of OCC. This is true even if the director was elected to the Board because of his or her affiliation with a clearing member or an exchange.

**1.1 (e) the clearing agency has policies and procedures to appropriately identify and manage conflicts of interest;**

In 2004, OCC adopted a Code of Conduct for OCC Directors that reminds directors of their duty of loyalty to OCC, defines "conflict of interest," requires disclosure of conflicts of interest, and requires conflicted directors to recuse themselves from a discussion and/or vote if requested by the chair of the meeting.

The Code of Conduct has been adopted by the Board of Directors in order to reinforce and enhance OCC's commitment to doing business lawfully and ethically. The General Counsel is responsible for the monitoring and overseeing compliance by the directors and board committee members with the Code of Conduct. Additionally, the individual Member Directors and Exchange Directors are subject to a code of conduct with their respective regulated organizations.

All directors are required to comply with the Code of Conduct and annually certify that they have read and understood its contents and the consequences of non-compliance. The communication and certification is conducted at the Board's Annual Meeting. In certain extraordinary situations, a waiver of a provision of the Code of Conduct may be granted by the Chairman of the Board. Any such waiver must be promptly reported to the entire Board and disclosed as required by any applicable laws, rules and regulations.

Directors are required to communicate to the General Counsel or the Chairman of the Board any concerns, in good faith, that there has been a breach of a provision of the Code of Conduct. The Board (or its designee) has the independence and authority to utilize the services of any OCC personnel or retain any third party consultants and/or advisors determined to be appropriate under the circumstances to assist in the investigation of the violation. The Board shall determine appropriate and timely action to be taken in the event of a violation of the Code of Conduct, taking into account the nature and severity of the violation.

**1.1 (f) each director or officer of the clearing agency, and each person or company that owns or controls, directly or indirectly, more than 10 percent of the clearing agency is a fit and proper person; and**

OCC is not presently subject to any direct requirement to ensure that directors, officers, and 10% holders are “fit and proper” persons, but OCC certainly believes this to be the case. All of OCC’s directors are well-known within the securities industry. Member Directors associated with registered broker-dealers are subject to fitness requirements in that capacity. Exchange Directors are all senior officers of stockholder exchanges, and the backgrounds of the Public Director and the Management Director are well known to OCC’s management. OCC routinely conducts background checks on all new hires, including officers, and would not employ a candidate if a background check revealed that he or she was not a “fit and proper” person.

Proposed SEC rules would require clearing agencies to adopt governance standards (i) clearly articulating the roles and responsibilities of directors and board committee members, (ii) specifying director qualifications, (iii) specifying disqualifying factors, and (iv) specifying policies and procedures for periodic review by the board or a committee of the performance of individual directors.

Proposed CFTC rules would require DCOs, including OCC, to establish and enforce appropriate fitness standards for directors, members of any disciplinary committee, members of the DCO, any other party with direct access to the DCO’s clearance and settlement activities, and parties affiliated with any of the foregoing.

OCC intends to comply with the proposed SEC and CFTC governance requirements described above. OCC has filed fitness standards to comply with the DCO rules, which are already in effect.

**1.1 (g) there are appropriate qualifications, limitation of liability and indemnity provisions for directors and officers of the clearing agency**

Qualifications for OCC directors are set forth in Article III of OCC’s By-Laws. OCC has no formal qualifications for officers. Determinations as to whether a prospective officer is qualified for the position are made on a case by case basis.

Indemnification provisions for directors and officers are set forth in Article X of OCC’s By-Laws, and OCC carries US\$40 million of directors’ and officers’ liability insurance. Provisions exculpating directors, to the extent permitted by the Delaware General Corporation Law, from monetary liability to OCC or its stockholders for breach of fiduciary duty are set forth in Article VIII of OCC’s Certificate of Incorporation.

**2. Fees**

**2.1 All fees imposed by the clearing agency are equitably allocated. The fees do not have the effect of creating unreasonable barriers to access.**

OCC’s fees are the same for all products and clearing members, and OCC believes that its fees are the lowest of any DCO in the world. After refunds, OCC’s average fee for 2010 was 1.8 cents per 100-share contract, which is far too low to constitute a barrier to access.

Section 17A(b)(3)(D) of the Exchange Act prohibits the SEC from registering a clearing agency unless the SEC determines that:

*“The rules of the clearing agency provide for the equitable allocation of reasonable dues, fees, and other charges among its participants.”*

This requirement is quite similar to the OSC’s criterion 2.1(a). As noted above, the SEC has determined that OCC’s Rules satisfy its registration requirements, including Section 17A(3)(C), and OCC’s current fees are substantially lower than the fees in effect when the SEC made that determination.

**2.2 The process for setting fees is fair and appropriate, and the fee model is transparent.**

OCC’s policy is to set fees at the beginning of each year at a level conservatively estimated to cover its expenses. To do so, OCC’s policy is to maintain a retained earnings balance equal to or greater than 45% of the prior year’s cash operating expense. Fees and fee schedules are, at a minimum, reviewed annually to ensure that OCC revenue will exceed operating expenses for the current year.

OCC’s Schedule of Fees is transparent and fully disclosed on its public website at: <http://www.optionsclearing.com/membership/schedule-of-fees/>.

Historically, OCC has paid a refund back to the clearing membership once all retained earnings and capital expenditure requirements are met. This refund is approved by the Board of Directors.

### **3. Access**

#### **3.1 The clearing agency has appropriate written standards for access to its services.**

OCC's membership standards are set forth in Article V of its By-Laws. Initial and ongoing financial requirements for clearing membership are set forth in Chapter III of its Rules.

A clearing member applicant must be a broker-dealer or futures commission merchant ("**FCM**") with the SEC or CFTC, or a non-U.S. securities firm. U.S. broker-dealer applicants that desire to clear transactions in security futures must also either be fully registered or notice registered as U.S. FCMs. Fully registered U.S. FCMs may become clearing members of OCC for the purpose of clearing futures, options on futures and commodity options. FCMs that desire to clear transactions in security futures must also either be fully registered or notice registered as U.S. broker-dealers.

Non-U.S. firms may also become OCC clearing members. All non-U.S. firms are required to submit financial reports. Non-U.S. firms of certain countries are permitted to file financial statements consistent with the financial responsibility standards of their home countries (e.g., a Canadian clearing member firm that elects to be admitted as an exempt Non-U.S. Clearing Member may file a copy of its Joint Regulatory Financial Questionnaire and Report ("**JRFQR**") in accordance with the Investment Industry Regulatory Organization of Canada ("**IIROC**") rules instead of filing the financial reports applicable to U.S. clearing members). All other non-U.S. firms must meet the same financial reporting requirements as U.S. clearing members.

A clearing member applicant must meet minimum net capital requirements. This includes a minimum requirement equal to the greater of US\$2.5 million in initial net capital, 12.5% of aggregate indebtedness or 5% of aggregate debit items (in the case of a registered broker-dealer) or US\$2.5 million in adjusted net capital (in the case of a registered FCM). In the case of a Canadian clearing member that has been admitted as an exempt Non-U.S. Clearing Member, the Canadian clearing member must maintain an early warning reserve (as determined in accordance the JRFQR) of not less than the greater of US\$2 million or 2% of the Canadian clearing member's total margin required (as determined in accordance with the JRFQR). In addition, a clearing member applicant must have qualified staff and adequate facilities to self-clear options and interface with OCC and other clearing members. All clearing members must maintain adequate facilities and personnel to transact business in an orderly manner with OCC and its clearing members. For applicants with limited in-house operational capabilities, OCC accepts a facilities management relationship, an arrangement whereby one clearing member (the managed firm) authorizes another clearing member (the managing firm) to provide certain back-office services on its behalf. The arrangement is evidenced by a Facilities Management Agreement, which specifies services to be performed and the responsibilities of each party. Managing clearing members must also meet higher than normal financial requirements.

After submitting an application, a Pre-membership Examination is conducted by representatives from OCC's Regulation Department. The session consists of an examination of the firm's books and records and interviews with the firm's principals and compliance staff.

In addition, an Operations Orientation is conducted by representatives of OCC's Membership/Operations Services area. The meeting addresses OCC procedures, time frames, reports, input forms, exercise and assignment, exercise-by-exception ("**Ex-by-Ex**") procedures, OCC financial and operational services and general OCC information. Specifics of different option products are also reviewed.

A clearing member of OCC is also subject to ongoing requirements for clearing membership. OCC monitors the ongoing creditworthiness of its clearing members. Each member firm is required to file monthly financial statements with OCC's Financial Surveillance Department. The clearing member's financial condition is then evaluated in relation to predefined standards that are reviewed annually by the Membership/Risk Committee. Clearing members are also required to submit annual audited financial statements to OCC staff.

OCC has a financial reporting requirement known as an "early warning" notice. The early warning requirement imposes an obligation on clearing members to promptly notify OCC of certain material adverse changes in its financial condition.

OCC's surveillance staff also employs a variety of automated systems to continuously monitor the operational and financial condition of each clearing member in relation to general market conditions and such clearing member's exposure to market risk. First, OCC identifies those clearing members whose financial or operational condition has deteriorated over time by analyzing the trends in key financial ratios evidenced in monthly financial statements. Then, OCC identifies clearing members whose uncollateralized position risk exposure relative to capital proves excessive. The ultimate goal of the analysis is to provide corrective action in the form of higher margin requirements, reductions in the clearing member's positions, increased capital or some combination of these corrective actions.

