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Via Electronic Mail

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

Re: S7-08-11 Clearing Agency Standards for Operations and Governance

Dear Ms. Murphy:

This letter is submitted by The Options Clearing Corporation ("OCC") in response to the Commission's recent release (the "Release")[1] requesting comment on proposed rules (the "Proposed Rules") regarding registration of clearing agencies and standards for the operation and governance of clearing agencies, as mandated by Sections 763 and 805 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[2] and Section 17A of the Securities Exchange Act of 1934, as amended by Dodd-Frank (the "Exchange Act"). The Commission states that the Proposed Rules are "designed to enhance the regulatory framework for the supervision of clearing agencies."[3] Subject to the specific comments and exceptions discussed herein, OCC supports adoption of the Proposed Rules, which we believe are generally well reasoned and, in most respects, wisely avoid being overly prescriptive. We welcome this opportunity to provide our specific comments based upon OCC's experience and unique circumstances. Certain of the Proposed Rules would apply to registered clearing agencies generally while others would apply only to clearing agencies that provide central counterparty services or only to those clearing agencies that clear security-based swaps ("SB Swaps"). As OCC currently provides central counterparty services and may clear SB Swaps in the future, we are submitting comments on all of the Proposed Rules.

OCC Background

Founded in 1973, OCC is currently the world's largest clearing organization for financial derivatives. OCC is the only clearing organization that is registered with the Commission as a

1 76 FR 14472 (March 16, 2011).

2 Pub. L. 111-203.

3 76 FR at 14472.

securities clearing agency pursuant to Section 17A of the Exchange Act and with the Commodity Futures Trading Commission ("CFTC") as a derivatives clearing organization ("DCO") pursuant to Section 5b of the Commodity Exchange Act, as amended by Dodd-Frank (the "CEA"). OCC clears securities options, security futures and other securities contracts subject to the Commission's jurisdiction, and commodity futures and commodity options subject to the CFTC's jurisdiction. OCC clears derivatives for all nine U.S. securities options exchanges and five futures exchanges.[4]

Nature of the Proposed Rules and Coordination with Other Regulators

The Commission has specifically requested comment on the effect of "differences between the Commission and CFTC approaches to the regulation of clearing agencies and DCOs respectively."[5] While we appreciate that the Commission and the CFTC "regulate different products and markets, and as such, appropriately may be proposing alternative regulatory requirements,"[6] there are many areas in which the Commission's rules and the CFTC's rules differ in ways that appear to reflect differences of opinion or policy that do not bear any identifiable relationship to differences between the products or markets regulated. Examples of ways in which the CFTC proposes more prescriptive and restrictive rules than those proposed by the Commission include the CFTC's requirements regarding gross margining, large trader surveillance, clearing member risk management review, settlement bank procedures (*e.g.*, concentration limits), restrictions on types of margin collateral (including prohibitions against acceptance of letters of credit), governance, and disaster recovery time. While the CFTC's requirements might be appropriate for some clearing organizations, they are not appropriate for others. OCC strongly believes that the degree of micro-management reflected in the CFTC's requirements should be eschewed in favor of case-by-case review of clearing organizations' proposed rule changes. We support the Commission's approach in this regard. Many other differences are highlighted in the remainder of this comment letter.

As a general matter, we favor rules that are more principles-based and less specifically prescriptive. While we applaud the Commission's approach as more appropriately flexible on the whole, we believe that the proposals of both agencies contain provisions that are too prescriptive and detailed. As a dual registrant, OCC is particularly sensitive to the need for consistency between the Commission's rules and those of the CFTC. Rules that are more principles-based and less prescriptive will be inherently easier to reconcile, and we urge the two agencies to reconcile differences by opting for the less prescriptive standard.

Dodd-Frank recognized the importance of harmonizing regulation of the OTC derivatives markets internationally. OCC encourages the Commission to coordinate with foreign regulators

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

5 76 FR at 14501.

6 *Id.*

and CPSS/IOSCO to ensure harmonious clearinghouse regulation. We strongly encourage the Commission to avoid taking final action on the Proposed Rules prior to receiving greater clarity on what clearinghouse regulations are ultimately adopted by European and U.K. legislators and regulators and what approaches to regulation are ultimately embraced by CPSS/IOSCO. Many potential market participants will be able to choose the jurisdiction in which they conduct their clearing activity, and imposing more prescriptive and costly regulatory burdens on U.S. clearing agencies will have a predictably adverse competitive impact on those clearing agencies.

Designation of Chief Compliance Officer (Rule 3Cj-1)

Prescriptive Nature of the Proposed Rules and Need for Coordination with the CFTC

On December 1, 2010, the CFTC proposed rules that would apply to the chief compliance officer ("CCO") of a DCO (the "CFTC CCO Proposal").[7] OCC submitted a comment letter on the CFTC CCO Proposal on February 10, 2011 (the "CFTC CCO Comment Letter"). The statutory requirements imposed by Dodd Frank on clearing agencies and DCOs with respect to their CCOs are substantially identical and we believe it appropriate for the commissions to adopt substantially similar rules governing the CCOs of clearing organizations. The CFTC CCO Proposal, however, is much more detailed and prescriptive than the Commission's Proposed Rules, which are found in Proposed Rule 3Cj-1, and the commissions' rules, while they substantially overlap in many respects, differ in several key respects. As the only current joint clearing agency/DCO registrant, OCC will be immediately burdened by requirements of the two commissions that differ. However, as these markets develop in response to Dodd-Frank, other clearing organizations may also become dually registered.

The Commission's Proposed Rules would require that the compensation of a clearing agency's CCO be approved by a majority of the clearing agency's board of directors[8], while the CFTC CCO Proposal would allow the compensation of a DCO's CCO to be approved *either* by the DCO's board of directors or by the DCO's senior officer.[9] As OCC intends to have a single individual serve as its CCO in its capacity both as a clearing agency and as a DCO, the practical impact of this difference will be that OCC will need to obtain board approval for the CCO's compensation. While we understand that the intention is to protect the integrity of the CCO's function, we believe that the board has ample authority to accomplish this purpose through the ordinary course of its oversight of the management function. There are several other examples of proposed rules where the divergence between the Commission's proposal and the CFTC's proposal will effectively require OCC to adhere to the more stringent of the commissions' rules with respect to CCOs– (1) the Commission's Proposed Rule provides that a CCO may be removed only by a majority of the board of directors while the CFTC's rule includes no such requirement; (2) the CFTC's Proposed Rule requires the CCO to "meet with the board of directors or the senior officer [annually] to discuss the effectiveness of [OCC's] compliance policies and procedures, as well as the administration of those policies and procedures by the

7 *See* General Regulations and Derivatives Clearing Organizations, 75 FR 77576 (December 13, 2010).

8 *See* Proposed Rule 3Cj-1(a).

9 75 FR at 77587.

[CCO]"[10] but the Commission's Proposed Rule includes no such requirement; (3) the Commission's proposal would require consultation concerning conflicts to take place between the CCO and a "body performing a function similar" to that of the board of directors, while the CFTC would require this consultation to take place between the CCO and the board of directors or the senior officer; (4) the CFTC would require a clearing organization to create a "compliance manual designed to promote compliance with the applicable laws, rules, and regulations and a code of ethics designed to prevent ethical violations and to promote ethical conduct" whereas the Commission proposes no such requirement. While many of the proposed requirements are not inherently unreasonable in themselves and are in some cases consistent with OCC's present practice, the combined effect of so many detailed requirements places a burden on a dual registrant such as OCC that neither agency alone would impose. And the negative effect of imposing such detailed requirements is not simply the administrative and compliance costs imposed (though they are significant), but more importantly, a clearing agency that is subject to such detailed regulation will be forced to focus its attention and resources (including the time and attention of its directors) on bureaucratically determined matters that will inevitably draw attention away from matters that are more urgent and critical to the sound functioning of the clearing agency. The Commission should coordinate its rulemaking with the CFTC to resolve differences in the agencies' rules for CCOs in favor of the least prescriptive alternative.

Approval of CCO Compensation

Proposed Rule 3Cj-1(a) would require that compensation of a clearing agency's CCO be approved by a majority of the clearing agency's board of directors.[11] As mentioned above, the CFTC's CCO Proposal would allow the CCO's compensation to be approved by either the board or the senior officer of the clearing organization. We believe that the CFTC's approach is more appropriate.

Removal of the CCO

Proposed Rule 3Cj-1(a) would also require that any removal of the CCO be approved by a majority of a clearing agency's board of directors. The CFTC CCO Proposal included no such requirement. As in the case of compensation decisions, we do not believe that it is necessary or appropriate to require board approval for "removal" of a CCO. In the first place, it is unclear to us what is meant by "removal." If the clearing agency simply decides that, for example, its current CCO would be better utilized in a different capacity (a decision with which the CCO may be in full agreement or even advocating) and management hires or appoints a replacement, has the CCO been "removed"? Must management wait to bring this action to the board? We think that, with respect to this matter as with compensation decisions, the board has the ability and the responsibility to oversee the CCO function without these kinds of specific requirements.

Scope of Annual Compliance Report

Proposed Rule 3Cj-1(c)(1)(ii) would require the CCO of a clearing agency to include in his or her annual report "a description of . . . [e]ach policy and procedure of the clearing agency

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10 75 FR at 77587.

11 *See* 76 FR at 14537.

of the compliance officer (including the code of ethics and conflict of interest policies of the registered clearing agency)." This requirement is impractical, unnecessary and unduly burdensome. We believe the description in the annual report should be limited only to those policies and procedures that address compliance with applicable requirements under the Exchange Act or SEC regulations thereunder. A clearing agency may have many policies and procedures designed to assist it in its daily operations that have no particular connection with compliance with applicable laws and regulations. Requiring a clearing agency to describe all such policies and procedures would present an enormous task and yield an annual report loaded down with voluminous descriptions of little practical use to either the clearing agency or the Commission.