There are no material differences in terms of membership standards and financial requirements between Canadian and U.S. Clearing Members.

**3.2 The access standards and the process for obtaining, limiting and denying access are fair and transparent. A clearing agency keeps records of:**

- (a) each grant of access including, for each participant, the reasons for granting such access, and
- (b) each denial or limitation of access, including the reasons for denying or limiting access to an applicant.

OCC believes that its access standards are fair and transparent. The process for reviewing membership applications and granting or denying access is set forth in detail in Article III, Section 2 of OCC's By-Laws. The process for obtaining membership at OCC consists of three (3) phases: documentation, a site visit, and approval.

Documentation

The application for OCC clearing membership must include the following documentation:

- OCC Pre-Qualification Online Application;
- Appropriate paperwork received from Pre-Qualification;
- FOCUS Report;
- Audited financial statements;
- Findings of securities and commodities regulators;
- US\$4,000 non-refundable qualification fee; and
- Brief resumes of staff responsible for purchase and sale statements, positions reconciliation and margin.

Site Visit

A Pre-membership Examination is conducted by representatives from OCC's Regulation Department. The session consists of an examination of the firm's books and records and interviews with the firm's principals and compliance staff.

An Operations Orientation is conducted by representatives of OCC's Membership/Operations Services area. The meeting addresses OCC procedures, time frames, reports, input forms, exercise and assignment, Ex-by-Ex procedures, OCC financial and operational services and general OCC information. Specifics of different option products are also reviewed.

Approval

The Applicant's designated examining authority ("DEA") is contacted for pertinent information relative to the firm's request for membership with OCC.

The findings of OCC staff from the meetings noted above and the comments from the DEA are submitted to OCC's Membership/Risk Committee (which is comprised of members of OCC's Board of Directors) and then to OCC's Board of Directors for membership approval. The membership application process may take up to twelve (12) weeks after receipt of a completed membership application.

OCC staff recommendations on membership applications, including the reasons therefor, are presented to OCC's Membership/Risk Committee and the briefing books containing those recommendations are preserved along with the minutes of the meeting. Denials of access are reviewable by the SEC under Section 19(f) of the Exchange Act.

**4. Rules and Rulemaking**

**4.1 The clearing agency's rules are designed to govern all aspects of the settlement services offered by the clearing agency, and**

- (a) are not inconsistent with securities legislation,

- (b) do not permit unreasonable discrimination among participants, and
- (c) do not impose any burden on competition that is not necessary or appropriate.

OCC has comprehensive rules governing all aspects of its services. All of its rules must be filed with the SEC and the CFTC, and most rules filed with the SEC require affirmative approval. Rules that do not require affirmative approval are generally subject to abrogation by the SEC or the CFTC.

OCC's Rules are not inconsistent with securities legislation, do not permit unreasonable discrimination among participants, and do not impose any burden on competition that is not necessary or appropriate. Section 17A(b)(3)(F) of the Exchange Act prohibits the SEC from registering a clearing agency unless it determines that the clearing agency's rules "are not designed to permit unfair discrimination in the admission of participants or among participants in the use of the clearing agency." Section 17A(b)(3)(I) of the Exchange Act requires a determination that "[t]he rules of the clearing agency do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of this title." The SEC would disapprove or abrogate a rule that it considered to be inconsistent with U.S. securities legislation, including the quoted language.

#### **4.2 The clearing agency's rules and the process for adopting new rules or amending existing rules should be transparent to participants and the general public.**

OCC's process for adopting and amending rules is entirely transparent. In most cases, OCC staff makes a written recommendation to the board of directors, explaining the need for the rule or amendment ("**rule change**"), and the board either votes on the proposed rule change (sometimes with changes agreed upon at the meeting) or defers it to a future meeting. Where a proposed rule change falls within the jurisdiction of a Board committee, staff makes its recommendation to the committee, and the committee in turn makes a recommendation to the Board.

When the Board approves a rule change, the rule change is filed with the SEC and the CFTC and posted to OCC's public website. The SEC publishes the rule change for comment in the *Federal Register*. Any written comments are published on the SEC's website. The SEC then determines whether to approve the rule change, or, in the case of a rule change filed for immediate effectiveness, whether to abrogate it.

The CFTC publishes the proposed rule change on its website. If OCC certifies that the rule change complies with the CEA and the CFTC's regulations thereunder, the rule change becomes effective automatically, subject to being stayed or altered by the CFTC. If OCC requests affirmative CFTC approval, the rule change becomes effective 45 (or, in certain cases, 90) days after filing unless the CFTC disapproves it within that period.

#### **4.3 The clearing agency monitors participant activities to ensure compliance with the rules.**

OCC regularly monitors clearing members' compliance with its financial requirements. Clearing members are required to file monthly financial reports with OCC. OCC staff monitors profits and losses, net capital, and other financial criteria that might negatively impact the member's financial condition. These criteria are reviewed on an absolute and trend basis not only to identify rule violations, but also to preemptively identify members approaching rule violations. More frequent reporting can be imposed in management's discretion. On a daily basis, OCC monitors position risk, periodically revaluing members' portfolios during the course of the day. If adverse market developments erode more than 50% of a member's risk margin, OCC may call for additional margin on an intraday basis. OCC's response to any violation is dependent on the nature of the violation and OCC's assessment of the situation. Non-financial requirements are generally of an operational nature, and noncompliance would ordinarily come to OCC's attention in the course of OCC's normal day-to-day operations.

In addition to the monitoring efforts associated with OCC's financial requirements, OCC continually monitors clearing member compliance with operational deadlines which include window timeframes, file submissions, and proper documentation. OCC tracks any outstanding operational issues in a database and notifies clearing members of any concerns or issues that require remediation. OCC also conducts routine visits with clearing members which includes, to the extent necessary, a discussion of any patterns of operational issues, to ensure that remedial steps are being taken by the clearing member and to ensure there is no impact to OCC's operational timeframes and data dissemination.

#### **4.4 The rules set out appropriate sanctions in the event of non-compliance by participants.**

OCC Rule 1201 provides that:

*"The Corporation [OCC] may censure, suspend, expel or limit the activities, functions or operations of any Clearing Member for any violation of the By-Laws and Rules or its agreements with the Corporation [OCC]. The Corporation [OCC] may, in addition to or in lieu of such sanctions, impose a fine on any Clearing Member for any violation of the By-Laws or Rules or procedures of or its agreements with the Corporation [OCC] or the correspondent clearing corporation [National Securities Clearing Corporation ("**NSCC**"), which handles settlements of equity option exercises], or for any*

*neglect or refusal by such person to comply with any applicable order or direction of the Corporation [OCC] or the correspondent clearing corporation, or for any error, delay or other conduct embarrassing the operations of the Corporation [OCC], or for not providing adequate personnel or facilities for its transactions with the Corporation [OCC] or the correspondent clearing corporation.”*

**5. Due Process**

**5.1 For any decision made by the clearing agency that affects an applicant or a participant, including a decision in relation to access, the clearing agency ensures that:**

- (a) an applicant or a participant is given an opportunity to be heard or make representations; and**
- (b) the clearing agency keeps a record of, gives reasons for, and provides for appeals or reviews of, its decisions.**

Article V, Section 2 of OCC's By-Laws provides extensive due process protections, satisfying criterion 5.1, for denials of membership. OCC Rule 1202 provides similar due process protections for the imposition of sanctions on a clearing member. Rule 305(c) provides due process protections for the imposition of operational restrictions on a clearing member.

**A. Membership Denials**

Applications for membership are reviewed by OCC's Membership/Risk Committee which recommends approval or disapproval to the Board of Directors. If the Membership/Risk Committee proposes to recommend to the Board of Directors that an application for clearing membership be disapproved, it first provides the applicant with a written statement of its proposed recommendation and the specific grounds therefor, and affords the applicant an opportunity to be heard and to present evidence on its own behalf. If, after an opportunity to be heard, the Membership/Risk Committee still proposes to recommend disapproval, the Membership/Risk Committee shall make its recommendation to the Board of Directors in writing, accompanied by a statement of the specific grounds therefor, and a copy thereof shall be furnished to the applicant on request.

The Board of Directors independently reviews any recommendation by the Membership/Risk Committee, and may, in its discretion, if the applicant so requests, afford the applicant a further opportunity to be heard and to present evidence. If the Board of Directors disapproves the application, written notice of its decision, accompanied by a statement of the specific grounds therefor, is delivered to the applicant. An applicant shall have the right to present such evidence as it may deem relevant to its application. A verbatim record shall be kept of any hearing held pursuant hereto.