Timing of Annual Compliance Report

Proposed Rule 3Cj-1(c)(2) would require that the CCO's annual compliance report be filed with the Commission within 60 days after the end of the fiscal year to which the report relates. The CFTC CCO Proposal would allow a DCO 90 days after the end of its fiscal year to file its annual CCO compliance report. We see no reason for a disparity in the timing of this report and believe 60 days is too short a period to allow the CCO and the clearing agency adequate time to fully vet the issues relevant to the report. In addition, the Commission is proposing that the annual compliance report must be submitted to the clearing agency's board of directors and audit committee (or equivalent bodies) before it is filed with the Commission. Interposing such reviews would further shorten the time the CCO and the clearing agency have to prepare the annual report. The Release states that the Commission "preliminarily believes it would be appropriate to require that the annual compliance report be submitted to the board of directors and audit committee (or equivalent bodies) *prior to* filing of the report with the Commission because it would *help to focus attention at senior levels of the clearing agency on the contents* of the report that is being filed with the Commission."[12] We agree that it is appropriate for the board of directors and audit committee to review the CCO's annual report before it is submitted to the Commission, but 60 days is too short a deadline to allow the report to both be prepared and reviewed in an adequate manner. We therefore encourage the Commission to adopt a 90 day filing requirement. We also believe that the first annual compliance report prepared by a clearing agency's CCO could be substantially more difficult and complex to prepare than subsequent annual reports, due to the time required to create a template for the report, determine what information is appropriately included in the report and establish internal procedures to ensure that information necessary for the report is gathered in a timely manner. We therefore request that the Commission allow a clearing agency 120 days after the end of its fiscal year to file its first annual compliance report.

Confidentiality of Annual Compliance Report

Proposed Rule 3Cj-1(c)(iv) would require that a clearing agency's annual compliance report be filed with the Commission via EDGAR and made public. OCC strongly believes that clearing agencies' annual compliance reports should not be publicly disclosed via EDGAR or any other means and that they should not be the proper subject of a FOIA request. Dodd-Frank does not require the clearing agency annual compliance report to be made public and we see little

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[12] 76 FR at 14500 (emphasis added).

public purpose served by such disclosure. Neither broker-dealers nor investment advisers have their compliance reports subjected to public scrutiny and we see no purpose served by subjecting similar reports prepared by a clearing agency to such scrutiny either. The nature of a clearing agency's annual report is such that it will likely include information that is highly confidential or proprietary. We believe the proper purpose of these reports is the communication of compliance information between the clearing agency and its regulator.

Dual Role of the CCO

The Commission indicates in the Release that it "preliminarily believes that a clearing agency would not necessarily need to hire an additional person to serve as its CCO. Instead, a clearing agency could designate an individual already employed by the clearing agency as its CCO."[13] We support this view.

Lines of Authority

Proposed Rule 3Cj-1(b)(1) would require that a CCO report directly either to the board of directors or to its senior officer. The Commission has specifically requested comment on whether "clearing agencies [should] be required to have the CCO report directly to the board instead of also permitting reporting to a senior officer of the clearing agency[.]"[14] We believe that allowing the CCO to report to either the board of directors or the senior officer is appropriate and such flexibility is consistent with the CFTC CCO Proposal. As a practical matter, a board ordinarily could not provide direct, on-going supervision of a CCO, and to implicitly remove the CCO from the supervisory purview of the CEO would create an unnecessarily awkward, inefficient and potentially ineffective supervisory structure.

"Ensuring" Compliance

Proposed Rule 3Cj-1(b)(4) would require a clearing agency's CCO to "*[e]nsure* compliance with the [Exchange] Act and the rules and regulations thereunder[.]"[15] While we appreciate that the phrase "ensure compliance" is found in the Exchange Act, as amended by Dodd-Frank, we believe imposing this standard on a CCO is impractical, unrealistic and unduly burdensome. The appropriate standard, and one that is actually achievable, is to require the CCO to put in place measures reasonably designed to ensure compliance with the Exchange Act and SEC regulations. Ultimately it is management of the clearing agency, and not the CCO, that is responsible for ensuring compliance.

"Resolving" Conflicts of Interest

Proposed Rule 3Cj-1(b)(2) would require a clearing agency's CCO to "[i]n consultation with [the clearing agency's] board, a body performing a function similar thereto, or the senior officer of the registered clearing agency, *resolve* any conflicts of interest that may arise[.]"[16]

[13] 76 FR at 14499.

[14] 76 FR at 14500.

[15] Emphasis added.

[16] Emphasis added.

This language is found in the Exchange Act, as amended by Dodd-Frank. However, if read literally it would result in CCOs being held to an impossibly strict standard. We think the Commission should revise the Proposed Rule or provide additional guidance to the effect that the CCO's obligation is merely to take actions reasonably designed to resolve or appropriately mitigate conflicts of interest, and not, strictly speaking, to "resolve" such conflicts of interest.

Standards for Clearing Agencies (Rule 17Ad-22)

General Approach to Clearing Agency Standards

We applaud the Commission for choosing to incorporate many aspects of the current CPSS/IOSCO clearing organization standards (2004) into the Proposed Rules, rather than attempting to incorporate the draft revised CPSS/IOSCO standards that were only recently released for comment. We believe this is the prudent course, as the recently proposed standards may undergo significant changes in response to comments received from, among others, OCC and other clearing organizations. We nevertheless have some specific comments on Proposed Rule 17Ad-22 as set forth in the following paragraphs.

Margin Requirements and Risk-Based Models and Parameters

Proposed Rule 17Ad-22(b)(2) would require each clearing agency that performs central counterparty services to "establish, implement, maintain and enforce written policies and procedures reasonably designed to . . . [u]se margin requirements to limit its credit exposures to participants in normal market conditions and use risk-based models and parameters to set margin requirements and review them at least monthly." Proposed Rule 17Ad-22(a)(4) would define "normal market conditions" as "conditions in which the expected movement of the price of cleared securities would produce changes in a clearing agency's exposures to its participants that would be expected to breach margin requirements or other risk control mechanisms only one percent of the time." We find it unusual to define normal market conditions using a metric that is based on margin requirements, as margin models, including OCC's STANS, adjust during periods of market turbulence to increase margin requirements.

The Commission also notes that it "preliminarily believes that the review of these models and parameters should be required to occur at least monthly."[17] OCC currently refreshes its estimates monthly, and in some cases even daily. However, there are many other matters such as the choice of confidence levels at which OCC estimates "Expected Shortfall," the number of days' data we require for certain purposes, the various weights that are used to determine our stress test charges, etc., that OCC believes do not need to be reviewed on a monthly basis. If a monthly review standard is included in the final rule, we urge that clearing agencies be given substantial discretion in determining which aspects of the model are appropriate for monthly review.

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17 76 FR at 14478.

Clearing Agency Financial Resources

Proposed Rule 17Ad-22(b)(3) would require a clearing agency to maintain "sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme but plausible market conditions" and would further require "that a . . . clearing agency [that clears SB Swaps must] maintain sufficient financial resources to withstand, at a minimum, a default by the two participants to which it has the largest exposures in extreme but plausible market conditions."[18] The Commission's stated rationale for requiring a clearing agency that clears SB Swaps to follow a "two largest" coverage rule, while requiring other clearing agencies to follow only a "single largest" coverage rule is that clearing agencies that act as central counterparties in SB Swaps "face additional risk-management challenges because of factors unique to the security-based swaps market, such as more limited historical information on pricing and the jump-to-default risk associated with certain security-based swaps, such as CDS."[19] We disagree that clearing SB Swaps *inherently* entails substantial additional risk requiring significantly higher financial resources and a "two largest" coverage rule.

Not all SB Swaps will necessarily involve risks that exceed those of instruments already cleared by clearing agencies. For example, a total return SB Swap based on a single underlying security of a large cap company poses even less risk management challenge than a put or call option on the same underlying security and is much the same as a security future on the same underlying. The Commission should also consider what impact the launch of one or more security-based swap execution facilities ("SB SEFs"), as well as other price and trade transparency improvements currently being implemented, will have on a clearing agency's ability to manage the risk of cleared SB Swaps. The Commission should not view risk-management of SB Swaps in a vacuum. The markets for these instruments will change substantially as Dodd-Frank is implemented, and assumptions about the risks inherent in these instruments in the past may no longer be relevant. In addition, we disagree with the Commission's position that the proper way to handle the jump-to-default risk of CDS and the lack of historical data on CDS is to apply a "two largest" coverage model. The better approach would be to use more extreme market scenarios, not to alter the types of default addressed by the model. Indeed, we see little connection between the riskiness of any given product and the types of default event ("single largest" coverage versus "two largest" coverage, for example) used to ensure the adequacy of margin on such product.

While we agree that all clearing agencies should consider possible simultaneous defaults by multiple clearing members, we do not think simultaneous default should be a fixed assumption of the Commission's rules and of a clearing agency's margin models. A simultaneous default of a clearing agency's two largest clearing members, at least in the context of how that might occur within OCC, seems to us an extremely implausible occurrence that does not warrant being grafted into permanent and inflexible rules. While the identities of OCC's two largest clearing firms, from a risk perspective, shift occasionally among several members, our two largest firms are always among the largest, most well-capitalized global firms. While the 2008 financial crisis proved that large firms can indeed fail, we believe subsequent reforms,

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[18] 76 FR at 14538.

[19] 76 FR at 14479.

including higher capital standards for banks and new OTC derivatives trading and clearing requirements, will greatly reduce the likelihood of the kind of catastrophic scenario contemplated by a "two largest" coverage rule. In addition, imposing a heightened risk management standard on a clearing agency will increase the cost for clearing members and their customers to clear through a particular clearing agency. If these costs are substantial, there is a risk that the Commission may undermine the goals of Title VII of Dodd-Frank by discouraging clearing agencies from clearing SB Swaps and discouraging customers and clearing members from submitting trades for clearing by clearing agencies subject to the heightened standards.

A "single largest" coverage requirement is consistent with the current CPSS/IOSCO best practices and should be adopted by the Commission. Although CPSS/IOSCO is currently considering whether to adopt a "two largest" test as a revised standard and the Working Party on Financial Services of the European Union has also proposed (but the European Parliament has not yet adopted) a "two largest" test, the international community is far from a consensus on this issue and CPSS/IOSCO itself has not expressed a definitive view on the issue. CPSS/IOSCO has instead requested comment on whether a central clearing counterparty should be subject to a "single largest" or "two largest" coverage requirement, depending on the particular risk and other characteristics of the products it clears, the markets it serves and the number and type of participants in the CCP. CPSS/IOSCO has also flagged the potential competitive issues involved in subjecting certain CCPs to a "single largest" test while others are subjected to a "two largest" test. We remain of the view that a "single largest" standard is more appropriate, whether or not a given clearing agency clears SB Swaps. Any heightened risk caused by clearing SB Swaps can, and should, be addressed by use of appropriately conservative risk models for these instruments. We urge the Commission not to leap ahead of the international process currently underway on this issue by dictating a "two largest" coverage requirement.