**B. Imposition of Operational Restrictions**

Under OCC's Rules, the Chairman, the Management Vice Chairman, or the President of OCC may determine that the financial or operational condition of a Clearing Member makes it necessary or advisable to impose certain restrictions on the Clearing Member's transactions, positions or activities. Such actions taken are subject to review by the Membership/Risk Committee of OCC upon a request for review submitted by the Clearing Member within five (5) days of the date such action is taken. At the hearing, the Clearing Member shall be afforded an opportunity to be heard and to present evidence in its behalf and may be represented by counsel. A verbatim record of the hearing is prepared and the cost of the transcript may, in the discretion of the Membership/Risk Committee, be charged in whole or in part to the Clearing Member if the Membership/Risk Committee does not modify the action taken by the Chairman, the Management Vice Chairman, or President. The Clearing Member shall be notified in writing of the outcome of the Membership/Risk Committee's review.

**C. Imposition of Sanctions**

OCC may sanction any clearing member for any violation of OCC's By-Laws and OCC's Rules or the clearing member's agreements with OCC through censure, suspension, expulsion or placing limits on the activities, functions or operations of the clearing member. OCC may also impose a fine on any clearing member in addition to or in lieu of such sanctions. Under Rule 1102 of OCC's Rules, OCC may summarily suspend any clearing member which: (i) has been and is expelled or suspended from any self-regulatory organization; (ii) fails to make any delivery of cash, securities or other property to OCC in a timely manner as required by OCC's By-Laws or Rules; (iii) fails to make delivery of funds or securities to another clearing member required pursuant to OCC's By-Laws or Rules; (iv) fails to make any delivery of funds or securities to the correspondent clearing corporation in a timely manner, has appointed an Appointed Clearing Member to act on its behalf and such Appointed Clearing Member fails to make any delivery of funds or securities to the correspondent clearing corporation in a timely manner or effects settlement at the correspondent clearing corporation in a timely manner; (v) is in such financial or operating difficulty that OCC determines and notifies the clearing member's regulatory agency and the SEC or CFTC that suspension is necessary for the protection of OCC, other clearing members or the general public; or (vi) in the case of a Non-U.S. Clearing Member, has been expelled or suspended by its Non-U.S. Regulatory Agency or any securities exchange or clearing organization of which it is a member. OCC may also summarily suspend a clearing member that is in default of payment

of funds or any other obligation in respect of sets of cross-margining accounts (Rule 707 of OCC's Rules) or in respect of an internal non-proprietary cross margining account (Article VI, subsection 25(g) of OCC's By-Laws).

Before imposing any sanction, OCC provides the person against whom the sanction is sought to be imposed ("**Respondent**") with a concise written statement of the charges against the Respondent. The Respondent is provided fifteen (15) days after the service of such statement to file a written answer thereto, either admitting or denying each allegation contained in the statement of charges and may also contain any defense which the Respondent wishes to submit. Allegations contained in the statement of charges which are not denied in the answer shall be deemed to have been admitted. Any defense not raised in the answer shall be deemed to have been waived.

If an answer is not filed within the time prescribed or any extension that may be granted, OCC shall furnish to the Respondent a final request for an answer, specifying a time prior to which an answer must be filed and a sanction which will be imposed if an answer is not filed within that time. If an answer is not filed prior to the time so specified, the charges against the Respondent shall be deemed to have been admitted, and the sanction specified in the final request shall be imposed without further proceedings and the Respondent shall be notified thereof in writing. If an answer is timely filed, the Secretary of OCC shall (unless the Respondent and OCC shall have stipulated to the imposition of an agreed sanction) schedule an early hearing before a Disciplinary Committee composed of the Vice Chairman of the Board of Directors (or such other director as the Board of Directors shall designate in his place), who will act as Chairman of the Committee, and two (2) other directors appointed by the Chairman of the Committee.

The Respondent shall be given not less than three (3) days advance notice of the place and time of such hearing. At the hearing, the Respondent shall be afforded the opportunity to be heard and to present evidence in his behalf and may be represented by counsel. A verbatim record of the hearing shall be prepared and the cost of the transcript may, in the discretion of the Disciplinary Committee, be charged in whole or in part to the Respondent in the event any sanction is imposed on the Respondent. As soon as practicable after the conclusion of the hearing, the Disciplinary Committee shall furnish the Respondent and the Board of Directors with a written statement of its decision. If the decision shall have been to impose a disciplinary sanction, the written statement shall set forth (i) any act or practice in which the Respondent has been found to have engaged, or which the Respondent has been found to have omitted; (ii) the specific provisions of the statutory rules of OCC which any such act, practice or omission has been deemed to violate; and (iii) the sanction imposed and the reasons therefor.

In the event that a Disciplinary Committee censures, fines, suspends, expels or limits the activities, functions or operations of any Respondent, any affected person may apply for review to the Board of Directors, by written motion filed with the Secretary of OCC within five (5) business days after issuance of the Disciplinary Committee's written statement of its decision. The granting of any such motion shall be within the sole discretion of the Board of Directors. In addition, the Board of Directors may determine to review any such action by a Disciplinary Committee on its own motion, including operational actions (i.e., actions that relate to the operations of a Respondent).

Review by the Board of Directors shall be on the basis of the written record of the proceedings in which the sanction was imposed, but the Board of Directors may, in its discretion, afford the Respondent a further opportunity to be heard or to present evidence. A verbatim record shall be kept of any such further proceedings. Based upon such review, the Board of Directors may affirm, reverse or modify, in whole or in part, the decision of the Disciplinary Committee. The Respondent shall be notified in writing of the decision of the Board of Directors and if the decision shall have been to affirm or modify the imposition of any disciplinary sanction, the Respondent shall be given a written statement setting forth (i) any act or practice in which the Respondent has been found to have engaged, or which the Respondent has been found to have omitted; (ii) the specific provisions of the statutory rules of OCC which any such act, practice or omission has been deemed to violate; and (iii) the sanction imposed and the reasons therefor.

Any action taken by a Disciplinary Committee shall be deemed to be final upon (i) expiration of the time provided for the filing of a motion for review, or any extension thereof granted to the Respondent; or (ii) if a motion for review is timely filed, when the Respondent is notified of the denial of the motion or the decision of the Board of Directors on review, as the case may be. When any sanction imposed hereunder becomes final, (i) OCC shall notify the Respondent in writing that the imposition thereof may be subject to review by the appropriate regulatory agency for the Respondent pursuant to Section 19(d)(2) of the Exchange Act and the rules and regulations of such appropriate regulatory agency thereunder or, (ii) in the case of disciplinary proceedings concerning solely the Respondent's activities as a futures commission merchant, OCC shall notify the Respondent in writing that the imposition thereof may be subject to review by the appropriate regulatory agency for the Respondent pursuant to the provisions of Section 8c of the CEA; with respect to Non-U.S. Clearing Members, such review shall lie solely with the SEC. If, on the other hand, the Board of Directors elects on its own motion to review any action by a Disciplinary Committee, such action shall not be deemed final until the Respondent is notified of the decision of the Board of Directors on review.

## 6. Risk Management

### 6.1 The clearing agency's settlement services are designed to minimize systemic risk.

OCC's role as a central counterparty for U.S. listed derivatives is primarily to minimize systemic risk. OCC novates the contracts that it clears, becoming the seller to the buyer and the buyer to the seller. In doing so, OCC assumes the obligations of its members, guaranteeing that the terms of the contracts are met. Substituting OCC minimizes systemic risk by providing increased assurance that the assumed obligations will be settled and minimizing the potential ripple effect that default by one member could have on others in a market without a central counterparty. The ways in which OCC minimizes systemic risk are discussed below.

### 6.2 The clearing agency has appropriate risk management policies and procedures and internal controls in place.

OCC enjoyed a AAA counterparty credit rating from Standard & Poor's ("S&P") from 1993 until 2011. In August 2011, S&P continued its lockstep approach of linking the ratings of a number of financial institutions and instruments to its rating of U.S. sovereign debt. Following the downgrade of U.S. sovereign debt to AA+, S&P also downgraded OCC to AA+. That rating continues to be based on the strength of OCC's risk management. In its most recent rating report, dated March 29, 2012, S&P states:

*"Standard & Poor's considers OCC's enterprise risk management to be strong. The clearinghouse manages clearing risk through what we consider as a comprehensive set of financial safeguards including rigorous admission standards and clearing member surveillance activities, the collection of high-quality collateral, and mutualization of risk among its financially strong clearing members in the form of a clearing fund and the power to assess members for funds to cover losses of a defaulting clearing member. This would include its planned OTC clearing activities."*

The full text of S&P's report, which discusses OCC's risk management in some detail, is available on OCC's public website: [http://www.optionsclearing.com/components/docs/about/sp\\_rating.pdf](http://www.optionsclearing.com/components/docs/about/sp_rating.pdf)

OCC also believes that it has appropriate internal controls in place. OCC's 2011 annual report contains a report by OCC's independent accountants, Deloitte & Touche ("**Deloitte**"), in which they conclude that:

*"In our opinion, management's assertion that the Corporation [OCC] maintained effective internal control over clearing and settlement of options and futures transactions cleared by the Corporation [OCC] for the year ended December 31, 2011, is fairly stated, in all material respects, based on criteria established in the "Internal Control-Integrated Framework" issued by COSO."*

The annual report is available on OCC's public website at: [http://www.optionsclearing.com/components/docs/about/annual-reports/occ\\_2011\\_annual\\_report.pdf](http://www.optionsclearing.com/components/docs/about/annual-reports/occ_2011_annual_report.pdf)

### 6.3 Without limiting the generality of the foregoing, the clearing agency's services or functions are designed to achieve the following objectives:

#### 6.3.1 Where the clearing agency acts as a central counterparty, it rigorously controls the risks it assumes.

OCC controls the risks that it assumes as a central counterparty through a three-tiered risk management system consisting of rigorous membership standards, a state-of-the-art margin system, and a substantial clearing fund.

#### Membership Standards

The first line of defense consists of OCC's initial and ongoing membership standards. Firms are reviewed for minimum net capital, minimum profitability, operational systems and staffing. For a more detailed description of OCC's membership standards, please refer to Paragraph 3.1.

#### Margin

OCC's second line of defense against clearing member default is a clearing member's margin deposits. Margin refers to cash, letters of credit, eligible U.S. and Canadian government securities, debt securities of eligible government-sponsored enterprises, corporate debt and equity securities, money market fund shares or other forms of eligible collateral deposited by a clearing member to satisfy its margin requirement with OCC. At the end of 2011, OCC held approximately US\$76.3 billion in aggregate clearing member margin deposits.



OCC's Rules state that clearing members representing options sellers or futures holders must collateralize positions either by making a deposit in lieu of margin (in the case of options) or by depositing margin in one or more of the forms listed above.

All margin deposits except letters of credit are held at securities depositories or banks. All obligations and non-cash margin deposits are marked to market daily. OCC haircuts the value of securities held as margin to provide a cushion against price fluctuations.

OCC was the first clearing organization in the world to develop a margin system based on options price theory and modern portfolio theory. In 2006, OCC introduced a new proprietary risk management system, System for Theoretical Analysis and Numerical Simulations ("**STANS**"), as a replacement to the TIMS methodology. OCC's margin system measures clearing member position risk and establishes margin requirements, which provides protection to clearing members and OCC against possible defaults.

The total margin requirement for an account consists of two (2) parts: the Net Asset Value ("**NAV**") calculation or mark to market component, which is the cost to liquidate a position at current market prices; and the risk component, which provides a cushion to cover two-day market risk. The additional risk component covers the market risk portion of the total margin requirement by means of dynamic expected shortfall ("**ES**") risk measures. These measures are obtained from a large-scale Monte Carlo implementation of a copula-based approach with heavy-tailed marginal distributions.

STANS simulates a set of 10,000 hypothetical market scenarios to produce a profit/loss distribution for each distinct clearing member portfolio. These simulated scenarios incorporate information extracted from the historical behavior of each individual security (risk factor) as well as its relationship to the behavior of other securities (risk factors). Scenarios are generated for more than 7,000 risk factors, including a broad range of individual equities, exchange-traded funds, stock indices, currencies and commodity products. OCC uses a dynamic model to update volatilities on a daily basis. Dependence among risk factors is reflected in three (3) ways. The base case is historical copula-based dependence, estimated from the historical data. The base case is supplemented by stress test simulations for single stock risk factors assuming perfectly correlated and independent (zero correlated) scenarios. The portfolio margin (risk) requirement is a function of ES measures from different dependence structure simulations. The ES measure is the mean beyond the Value at Risk cut-off level and reflects the expected tail loss. The total margin requirement for a given portfolio is the sum of NAV and risk component as described above.

Long securities options positions carried in clearing members' customers' accounts are segregated from other positions, free of any lien in favour of OCC, unless the clearing member submits spread instructions to OCC designating customer long positions to be released from segregation. A clearing member may only submit such instructions if it simultaneously carries a short position in options for the same customer and the margin required to be deposited by the customer on the short position has been reduced as a result of carrying the long position.

OCC continuously monitors intra-day price changes and is empowered to issue intra-day margin calls, should market or other conditions warrant such action. The net asset value of every account is recalculated multiple times throughout the day using start-of-day positions and current market prices and losses are compared to start-of-day risk requirements. If losses exceed a predetermined threshold, an intra-day margin call is initiated to collect the full amount of the loss.

STANS and Portfolio Revaluation enable OCC to maintain adequate but not excessive margin requirements. Inadequate collateral requirements threaten market integrity while excessive requirements discourage trading and reduce liquidity. All of OCC's risk management systems and policies are continually monitored and enhanced. Backtesting results are reviewed daily, and the overall adequacy of OCC's margin methodology is reviewed at least yearly.

The STANS RISK application is available to all clearing members via a secure Web site and it allows them to measure, monitor and manage the level of risk exposure of their portfolios. It is also designed to be used as a flexible risk analysis tool to identify areas of increased risk and dependence and to offer a new set of analytical tools to analyze the risk of clearing members' portfolios at much more detailed levels. OCC staff uses dynamic functionality in the application to recalculate risk exposure using hypothetical changes to clearing member portfolios.

OCC operates cross-margin programs with the Chicago Mercantile Exchange Inc. ("**CME**") and ICE Clear US, Inc., which provide for the calculation of margins for eligible index options, options on exchange-traded fund shares, futures and options on futures as if they were held within a single account. OCC also offers internal cross-margining for intermarket hedge positions where OCC is the clearing house on both the securities and futures side. OCC is currently seeking regulatory approval to add security futures to such cross-margin programs, as applicable.

Cross-margining involves a sophisticated analysis of the economic risk inherent in a clearing member's intermarket positions when viewed on a combined basis. This analysis results in overall savings in clearing member margin requirements. At the end of 2007, the cross-margin program reduced participants' combined daily margin requirements by approximately US\$3.2 billion, while enhancing the financial integrity of the clearance and settlement system. Cross-margining increases the pricing

efficiency and liquidity of options and futures markets while decreasing the over-collateralization of intermarket hedged position risk at the clearinghouse level.

### Clearing Fund

The third line of defense against clearing member default is the members' contributions to the Clearing Fund. A member's Clearing Fund deposit is based on its proportionate share of positions, computed monthly. Clearing Fund deposits must be in the form of cash or government securities, as the Clearing Fund is intended to provide OCC with a pool of highly liquid assets. The entire Clearing Fund is available to cover potential losses in the event that a defaulting member's margin and Clearing Fund deposits are inadequate or not immediately available to fulfill that member's outstanding financial obligations. The Clearing Fund may also be used to reimburse OCC for losses sustained due to the failure of a bank or another clearing organization to meet an obligation to OCC. At the end of 2011, OCC's Clearing Fund totaled nearly US\$2.9 billion.

The overall size of the Clearing Fund is based upon total margin requirements and open interest and can be replenished via additional assessments upon its clearing members. Therefore, OCC's Clearing Fund expands and contracts in size in relation to market exposure. An individual clearing member's Clearing Fund deposit is based on the relative size of its open positions, subject to a minimum required deposit. In most instances, the minimum required deposit is US\$150,000. In May 2012, the sizing of the clearing fund will change from being calculated as a percentage of total aggregate margins to a scenario based approach that models the default of our largest member under stressed market conditions.

The Clearing Fund mutualizes the risk of default among all clearing members. Losses are charged on a proportionate basis against all other Clearing Member's contributions. The proportionate share is a fraction calculated as a respective members' computed contribution to the clearing fund divided by the sum of all clearing members' computed contributions to the clearing fund. Therefore, each clearing member is required to share proportionately in any Clearing Fund assessment.

Clearing Members that become insolvent will be suspended by OCC and no further trades will be accepted on behalf of the member. Existing positions will be closed-out, and collateral will be liquidated in order to satisfy outstanding obligations.

In the event of a default that requires the use of the Clearing Fund, Clearing Members are obligated to replenish their contribution via assessment. If, after the first replenishment, a Clearing Member wishes to withdraw from OCC, they will only be allowed to do so after closing out or transferring all of their open positions.

In the unlikely event that Clearing Fund deposits prove to be inadequate to cover OCC's losses, each clearing member may be assessed an additional amount equal to the amount of its initial deposit. A clearing member is liable for further assessments until the balance of OCC's losses are covered or the clearing member has withdrawn from membership in OCC.

### **6.3.2 The clearing agency minimizes principal risk by linking securities transfers to funds transfers in a way that achieves delivery versus payment.**

OCC does not handle any physical settlements itself, but either uses a correspondent clearinghouse (equity option exercises, like stock trades, are settled at NSCC) or arranges for settlement to take place directly between two (2) clearing members on a delivery vs. payment basis (e.g., physical settlement of treasury futures). In either situation steps are taken to minimize principal risk. Principal risk refers to the potential loss associated with the failure of a counterparty to fulfill its obligations.

### **6.3.3 Final settlement occurs no later than the end of the settlement day. Intraday or real-time finality is provided where necessary to reduce risks.**

Early each morning, OCC presents drafts to approved settlement banks, directing the bank to (i) debit the accounts of specified clearing members and credit OCC's account with the settlement amounts owed by the respective clearing members, and (ii) debit OCC's account and credit the accounts of specified clearing members with the settlement amounts owed by OCC to those clearing members. By agreement, a bank's acceptance of OCC's draft irrevocably obligates it to complete the settlement. The deadline for accepting drafts on clearing member accounts is 9:00 a.m. Chicago time, although banks ordinarily accept OCC's drafts substantially in advance of that time. Final (irrevocable) settlement thus occurs by 9:00 a.m. Chicago time, although interbank transfers moving funds from banks where OCC is a net payee to banks where OCC is a net payor occur later the same day.