As part of our daily run of our clearing fund size model, OCC stress tests its financial resource requirements based on the currently accepted "single largest" coverage requirement. Stress tests involve many important assumptions and modeling decisions. With respect to stress tests that involve multiple simultaneous defaults, an assumption must be made as to the level of volatility in the market prior to the defaults. Our modeling assumptions for simultaneous default scenarios reasonably assume heightened volatility. By contrast, the stress tests we apply to our "single largest" firm incorporate a very conservative assumption that volatility could be low prior to default (*i.e.*, a "bolt out of the blue" or surprise event), but that volatility would increase substantially immediately after the default. The significance of elevated volatility prior to a default is that collected margins would be much higher when the default occurred, greatly reducing the risk of loss to OCC. We believe it is reasonable to assume that a simultaneous default of OCC's two largest clearing members, in the extraordinarily unlikely event that it were to occur, could only happen against a backdrop of already elevated market volatility. We make this point primarily to illustrate that, while it may appear intuitive that a "two largest" test would require a clearing agency to maintain substantially greater financial resources than a "single largest" test, that might not always be the case when legitimate distinctions among various scenarios are taken into account. Similarly, we are aware of speculation by some regulators as to whether a "two largest" test may actually result in lower financial resource requirements than a "single largest" test where the ability to net out open positions across the two defaulting members is taken into account. Our current models do not take such netting possibilities into account, but the concept appears reasonable, provided that a clearing organization has legal authority to do such netting. Mandating a "two largest" coverage requirement may therefore not have a predictably risk-reducing effect on clearing organizations, but instead may merely restrict the ability of the clearing agency to construct a financial resource model that it deems appropriate to protect itself against defaults.

Extreme but Plausible Market Conditions

The Commission specifically requests comment on whether the Commission should "provide additional guidance regarding what constitutes 'extreme but plausible market conditions'[.]"[20] The Commission also asks whether "allowing clearing agencies providing CCP services discretion to interpret this term create[s] uncertainty or introduce[s] more risk into the financial system than might otherwise be the case[.]"[21] We believe that the definition of "extreme but plausible marketing conditions" is best left to the discretion of each clearing agency. OCC is in a much better position than the Commission to know the range of possible market conditions in the markets for which it provides CCP services. We do not believe that additional guidance from the Commission would be helpful, and indeed such guidance could unnecessarily hinder OCC's own risk management efforts. We do, however, believe that it would be helpful for the Commission to state explicitly in the final rule release that the definition of "extreme but plausible market conditions" is to be determined by each clearing agency in its reasonable discretion, which is consistent with the current CPSS/IOSCO standards.

Persons Eligible to Perform Model Validation

Proposed Rule 17Ad-22(b)(4) would require each clearing agency that performs central counterparty services to have written policies in place that provide for an "annual model validation consisting of evaluating the performance of the clearing agency's margin models and the related parameters and assumptions associated with such models by a qualified person who does not perform functions associated with the clearing agency's margin models (except as part of the annual model validation) and does not report to a person who performs these functions."[22] We believe that requiring model validation to be performed by a person who "does not perform functions associated with the clearing agency's margin models (except as part of the annual model validation) and does not report to a person who performs these functions" is overly restrictive. Eliminating anyone who "performs functions associated" with the models and anyone within the supervisory chain with such a person may make it impossible for the clearing agency to use any of its own employees to perform the work as most persons who are qualified are likely to be excluded under the current scope of the rule, and it may be impossible to obtain outside consultants who can perform the work efficiently. While we recognize that it is inappropriate to expect an individual to effectively validate his or her own work, the proposed requirement goes further than necessary.

The Commission's Proposed Rules in this regard suggest a severe risk that an employee's finding fault with a model would be a career-damaging move if the reviewer were involved with

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20 76 FR at 14480.

21 *Id.*

22 76 FR at 14538.

margin analytics in any way other than review. We disagree. The most effective approach to model quality assurance is a culture in which model quality assurance is prized, and finding a problem in a model – or finding a way to improve one, especially one that those in senior positions have not thought of – is career-enhancing. OCC believes that it has such a culture. Moreover, OCC's policies and procedures for model review ensure a transparent, auditable process that should avoid the risks the Commission is apparently concerned about.

If a clearing organization nevertheless undertook to detach model review totally from model development, it would be necessary for a clearing organization to have two quantitative teams. This has several familiar pitfalls: (a) cost; (b) staffing problems, since talented young people with the requisite quantitative skills tend to see review as non-creative; (c) adversarial relations (a team dedicated solely to review may be seen to contribute only if it finds fault); and (d) tensions that require senior management to resolve highly technical disputes between the development and review teams.

We believe that a better rule would be to require a clearing organization to (a) maintain a culture of commitment to quality where correcting/improving models is career-enhancing; (b) adopt sound policies and procedures creating a transparent and auditable model review process; and (c) require that, given that reporting lines must come together somewhere, they come together at a person well-versed in technical quantitative matters. In the recently released Supervisory Guidance on Model Risk Managements, the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency stated that "corporate culture plays a role [in providing appropriate incentives for proper model review] if it establishes support for objective thinking and encourages questioning and challenging of decisions."[23] The foregoing guidance also states that "independence *may* be supported by separation of reporting lines, [but] it should be judged by actions and outcomes, since *there may be additional ways* to ensure objectivity and prevent bias."[24]

We think that a clearing agency is capable of validating its own models through the use of qualified internal personnel, provided that appropriate steps are taken to ensure objectivity, such as ensuring that the reviewers are not the same individuals as those who are or were involved in *designing* such models or are *otherwise biased* due to their involvement in implementation of the models.[25] Many employees who perform functions associated with margin models may have no particular conflict or bias that would prevent them from conducting

23 Supervisory Guidance on Model Risk Management, Board of Governors of the Federal Reserve System and the Office of Comptroller of the Currency, April 4, 2011, at p. 9.