In cases where OCC's markets experience extraordinary intraday volatility OCC may issue margin calls against members' accounts where excessive risk is observed. By rule our members must satisfy these margin calls in cash within one (1) hour of being notified of the call. Failure to meet margin calls in a timely manner may result in suspension of the Clearing Member.

**6.3.4 Where the clearing agency extends intraday credit to participants, including a clearing agency that operates net settlement systems, it institutes risk controls that, at a minimum, ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle.**

OCC maintains a US\$2 billion syndicated credit facility, secured by Treasury securities held as clearing fund deposits, to provide emergency liquidity. OCC's immediate liquidity demands are typically the result of settlement obligations arising from trades initiated the prior trading day or from the expiration of cash settled index option contracts. In order to determine the size of its committed credit facility, OCC reviews its historically largest settlements and looks to set the facility such that it would have provided coverage adequate to most of the largest liquidity demands produced by a single family of firms defaulting at the same time.

Since 2007, individual settlements have exceeded that amount fewer than ten (10) times. In addition to the credit facility, OCC would have access to its own operating cash, cash clearing fund deposits, and any cash margin deposited by the defaulting clearing member. In addition, OCC was designated by FSOC as a "systemically important" financial market utility on June 18, 2012, and subsequently it is possible for OCC to obtain emergency liquidity from the Federal Reserve System, secured by clearing fund assets not otherwise pledged. As a result of this designation, discount and borrowing privileges granted under Title VIII of Dodd-Frank must comply with section 10B of the *Federal Reserve Act*.

**6.3.5 Assets used to settle the ultimate payment obligations arising from securities transactions carry little or no credit or liquidity risk. If central bank money is not used, steps are to be taken to protect participants in settlement services from potential losses and liquidity pressures arising from the failure of the cash settlement agent whose assets are used for that purpose.**

OCC is unable at this time to effect settlements using central bank money. Clearing members choose from a list of OCC approved settlement banks through which they effect settlements with OCC, and assume the risk of the selected bank's insolvency prior to settlement. Clearing Members choose a settlement bank for each account. All transactions for a particular account are required to use that same settlement bank. OCC's approval process includes review of the bank's capitalization, regulatory standing and compliance with minimum Basel standards. OCC reviews the capitalization, owner's equity, and credit rating of settlement banks prior to approval. OCC also monitors the capital level of settlement banks on a quarterly basis and for timely performance on an on-going basis.

OCC has nine (9) U.S. Settlement Banks, and three (3) EURO Settlement Banks (JPMorgan Chase Bank, N.A. (London), BMO Harris Bank N.A. and Brown Brothers Harriman and Co.). The EURO banks are also U.S. Dollar Settlement Banks. Choice of Settlement Bank can be switched overnight, provided the member has accounts open at the respective bank.

**6.3.6 If the clearing agency establishes links to settle cross-border trades, it designs and operates such links to reduce effectively the risks associated with cross-border settlements.**

Not applicable. OCC does not maintain links to settle cross-border trades.

**6.4 The clearing agency engaging in activities not related to settlement services carries on such activities in a manner that prevents the spillover of risk to the clearing agency that might affect its financial viability or negatively impact any of the participants in the settlement service.**

Not applicable. OCC does not engage in any activities not related to its role as a central counterparty.

**7. Systems And Technology**

**7.1 For its settlement services systems, the clearing agency:**

- (a) **develops and maintains**
  - (i) **reasonable business continuity and disaster recovery plans,**

OCC maintains robust business continuity and disaster recovery plans. First, OCC maintains a primary data processing center based in the south-western region of the U.S. and has established an alternate business center at a different location than the primary data center that is staffed with personnel who have daily responsibility for business functions and production support. The alternative business center also serves as OCC's storage bunker facility. OCC uses synchronous data replication technology between OCC's primary data center and its alternate business center (*i.e.*, bunker). This technology ensures each write is acknowledged by both the primary and secondary data store before the next write command is accepted.

Second, OCC has a dedicated alternate data processing center located in the Midwest U.S. Independent from the alternate data center, OCC has also established its primary business operations facility in Chicago, Illinois, which is supported by a series of redundant power sources.

Third, OCC has a dedicated business user recovery site in the Chicago suburbs, separate from the alternate data processing center, where certain Chicago based employees could relocate in the event that OCC's Chicago offices become unavailable. OCC also uses the business user recovery site under certain Homeland Security alert levels to disperse its staff.

Fourth, OCC currently maintains sufficient personnel in both geographic locations to independently handle all of OCC's critical clearance, settlement and risk management processes if so required. Additionally, key OCC staff has the capability to securely connect to either data center or either business center from outside of OCC facilities.

Fifth, OCC maintains communication and storage networks that are supported by redundant systems to ensure re-routing in the event of outages from network failure or catastrophe.

Sixth, OCC maintains a multi-level Business Continuity Program, in which each level of documented plan is designed to provide the necessary processes, procedures and assignments for critical business continuance with minimal service level impacts. The plans cover company-wide, management team and departmental matters.

Seventh, OCC's Disaster Recovery group operates a Disaster Recovery Testing Program to ensure OCC's ability to recover and resume processing after a disaster in accordance with parameters established in the *Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System* ("**Interagency Paper on U.S. Financial System**"). OCC's policy is to perform Disaster Recovery/Business Continuity ("**DR/BC**") testing at least quarterly and within one (1) month of significant systems and/or infrastructure upgrades. Historically, OCC conducts nine (9) or ten (10) DR/BC tests annually. The 2011 DR/BC schedule included fifteen test events.

**(ii) an adequate system of internal control,**

OCC maintains an effective system of internal control. See the discussion of criterion 6.2 above.

**(iii) adequate information technology general controls, including controls relating to information systems operations, information security, change management, problem management, network support, and system software support;**

OCC maintains adequate information technology general controls, including controls relating to information systems operations, information security, change management, problem management, network support, and system software support. Documentation of information technology controls, including those referred to in criterion 7.1(a)(iii), is routinely reviewed by OCC's internal auditors. In addition, please note that the independent accountants' report on internal controls quoted in the discussion of criterion 6.2 above related to "internal control over clearing and settlement of options and futures transactions cleared by [OCC]." The accountants' examination included "obtaining an understanding of the internal control over clearing and settlement of options and futures transactions cleared by [OCC and] testing and evaluating the design and operating effectiveness of the internal control . . . ." That examination therefore also included review of documentation for information technology controls.

**(b) on a reasonably frequent basis, and in any event, at least annually, and in a manner that is consistent with prudent business practice,**

**(i) makes reasonable current and future capacity estimates,**

**(ii) conducts capacity stress tests to determine the ability of those systems to process transactions in an accurate, timely and efficient manner,**

**(iii) tests its business continuity and disaster recovery plans;**

Capacity Testing

The SEC requires self-regulatory organizations ("**SROs**") under its jurisdiction, including registered clearing agencies, to take appropriate measures to ensure that their systems "have the capacity to accommodate current and reasonably anticipated future trading volume levels adequately and to respond to localized emergency conditions". SROs are required to establish comprehensive planning and assessment programs to:

- establish current and future capacity estimates;
- conduct capacity stress tests periodically; and
- assess whether the affected systems can perform adequately in light of estimated capacity levels and possible threats to the systems.

OCC's policy is to evaluate capacity at least annually. This is done each October by determining (i) whether transaction volume during the past twelve (12) months exceeded OCC's previous high transaction volume day; or (ii) whether there have been significant changes to OCC's technology systems since the last High Volume Test ("HVT"). If either of these conditions exist, OCC will schedule a HVT to be conducted during the next yearly test schedule. The HVT will be performed to ensure that OCC maintains sufficient systems capacity (2.5 times OCC's prior high transaction volume) to process transaction volume (e.g., if record daily transaction volume is 2.2 million transactions, the HVT will test OCC's ability to process 5.5 million transactions). If neither of the above conditions occurs, then a HVT will be conducted at least every other year. The last HVT was conducted March 5-6, 2011. OCC has not exceeded capacity on any one day.

#### Recovery Testing

As described in paragraph 7.1(a)(i), OCC's Disaster Recovery group operates a Disaster Recovery Testing Program to ensure OCC's ability to recover and resume processing after a disaster in accordance with parameters established in the Interagency Paper on U.S. Financial System. OCC's policy is to perform Disaster Recovery/Business Continuity ("DR/BC") testing at least quarterly and within one (1) month of significant systems and/or infrastructure upgrades. Historically, OCC conducts nine (9) or ten (10) DR/BC tests annually. The 2011 DR/BC schedule included fifteen test events.

Other than planned testing, there have been no incidents that have required the relocation of processing to the alternate data center.

**(c) promptly notifies the regulator of any material systems failures.**

Under the SEC's Automation Review Policy, OCC is required to give the SEC prompt notice of any significant systems problems or other operational impediments, including timely information on the nature, impact, and cause of the problem and steps OCC is taking to mitigate the damage and prevent a recurrence.

**7.2 The clearing agency annually engages a qualified party to conduct an independent systems review and prepare a report in accordance with established audit standards regarding its compliance with section 7.1(a).**

OCC's business continuity plan, disaster recovery plan and technology general controls are reviewed by OCC's Internal Audit department. In addition, IT internal controls are reviewed by the IT Controls Compliance team to ensure adequacy of controls in these areas.

OCC's independent auditors provide the aforementioned opinion based on a requirement contained in SEC Release No. 34-16900, Regulation of Clearing Agencies.

OCC annually engages its independent auditors to review and report on its internal controls. Their most recent report is included in OCC's 2010 annual report, which is available on OCC's public website at:  
[http://www.optionsclearing.com/components/docs/about/annual-reports/occ\\_2011\\_annual\\_report.pdf](http://www.optionsclearing.com/components/docs/about/annual-reports/occ_2011_annual_report.pdf)

OCC does not engage any third party to report specifically on the matters covered in criteria 7.1(a)(i) and (iii), but certain aspects of these matters may be reviewed as part of the audit of internal controls described in section 9.1 of this Application.

## **8. Financial Viability and Reporting**

**8.1 The clearing agency has sufficient financial resources for the proper performance of its functions and to meet its responsibilities and allocates sufficient financial and staff resources to carry out its functions as a clearing agency in a manner that is consistent with any regulatory requirements.**

OCC believes that it has sufficient financial resources for the proper performance of its functions and to meet its responsibilities. At the beginning of each year, OCC sets clearing fees based on a conservative volume forecast, with the intent of returning any excess profits to its clearing members through clearing fee refunds. For the 2008-2011 period, refunds amounted to US\$64,651,000 (2008), US\$57,928,000 (2009), US\$38,363,000 (2010) and US\$79,629,667 (2011). OCC has the ability to manage retained earnings by adjusting refund amounts. Since 1998, OCC has had a policy of maintaining a retained earnings balance equal to 45% of the prior year's cash operating expenses. In 2009, OCC reviewed that policy with the

assistance of an investment banker, and concluded that the policy continued to be adequate for OCC's working capital and routine capital expenditure needs. If expenses were to exceed the amounts budgeted, or if OCC's Performance Committee were to approve an unbudgeted project, the effect would be to reduce the amount of the current year's refund, so profits not yet refunded provide an additional financial resource.

OCC is satisfied that it allocates sufficient financial and staff resources to carry out its functions as a clearing agency in a manner that is consistent with applicable regulatory requirements.

## **9. Operational Reliability**

### **9.1 The clearing agency has procedures and processes to ensure the provision of accurate and reliable settlement services to participants.**

#### Quality Standards

OCC has procedures and processes to ensure the provision of accurate and reliable settlement services to participants, and has done so for nearly 40 years. At the beginning of each year, OCC's Board approves Quality Standards against which the performance of OCC's systems and staff is measured.

The OCC 2012 Quality Standards consist of 43 processing commitments across the four (4) following categories:

- 1. Data Integrity:** Standards focused on the accurate presentation and production of twelve (12) reports, eighteen (18) records, eighteen (18) screens, five (5) web-based reports and twelve (12) customer offered services.
- 2. System Availability:** Standards that measure the availability of five (5) specific services and specific websites within a given timeframe.
- 3. Data Timeliness:** Service Levels that ensure that data processing and delivery are completed within defined timeframes during daily and expiration processing.
- 4. Telephone and Recorded Calls Availability:** Ensures critical telecommunication services are available to support operations.

At each Performance Committee meeting during the course of the year, management reviews performance goals in each of the above categories since the last report. At year end, performance against Quality Standards is one of the factors considered by the Performance Committee in establishing incentive compensation pools and awarding incentive compensation to senior management.

#### Internal Audit Department

The Internal Audit Department operates under a charter approved by the OCC Audit Committee, and reports functionally to the Audit Committee and administratively to OCC's Chairman and Chief Executive Officer. The department is currently comprised of eight (8) full time positions, including a First Vice President, two (2) managers, four (4) senior IS auditors and an associate auditor. Each member of the department has a bachelor's degree and is certified; certain department members hold two (2) or more certifications and advanced degrees.

The primary focus of the Internal Audit Department's testing is on core clearing and settlement operations, risk management and supporting information technology areas. In addition, other areas within the company are tested by Internal Audit using a risk-based approach.

An audit report is issued at the completion of each audit project. The audit report includes management action plans in response to items raised by Internal Audit, and such items are tracked through resolution. The Audit Committee is provided with periodic updates on management's progress addressing audit recommendations.

#### Internal Control Reporting

As a registered clearing agency, OCC has a longstanding internal control reporting requirement under SEC Release 34-16900 (June 1980). To meet that requirement, each year OCC obtains an attestation report from Deloitte regarding management's assertion on the effectiveness of OCC's internal control. The form of report issued in connection therewith has evolved over the years as professional auditing and attestation standards issued by the American Institute of Certified Public Accountants have been updated.

In 2004, in parallel with public company efforts pursuant to the *Sarbanes-Oxley Act of 2002*, OCC created an initial baseline of structured documentation to support management's assessment of internal controls over clearing and settlement operations using criteria specified in the Committee of Sponsoring Organizations' ("**COSO**") *Internal Control Integrated Framework* ("**COSO Framework**"). This information consisted of matrixes, with links to underlying documentation in support of internal control activities performed by OCC staff. Several internal control matrixes across three (3) broad areas were created, as follows:

- **Enterprise Level Controls:** This matrix encompasses many business areas within OCC and covers the following four (4) areas of the COSO Framework – Control Environment, Risk Assessment, Information and Communication and Monitoring (the COSO "Control Activities" area is covered in the core clearing and settlement and information technology control matrixes, which are discussed below).
- **Core Clearing and Settlement Controls:** This includes four (4) matrixes covering Positions Processing, Prices and Margins, Master File Maintenance, and Collateral and Settlement.
- **Information Technology Controls:** This includes six (6) matrix areas including Change Management, Development and Implementation, Production Operations, Technology Infrastructure, Business Continuity and D/R, and Security.

This documentation comprises the equivalent of OCC's internal control "books and records" in support of management's assertion regarding internal control over clearing and settlement operations. The internal control books and records are maintained on an ongoing basis. OCC's Project Management Office ("**PMO**") has the responsibility for ensuring these matrixes are maintained. The PMO works with departments throughout OCC to verify the controls and documentation are reviewed and validated on an annual basis unless there's been a major implementation that affects existing controls.

Ongoing, internal control documentation is tested by OCC's Internal Audit department, and is made available to Deloitte, in line with their practices for performing an audit of internal control over clearing and settlement operations.

## **10. Protection of Assets**

### **10.1 The clearing agency has established accounting practices, internal controls, and safekeeping and segregation procedures to protect the assets that are held by the clearing agency.**

OCC has established accounting practices, internal controls, and safekeeping and segregation procedures to protect the assets that it holds. Positions that clearing members hold for customers are required to be held in segregated customers' accounts at OCC. Proprietary positions are required to be held in separate firm accounts.

OCC adheres to all SEC and CFTC regulatory rules that require separation of firm and customer assets. OCC maintains multiple accounts, at each of its banks, in accordance with the rules set forth by the regulatory agencies. A segregation of duties exists across multiple departments within OCC along with controls in each department. These controls are audited on a regular basis by internal and external auditors.

## **11. Outsourcing**

### **11.1 Where the clearing agency has outsourced any of its key functions, it has appropriate and formal arrangements and processes in place that permit it to meet its obligations and that are in accordance with industry best practices. The outsourcing arrangement provides regulatory authorities with access to all data, information, and systems maintained by the third party service provider required for the purposes of regulatory oversight of the agency.**

OCC has not outsourced any of its key functions.

## **12. Information Sharing and Regulatory Cooperation**

### **12.1 For regulatory purposes, the clearing agency cooperates by sharing information or otherwise with the Commission and its staff, self-regulatory organizations, exchanges, quotation and trade reporting systems, alternative trading systems, other clearing agencies, investor protection funds, and other appropriate regulatory bodies.**

OCC cooperates with all appropriate regulatory bodies, sharing information on both a formal and informal basis. On a monthly basis OCC shares the results of its surveillance activities for common members with other DEAs or exchanges including FINRA, CME and CBOE, and receives like information in return. In addition OCC transmits various trade and post-trade activity for surveillance purposes to various regulators and exchanges.

With regard to applicants that are domiciled in Canada, OCC contacts IIROC for a positive recommendation prior to granting approval. IIROC's role would be limited to that of any DEA. OCC staff would take the comments of an applicant's respective DEA into consideration when preparing its recommendation to the Membership/Risk Committee, though final approval rests with the Membership/Risk Committee. OCC does not provide the results of its surveillance activities for Canadian clearing members to IIROC on a regular basis.

**13. Enclosures**

In support of this application, we enclose the following:

- (i) a verification statement from OCC confirming our authority to prepare and file this application and confirming the truth of the facts contained herein at Appendix "A"; and
- (ii) a draft form of order.

If you have any questions or require anything further please do not hesitate to contact us.