24 *Id.* (emphasis added)

25 The Office of the Comptroller of the Currency, the Department of the Treasury, the Federal Reserve System and the Federal Deposit Insurance Corporation recently proposed revisions to their risk-based capital guidelines. These proposed revisions would require banks to validate their internal risk models initially and on an ongoing basis and would require that this "validation process . . . be independent of the internal models' development, implementation, and operation, or [that] the validation process . . . be subjected to an independent review of its adequacy and effectiveness." However, the proposed rules would also provide that "[t]he review personnel [would] not necessarily have to be external to the bank in order to achieve the required independence. A bank should ensure that individuals who perform the review are not biased in their assessment due to their involvement in the development, implementation, or operation of the models." Risk-Based Capital Guidelines; Market Risk, 76 FR 1890 (January 11, 2011), at 1897.

objective model validations and, in fact, many such employees may have a strong interest in ensuring that margin models are as well-designed as possible.

Membership Standards

Proposed Rule 17Ad-22(b)(5) would require clearing agencies that perform central counterparty services to have policies and procedures to "[p]rovide the opportunity for a person that does not perform any dealer or security-based swap dealer services to obtain membership at the clearing agency to clear securities for itself or on behalf of other persons." Proposed Rule 17Ad-22(b)(6) would require such clearing agencies to have "membership standards that do not require that participants maintain a portfolio of any minimum size or that participants maintain a minimum transaction volume." Proposed Rule 17Ad-22(b)(7) would require such clearing agencies to provide persons with net capital of $50 million or more with the ability to obtain membership, with net capital requirements being scalable so that they are proportional to the risks posed by the participant's activities. A clearing agency could, however, impose a higher net capital requirement with Commission approval. The Release makes it clear that applicants who meet the net capital requirement would not have to be admitted unless "they are able to comply with other reasonable membership standards."[26]

OCC does not object to the substance of these proposed requirements, and OCC's existing membership standards meet them. However, we question the need to "hard-wire" them into the Commission's rules. The Commission has ample authority to regulate clearing agency membership standards without adopting prescriptive requirements. Clearing agency membership standards are subject to Commission approval as proposed rule changes. Proposed Rule 17Ad-22(d)(2), to which OCC does not object, would require clearing agencies to "have participation requirements that are objective, publicly disclosed, and permit fair and open access." Section 17A(b)(3)(F) of the Exchange Act gives the Commission authority to deny registration to a clearing agency whose rules are "designed to permit unfair discrimination in the admission of participants or among participants in the use of the clearing agency." OCC does not see the need for "one size fits all" access requirements when the Commission will have the opportunity to review membership standards on a case-by-case basis, taking into account the nature of the particular clearing agency's activities and the risks associated with those activities.

Monitoring of Participation Requirements

Proposed Rule 17Ad-22(d)(2) would require each clearing agency to have procedures in place to "monitor that participation requirements are met on an ongoing basis."[27] This requirement seems appropriate if reasonably interpreted. The CFTC has proposed a similar rule that would require each DCO to "establish and implement procedures to verify, on an ongoing basis, the compliance of each clearing member with each participation requirement of the derivatives clearing organization."[28] OCC and other clearing organizations have such procedures, which in OCC's case include its "Watch Level Surveillance" procedures. We

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26 76 FR at 14482.

27 76 FR at 14538.

28 Proposed Rules § 39.12(a)(4), 76 FR at 3719.

believe that our current procedures are fully adequate and appropriate and should be compliant with the requirement. On the other hand, OCC has certain requirements for participation that are reviewed in connection with approval of an initial application for clearing membership and that do not, in our view, require any formal ongoing review. For example, we believe there is no reason for ongoing review of operational readiness requirements beyond the DCO's day-to-day experience with the clearing member's performance.

Clearing Agency Investments

Proposed Rule 17Ad-22(d)(3) would limit the types of assets in which a clearing agency may invest to "instruments with minimal credit, market and liquidity risks." In OCC's parallel CFTC comment letter,[29] OCC expressed serious concern about the "minimal credit, market and liquidity risks" limitation in the context of the assets that are accepted as initial margin or used as collateral. However, we do not believe the same concerns present themselves under the Proposed Rule, which we read as applying only to investments made by a clearing agency of its own funds (*e.g.*, clearing fund contributions), and would not in any way restrict the types of collateral that a clearing agency may accept in the form of margin or collateral deposits, whether the clearing agency takes actual delivery or merely a lien in the margin or collateral. In addition, we note that OCC's clearing fund consists exclusively of cash and U.S. Treasury securities. We assume that the Commission would consider U.S. Treasury securities to be, in all cases, "instruments with minimal credit, market and liquidity risks", notwithstanding that certain Treasury securities (particularly long-dated securities) could arguably be said to have more than a minimal amount of market risk in that such instruments may experience appreciable price movements from time to time. We doubt the Commission would take the view that a clearing agency must evaluate its portfolio of U.S. Treasury securities to determine whether such securities meet the standard described in Proposed Rule 17Ad-22(d)(3), as Treasuries are historically seen as the least risky asset class other than cash, but clarification of this view in the final rule release would be helpful.