Respectfully,

Terence W. Doherty

TWD/mm

cc: James E. Brown, *The Options Clearing Corporation*



[DRAFT ONLY]

IN THE MATTER OF  
THE SECURITIES ACT,  
R.S.O. 1990, CHAPTER S. 5, AS AMENDED  
(THE ACT)

AND

IN THE MATTER OF  
THE OPTIONS CLEARING CORPORATION

ORDER  
(Section 147 of the Act)

**WHEREAS** The Options Clearing Corporation (**OCC**) has filed an application dated August 17, 2012 (**Application**) with the Ontario Securities Commission (**Commission**) requesting an order pursuant to section 147 of the Act exempting OCC from the requirement to be recognized by the Commission as a clearing agency pursuant to section 21.2(0.1) of the Act.

**AND WHEREAS** OCC has represented to the Commission that:

- 1.1 OCC is a corporation organized under the laws of the state of Delaware and was founded in 1973.
- 1.2 OCC is registered as a clearing agency under Section 17A of the United States (**U.S.**) Securities Exchange Act of 1934 (**Exchange Act**) and as a derivatives clearing organization (**DCO**) under Section 7a-1 of the U.S. Commodity Exchange Act (**CEA**). It has been designated by the U.S. Financial Stability Oversight Council as a “systematically important” financial market utility under Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act.
- 1.3 In the U.S., OCC operates under the jurisdiction of both the Securities and Exchange Commission (**SEC**) and the Commodity Futures Trading Commission (**CFTC**). Under the SEC’s jurisdiction, OCC clears or is qualified to clear transactions in “standardized options,” as defined in SEC regulations. These include options on common stocks and other equity issues, stock indices (including volatility, variance, and strategy-based indices), foreign currencies, interest rate composites, and credit default options. Under SEC jurisdiction, OCC also clears futures on single equity issues and narrow-based stock indices (**security futures**). As a registered DCO under CFTC jurisdiction, OCC offers clearing and settlement services for transactions in commodity futures (*i.e.*, futures other than security futures) and options on commodity futures.
- 1.4 The Exchange Act establishes conditions that registered clearing agencies must satisfy relating to, among other things, the clearing agency’s capacity to promptly and accurately clear and settle transactions, safeguarding of funds and securities, enforcement of the clearing agency’s rules, equitable allocation of fees and charges among participants, and avoiding any unnecessary burden on competition. Similarly, the CEA establishes core principles with which registered DCOs must comply relating to, among other things, financial resources, appropriate admission and eligibility standards for participants, risk management, timely completion of settlements, ensuring the safety of funds and enforcement of the DCO’s rules.
- 1.5 Because the overwhelming majority of OCC’s business relates to clearing securities, the CFTC historically has deferred to the SEC as the lead regulator except in connection with matters specifically related to the clearing of transactions in commodity futures, options on such futures or other products subject to the CFTC’s jurisdiction and compliance with the CEA and the CFTC’s regulations thereunder.
- 1.6 In Quebec, OCC has received an exemption from certain requirements of the *Derivatives Act* (Quebec) in connection with its business and operations as a clearing house, subject to conditions.
- 1.7 OCC is owned equally by the following five participant securities exchanges that trade options, all of which are currently registered with the SEC:
  - (i) Chicago Board Options Exchange;
  - (ii) International Securities Exchange;
  - (iii) NYSE Amex (formerly the American Stock Exchange)
  - (iv) NYSE Arca (formerly the Pacific Stock Exchange); and

- (v) NASDAQ OMX PHLX (formerly the Philadelphia Stock Exchange).
- 1.8 In addition to the five stockholder exchanges, OCC also performs clearing and settlement functions for other securities and futures exchanges.
- 1.9 OCC currently clears options traded on the U.S. securities exchanges named above, security futures traded on OneChicago, LLC, and commodity futures and in some cases options on commodity futures traded on four U.S. futures exchanges. OCC also clears stock loan transactions executed on a broker-to-broker basis and on AQS, an electronic trading platform regulated by the SEC and by the U.S. Financial Industry Regulatory Authority as an automated trading system. OCC intends to clear OTC derivatives beginning in late 2012 or the first quarter of 2013.
- 1.10 OCC operates as a not-for-profit industry utility and refunds excess revenues to its members (**Clearing Members**).
- 1.11 OCC currently clears the following products:
  - (i) Options on equity securities (including exchange-traded funds);
  - (ii) Options on stock indices (including volatility indices);
  - (iii) Foreign currency options;
  - (iv) Interest rate options (cash settled options on the yields of U.S. Treasury securities);
  - (v) Credit default options;
  - (vi) Interest rate futures;
  - (vii) Security futures, including single stock futures and narrow-based stock index futures;
  - (viii) Broad-based stock index, volatility and variance futures;
  - (ix) Options on commodity futures; and
  - (x) Stock loan transactions.
- 1.12 OCC does not have any office or maintain other physical installations in Ontario or any other Canadian province or territory.
- 1.13 OCC has approximately 120 Clearing Members, who are U.S. registered broker-dealers, futures commission merchants and non-U.S. securities firms.
- 1.14 OCC allows entities that have a head office or principal place of business in Ontario and dealers that are registered in Ontario that meet the criteria set out in its Rules (collectively, **Ontario Clearing Members**) to become Clearing Members.
- 1.15 OCC currently has five Clearing Members that are Ontario Clearing Members.
- 1.16 Additionally, OCC currently has one approved clearing bank with a head office or principal place of business in Ontario. As an OCC approved clearing bank, the bank provides settlement services for exchange transactions on behalf of the Ontario Clearing Members. Such services may include, but not be limited to, the payment and release of margin, payment and rebate of fees, and the payment and withdrawal of option premiums.
- 1.17 OCC initiates no direct contact with Canadian clients of Ontario Clearing Members.
- 1.18 OCC submits that it does not pose a significant risk to the Ontario capital markets and is subject to an appropriate regulatory and oversight regime in a foreign jurisdiction.
- 1.19 OCC maintains rigorous Clearing Member criteria that all applicants must satisfy before their applications are accepted, including fitness criteria, review of corporate constating documentation, financial standards, operational standards, appropriate registration qualifications with applicable statutory regulatory authorities, and OCC applies a due diligence process to ensure that all applicants meet the required criteria.

- 1.20 There are no material differences in terms of membership standards and financial requirements between Ontario Clearing Members and other Clearing Members.
- 1.21 OCC utilizes processes to minimize systemic risk, which processes include operational and financial criteria for all clearing members, margining and financial protections, the maintenance of a clearing/guarantee fund, sound information systems, comprehensive internal controls, ongoing monitoring of clearing members, and appropriate oversight by the Board of Directors.
- 1.22 As OCC has Ontario Clearing Members, it is considered by the Commission to be “carrying on business as a clearing agency” in Ontario. OCC cannot carry on business in Ontario as a clearing agency unless it is recognized by the OSC as a clearing agency under subsection 21.2(0.1) of the Act or exempted from such recognition under section 147 of the Act.
- 1.23 Based on the facts and representations set out in the Application, OCC satisfies the criteria set out in Schedule “A” to this order.

**AND WHEREAS** based on the Application and the representations of OCC to the Commission, the Commission has determined that OCC satisfies the criteria set out in Schedule “A” and that the granting of exemption from the requirement to be recognized as a clearing agency would not be prejudicial to the public interest;

**AND WHEREAS** the Commission will monitor developments in international and domestic capital markets and OCC's activities on an ongoing basis to determine whether it is appropriate that OCC continue to be exempted from the requirement to be recognized as a clearing agency and, if so, whether it is appropriate that it continue to be exempted subject to the terms and conditions in this order;

**IT IS ORDERED** by the Commission that pursuant to section 147 of the Act, OCC is exempt from the requirement to be recognized as a clearing agency under subsection 21.2(0.1) of the Act.

**PROVIDED THAT** OCC complies with the terms and conditions attached hereto as Schedule “B”.

**DATED** \_\_\_\_\_, 2012.

## SCHEDULE "A"

### Criteria for Exemption from Recognition by the OSC as a clearing agency pursuant to section 21.2(0.1) of the OSA

#### PART 1 GOVERNANCE

- 1.1 The governance structure and governance arrangements of the clearing agency ensures:
- (a) effective oversight of the clearing agency;
  - (b) the clearing agency's activities are in keeping with its public interest mandate;
  - (c) fair, meaningful and diverse representation on the governing body (Board) and any committees of the Board, including a reasonable proportion of independent directors;
  - (d) a proper balance among the interests of the owners and the different entities seeking access (participants) to the clearing, settlement and depository services and facilities (settlement services) of the clearing agency;
  - (e) the clearing agency has policies and procedures to appropriately identify and manage conflicts of interest;
  - (f) each director or officer of the clearing agency, and each person or company that owns or controls, directly or indirectly, more than 10 percent of the clearing agency is a fit and proper person; and
  - (g) there are appropriate qualifications, limitation of liability and indemnity provisions for directors and officers of the clearing agency.

#### PART 2 FEES

- 2.1 All fees imposed by the clearing agency are equitably allocated. The fees do not have the effect of creating unreasonable barriers to access.
- 2.2 The process for setting fees is fair and appropriate, and the fee model is transparent.