Identification and Mitigation of Operational Risk

Proposed Rule 17Ad-22(d)(4) would require each clearing agency to "[i]dentify sources of operational risk and minimize them through the development of appropriate systems, controls, and procedures; implement systems that are reliable, resilient and secure, and have adequate, scalable capacity; and have business continuity plans that allow for timely recovery of operations and fulfillment of a clearing agency's obligations."[30] We think that the proposed requirements are appropriate. However, the Commission asks: "Should the Commission's proposal require a specific methodology to identify and mitigate operational risk?" Consistent with our view that the rules should not be overly prescriptive, we believe that no specific methodology should be required.

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29 *See* Letter from The Options Clearing Corporation to the Commodity Futures Trading Commission, dated March 21, 2011, on the CFTC's Notice of Proposed Rulemaking on Risk Management Requirements for Derivatives Clearing Organizations.

30 76 FR at 14538.

Money Settlement Risks

Proposed Rule 17Ad-22(d)(5) would require each clearing agency to "employ money settlement arrangements that eliminate or strictly limit the clearing agency's settlement bank risks, that is, its credit and liquidity risks from the use of banks to effect money settlements with its participants." This requirement is virtually identical to the CFTC's proposed rule 39.13(d)(5).[31] We believe it is impossible, strictly speaking, to "eliminate" all exposure to settlement bank risks. Even if a clearing organization were to use Federal Reserve Bank accounts to make settlement with participants, it would still be exposed to the risk of the commercial banks used by the participants. OCC recognizes the importance of selecting settlement banks with care, diversifying risk among them to the extent practicable, and monitoring their financial status. We suggest that the requirement to "strictly limit the clearing agency's settlement bank risks" be interpreted consistently with this standard.

The Commission has specifically requested comment on whether it should mandate the "minimum number of banks that a clearing agency may use to effect money settlements with its participants in order to avoid reliance on a small number of such banks" and whether the Commission should specify "characteristics of financial institutions that may be used by clearing agencies for settlement purposes[.]"[32] We do not believe the Commission should mandate a minimum number of settlement banks or specify such characteristics. Clearing agencies should have discretion to consider the creditworthiness of their settlement banks and other factors relevant to their selection of settlement banks. A rigid standard for all clearing agencies is both unnecessary and inappropriate, and could have the unintended consequence of concentrating risk in a few banks meeting the specified criteria.

Governance and Conflicts

Proposed Rule 17Ad-22(d)(8) would require each clearing agency to "[h]ave governance arrangements that are clear and transparent to fulfill the public interest requirements in section 17A of the [Exchange] Act applicable to clearing agencies, to support the objectives of owners and participants, and to promote the effectiveness of the clearing agency's risk management procedures." Furthermore, Proposed Rule 17Ad-25 would require "[e]ach clearing agency [to] establish, implement, maintain and enforce written policies and procedures reasonably designed to identify and address existing or potential conflicts of interest." These policies and procedures would be required to "be reasonably designed to minimize conflicts of interest in decision making by the clearing agency."

We believe that the Proposed Rules are quite reasonable, and find them a welcome departure from the highly prescriptive rules set forth in the Commission's prior proposed rulemaking on Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities

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31 *See* 76 FR at 3722.

32 76 FR at 14487.

Exchanges With Respect to Security-Based Swaps Under Regulation MC.[33] Our objections to the prior proposal were set forth in our comment letter dated November 22, 2010.

Information on Clearing Agency Services

Proposed Rule 17Ad-22(d)(9) would require each clearing agency to "provide market participants with sufficient information for them to identify and evaluate the risks and costs associated with using its services." In addition, the Commission has invited comment on what would constitute "sufficient information" and whether any such information should be required to be publicly disseminated.[34] We believe that there is no need for this rule. Information concerning a clearing agency's fees, collateral requirements, risk mutualization rules, rights to require additional collateral deposits, operational requirements, etc., are already included in the agency's Commission-approved rules and published procedures and are already required to be, and are, sufficiently available to market participants and to the public at large.

Timing of Settlement Finality

Proposed Rule 17Ad-22(d)(12) would require each clearing agency to have procedures and policies designed to ensure that final settlement occurs no later than the end of the settlement day. While we believe that this requirement is reasonable so long as it is interpreted reasonably, we think it would be helpful to expressly acknowledge in the final rules that circumstances may arise that make same date settlement impossible (*e.g.*, natural disasters, terrorist acts, major communication breakdowns). We note that the Proposed Rule would require "intraday or real-time finality to be provided where necessary to reduce risks." OCC currently has the ability to make margin calls on an intra-day basis as necessary, and OCC's agreements with its settlement banks expressly provide when payments in satisfaction of such calls become irrevocable by the settlement bank. If we are correct in inferring that such procedures would be deemed to meet this standard, it might be useful for the Commission to refer to such procedures as an aid to interpretation.

Elimination of Principal Risk

Proposed Rule 17Ad-22(d)(13) would require each clearing agency to "eliminate principal risk by linking securities transfers to funds transfers in a way that achieves delivery versus payment." The intended application of this standard to OCC is not entirely clear. As a matter of policy, and with exceptions for certain products, OCC has chosen to eliminate its right to reject matched trades that are reported to it by an Exchange even if the purchasing clearing member fails to pay the purchase price for the option. This policy, which was approved by the Commission, was adopted in response to the expressed preference of clearing members to mutualize the risk of such defaults rather than to bear the risk that a completed trade would be rejected on the following day because of the default of the counterparty. We would appreciate clarification that this policy would not be deemed to violate the Proposed Rule.

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33 75 FR 65882 (October 26, 2010).

34 *See* 76 FR at 14489.

Standards for Board or Board Committee Members

Proposed Rule 17Ad-26 includes governance and board composition requirements that we believe are very flexible, particularly as compared to parallel rules proposed by the CFTC. The Commission has invited comment on possible more detailed proposals for Commission oversight of clearing agency boards and board committees. We refer the Commission to OCC's comment letter submitted to the Commission on November 22, 2010 on the Commission's proposal on Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps under Regulation MC,[35] which includes a proposed "fair representation" model for clearing agency board composition. We believe this model effectively addresses the types of conflicts of interest that may be encountered by a clearing agency.

Confidentiality of Trading Information

Proposed Rule 17Ad-23 would require each clearing agency to implement procedures "to protect the confidentiality of any and all transaction information that the clearing agency receives" by adopting policies and procedures that include "[l]imiting access to confidential trading information of clearing members to those employees of the clearing agency who are operating the system or responsible for its compliance with any other applicable laws or rules; and . . . [s]tandards controlling employees and agents of the clearing agency trading for their personal benefit or the benefit of others." We have several issues with this Proposed Rule.

First, it is not clear to us what is meant by "operating the system." OCC has many computer systems and many groups at OCC must access those systems for legitimate business purposes. For example, member service representatives must have access to such data to facilitate resolution of clearing member issues, financial surveillance personnel must have access to position data in order to fulfill their obligations, and security services staff must assist our legal department in responding to requests for trading data by pulling responsive reports. However, certain of these groups have no (or only a limited) operational role with respect to the clearance system. Certain personnel are also involved in the off-site backup and storage of confidential trading information of clearing members and may be said to be "operating the system" with respect to such data. In addition, it could be said that a person who accesses the system, whether or not such person has permission to do so, could be deemed to be "operating the system." Overall, we think the "operating the system" standard is confusing and could lead to unintended results. We think a more appropriate standard is to require each clearing agency to implement procedures limiting access to confidential information to such personnel as have a legitimate and reasonable need to know such information in connection with the performance of their functions on behalf of the clearing agency.

In addition, the requirement that a clearing agency have standards controlling agents of the clearing agency trading for their personal benefit or the benefit of others is highly problematic. "Agents" may include all manner of outside service providers over which a clearing agency has little or no control. For example, would "agents" include third party

[35] 75 FR 65882 (October 26, 2010).

technology contractors or outside counsel? Although a clearing agency may be able to get such agents to enter into confidentiality agreements and agree to take reasonable steps to control the activities of their own personnel, would such agreements fulfill the requirement that the clearing agency itself have "standards controlling agents"? We believe agents should not be included, or that the provision should be clarified.

Rule 19b-4 Filings

The Commission's Rule 19b-4 requires self regulatory organizations, including clearing agencies, to file rules changes on Form 19b-4. The Proposed Rules require clearing agencies to establish, implement, maintain and enforce many different policies and procedures. The Release indicates that such policies and procedures should be "readily accessible by the public" and further that changes to a clearing agency's policies and procedures "would generally be deemed to be a proposed rule change."[36] We believe that there should be no change to the thresholds applicable to filing proposed rule changes under Rule 19b-4. Not all policies and procedures of a clearing agency designed to assist the clearing agency in complying with the Proposed Rules should trigger 19b-4 filings. This is particularly the case with respect to policies and procedures that contain proprietary or confidential information concerning internal operations or controls. We ask that the Commission take this into account and alter its statements on 19b-4 when the final rules are released.

Implementation of the Proposed Rules

The Release is silent on the anticipated effective date for final rules. If the Proposed Rules are approved in their current form, clearing agencies will need time to determine whether their current practices are in compliance with the rules. This would include, at a minimum, developing extensive new policies and procedures, drafting, proposing and obtaining approval of necessary rules and rule changes, executing plans to raise additional financial resources, conducting extensive internal training, hiring of additional compliance personnel, and many other tasks. All of this would need to be completed while each clearing agency is taking the necessary steps to comply with the many other rules adopted under Dodd-Frank. In OCC's case, to the extent we might be required to increase our financial resources as a result of the "two largest" test, we would need to look to our clearing members to fund such increase. This might occur in the form of an increase to the size of OCC's clearing fund, new margin requirements, new collateral requirements (*e.g.*, a minimum cash requirement), a new clearing fee policy, or a new fee rebate policy. Some of these expedients would require regulatory approval, and the process of gaining such approval could be protracted. Clearing agencies should be afforded a reasonable amount of time to raise any material amount of additional resources. We believe that the Proposed Rules should not become effective until at least two years after their approval. At a minimum, compliance with the "two largest" test should be afforded the two-year delayed implementation schedule. In addition, to the extent that the Commission makes significant changes to the Proposed Rules prior to adoption, we ask that the Commission republish the Proposed Rules for further comment.

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36 76 FR at 14484.

Conclusion

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

Sincerely,

William H. Navin

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Executive Vice President
and General Counsel

cc: Mary L. Schapiro
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