#### PART 3 ACCESS

- 3.1 The clearing agency has appropriate written standards for access to its services.
- 3.2 The access standards and the process for obtaining, limiting and denying access are fair and transparent. A clearing agency keeps records of
- (a) each grant of access including, for each participant, the reasons for granting such access, and
  - (b) each denial or limitation of access, including the reasons for denying or limiting access to an applicant.

#### PART 4 RULES AND RULEMAKING

- 4.1 The clearing agency's rules are designed to govern all aspects of the settlement services offered by the clearing agency, and
- (a) are not inconsistent with securities legislation,
  - (b) do not permit unreasonable discrimination among participants, and
  - (c) do not impose any burden on competition that is not necessary or appropriate.
- 4.2 The clearing agency's rules and the process for adopting new rules or amending existing rules should be transparent to participants and the general public.
- 4.3 The clearing agency monitors participant activities to ensure compliance with the rules.
- 4.4 The rules set out appropriate sanctions in the event of non-compliance by participants.

## **PART 5 DUE PROCESS**

- 5.1 For any decision made by the clearing agency that affects an applicant or a participant, including a decision in relation to access, the clearing agency ensures that:
- (a) an applicant or a participant is given an opportunity to be heard or make representations; and
  - (b) the clearing agency keeps a record of, gives reasons for, and provides for appeals or reviews of, its decisions.

## **PART 6 RISK MANAGEMENT**

- 6.1 The clearing agency's settlement services are designed to minimize systemic risk.
- 6.2 The clearing agency has appropriate risk management policies and procedures and internal controls in place.
- 6.3 Without limiting the generality of the foregoing, the clearing agency's services or functions are designed to achieve the following objectives:
- 1. Where the clearing agency acts as a central counterparty, it rigorously controls the risks it assumes.
  - 2. The clearing agency minimizes principal risk by linking securities transfers to funds transfers in a way that achieves delivery versus payment.
  - 3. Final settlement occurs no later than the end of the settlement day. Intraday or real-time finality is provided where necessary to reduce risks.
  - 4. Where the clearing agency extends intraday credit to participants, including a clearing agency that operates net settlement systems, it institutes risk controls that, at a minimum, ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle.
  - 5. Assets used to settle the ultimate payment obligations arising from securities transactions carry little or no credit or liquidity risk. If central bank money is not used, steps are to be taken to protect participants in settlement services from potential losses and liquidity pressures arising from the failure of the cash settlement agent whose assets are used for that purpose.
  - 6. If the clearing agency establishes links to settle cross-border trades, it designs and operates such links to reduce effectively the risks associated with cross-border settlements.
- 6.4 The clearing agency engaging in activities not related to settlement services carries on such activities in a manner that prevents the spillover of risk to the clearing agency that might affect its financial viability or negatively impact any of the participants in the settlement service.

## **PART 7 SYSTEMS AND TECHNOLOGY**

- 7.1 For its settlement services systems, the clearing agency:
- (a) develops and maintains,
    - (i) reasonable business continuity and disaster recovery plans,
    - (ii) an adequate system of internal control,
    - (iii) adequate information technology general controls, including controls relating to information systems operations, information security, change management, problem management, network support, and system software support;
  - (b) on a reasonably frequent basis, and in any event, at least annually, and in a manner that is consistent with prudent business practice,
    - (i) makes reasonable current and future capacity estimates,
    - (ii) conducts capacity stress tests to determine the ability of those systems to process transactions in an accurate, timely and efficient manner,

(iii) tests its business continuity and disaster recovery plans; and

(c) promptly notifies the regulator of any material systems failures.

7.2 The clearing agency annually engages a qualified party to conduct an independent systems review and prepare a report in accordance with established audit standards regarding its compliance with section 7.1(a).

**PART 8 FINANCIAL VIABILITY AND REPORTING**

8.1 The clearing agency has sufficient financial resources for the proper performance of its functions and to meet its responsibilities and allocates sufficient financial and staff resources to carry out its functions as a clearing agency in a manner that is consistent with any regulatory requirements.

**PART 9 OPERATIONAL RELIABILITY**

9.1 The clearing agency has procedures and processes to ensure the provision of accurate and reliable settlement services to participants.

**PART 10 PROTECTION OF ASSETS**

10.1 The clearing agency has established accounting practices, internal controls, and safekeeping and segregation procedures to protect the assets that are held by the clearing agency.

**PART 11 OUTSOURCING**

11.1 Where the clearing agency has outsourced any of its key functions, it has appropriate and formal arrangements and processes in place that permit it to meet its obligations and that are in accordance with industry best practices. The outsourcing arrangement provides regulatory authorities with access to all data, information, and systems maintained by the third party service provider required for the purposes of regulatory oversight of the agency.

**PART 12 INFORMATION SHARING AND REGULATORY COOPERATION**

12.1 For regulatory purposes, the clearing agency cooperates by sharing information or otherwise with the Commission and its staff, self-regulatory organizations, exchanges, quotation and trade reporting systems, alternative trading systems, other clearing agencies, investor protection funds, and other appropriate regulatory bodies.

**SCHEDULE "B"**

**Terms and Conditions**

**REGULATION OF OCC**

1. OCC will maintain its registration as a clearing agency with the SEC and as a DCO with the CFTC and will continue to be subject to the regulatory oversight of the SEC and CFTC.
2. OCC will continue to meet the Criteria for Exemption from Recognition as a Clearing Agency as set out in Schedule "A".

**FILING REQUIREMENTS**

**SEC/CFTC Filings**

3. OCC will provide staff of the Commission, concurrently, the following information to the extent that it is required to provide to or file such information with the SEC or the CFTC:
  - (a) the annual audited financial statements of OCC;
  - (b) details of any material legal proceeding instituted against it;
  - (c) notification that OCC has failed to comply with an undisputed obligation to pay money or deliver property to a Clearing Member for a period of thirty days after receiving notice from the Clearing Member of OCC's past due obligation;
  - (d) notification that OCC has instituted a petition for a judgment of bankruptcy or insolvency or similar relief, or to wind up or liquidate OCC or has a proceeding for any such petition instituted against it;
  - (e) the appointment of a receiver or the making of any voluntary arrangement with creditors;
  - (f) changes and proposed changes to its bylaws, rules, operations manual, participant agreements and other similar instruments or documents which contain any contractual terms setting out the respective rights and obligations between OCC and Clearing Members or among Clearing Members;
  - (g) A summary of risk management test results related to the adequacy of required margin and the level of the guaranteed fund, including but not limited to stress testing and back testing results; and
  - (h) new services or clearing of new types of products to be offered to Ontario Clearing Members or services or products that will no longer be available to Ontario Clearing Members.

**Prompt Notice**

4. OCC will promptly notify staff of the Commission of any of the following:
  - (a) a material change to its business or operations or the information in the Application;
  - (b) a material problem with the clearance and settlement of transactions in contracts that could materially affect the safety and soundness of OCC;
  - (c) an event of default by a Clearing Member; and
  - (d) a material change or proposed material change in OCC's status as a derivatives clearing agency or DCO or to the regulatory oversight by the SEC or the CFTC.

**Quarterly Reporting**

5. OCC will maintain the following updated information and submit such information to the Commission in a manner and form acceptable to the Commission on at least a quarterly basis, and at any time promptly upon the request of staff of the Commission:

- (a) a current list of all Ontario Clearing Members;
- (b) a list of all Ontario Clearing Members against whom disciplinary action has been taken in the previous quarter by OCC, or by the SEC or the CFTC with respect to activities on OCC;
- (c) a list of all investigations by OCC relating to Ontario Clearing Members;
- (d) a list of all Ontario applicants who have been denied Clearing Member status in OCC in the previous quarter;
- (e) the average daily volume and value of trades cleared during the previous quarter for each Ontario Clearing Member by asset class;
- (f) the average daily volume and value of assets loaned through OCC's stock loan facility during the previous quarter for each Ontario Clearing Member;
- (g) the portion of total volume and value of trades cleared during the previous quarter for all Clearing Members that represents the total volume and value of trades cleared during the previous quarter for each Ontario Clearing Member;
- (h) the portion of total volume and value of assets loaned during the previous quarter for all Clearing Members that represents the total volume and value of assets loaned during the previous quarter for each Ontario Clearing Member; and
- (i) any other information in relation to an OTC derivative cleared by OCC as may be required by the Commission from time to time in order to carry out the Commission's mandate.

**INFORMATION SHARING**

- 6. OCC will provide such information as may be requested from time to time by, and otherwise cooperate with, the Commission or its staff.
- 7. OCC will share information with and otherwise cooperate with other recognized and exempt clearing agencies as appropriate.

**SUBMISSION TO JURISDICTION AND AGENT FOR SERVICE**

- 8. OCC will submit to the non-exclusive jurisdiction of (i) the courts and administrative tribunals of Ontario and (ii) an administrative proceeding in Ontario, in a proceeding arising out of, related to or concerning or in any other manner connected with the activities of OCC in Ontario.
- 9. OCC will file with the Commission a valid and binding appointment of an agent for service in Ontario upon whom may be served a notice, pleading, subpoena, summons or other process in any action, investigation or administrative, criminal, quasi-criminal, penal or other proceeding arising out of or relating to or concerning the activities of OCC in Ontario.