THE OPTIONS CLEARING CORPORATION
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October 12, 2006

VIA E-MAIL

Ms. Eileen A. Donovan
Acting Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: Rule Filing SR-OCC-2006-19 Rule Certification

Dear Acting Secretary Donovan:

Enclosed is a copy of the above-referenced rule filing, which The Options Clearing Corporation ("OCC") is submitting pursuant to the self-certification procedures of Commission Regulation 40.6. This rule filing has been, or is concurrently being, submitted to the Securities and Exchange Commission (the "SEC") under the Securities Exchange Act of 1934 (the "Exchange Act"). This rule change replaces a prior filing, File No. SR-OCC-2005-17, which has not been implemented and is hereby withdrawn.

In conformity with the requirements of Regulation 40.6(a)(3), OCC states the following: The text of the rule is set forth at Item 1 of the enclosed filing. The date of implementation of the rule is the date the proposed rule is approved by the SEC or otherwise becomes effective under the Exchange Act. Item 5 of the enclosed filing sets forth a description of any written comments on the rule filing, including any such comments expressing opposing views that were not incorporated into the proposed rule.

OCC hereby certifies that the rule set forth at Item 1 of the enclosed filing complies with the Commodity Exchange Act and the Commission's regulations thereunder.

Should you have any questions regarding this matter, please do not hesitate to contact the undersigned at (312) 322-6269.

Sincerely,

William H. Navin

William H. Navin

Enclosure

cc: CFTC Central Region (w/ enclosure)
525 West Monroe Street, Suite 1100
Chicago, IL 60661
Attn: Frank Zimmerle

2006-19 cftc.ltr

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 19b-4

Proposed Rule Change

by

THE OPTIONS CLEARING CORPORATION

Pursuant to Rule 19b-4 under the
Securities Exchange Act of 1934

Item 1. **Text of the Proposed Rule Change**

In order to clarify the net capital treatment applicable to certain Clearing Members and their holding companies and other affiliated entities on a consolidated basis, The Options Clearing Corporation ("OCC") proposes to amend its By-Laws and Rules to provide for close-out netting procedures to be followed in the highly unlikely event that OCC becomes insolvent or otherwise defaults on its clearing obligations. This filing replaces a prior rule filing, OCC-2005-17, relating to close-out netting (the "Prior Netting Filing"), which has been withdrawn.

The proposed close-out netting procedures include OCC's notifying the Clearing Members and other interested persons, allowing any non-defaulting Clearing Member to initiate the liquidation of cleared contracts, and carrying out an orderly and efficient liquidation of such contracts, making maximum use of netting under the protection of Title IV of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") and applicable provisions of the U.S. Bankruptcy Code (as amended in 2005). The procedures are designed to allow Clearing Members to comply with guidelines under the Basel Capital Accord relating to bilateral netting (the "Basel Netting Standards"), which may be relevant as the result of capital rules applicable to their parent companies, or for Clearing Members that participate in the Commission's voluntary, alternative method of computing net capital, which requires as a condition of participation that a broker-dealer's ultimate holding company and affiliates (referred to as a consolidated supervised entity or "CSE") must consent to group-wide SEC supervision subject to, among other things, the Basel Netting Standards. In addition, OCC believes that the proposed close-out netting procedures should also clarify the accounting treatment of mutual obligations running between OCC and its Clearing Members under FASB Interpretation No. 39,

"Offsetting of Amounts Related to Certain Contracts," ("FIN 39"). FIN 39 specifies the circumstances in which assets and liabilities may be treated as offsetting in financial statements.

The proposed rule change will add a new Section 27 in Article VI of the By-Laws.[1] Because this section is entirely new, underlining ordinarily used to mark textual additions has been omitted to facilitate readability.

THE OPTIONS CLEARING CORPORATION

BY-LAWS

* * *

ARTICLE VI

Clearance of Exchange Transactions

* * *

Close-Out Netting

SECTION 27. (a) *Default or Insolvency of the Corporation.* If at any time the Corporation: (i) fails to comply with an undisputed obligation to pay money or deliver property to a Clearing Member under the By-Laws or Rules for a period of thirty days from the date the obligation became due, (ii) institutes or has instituted against it a proceeding seeking a judgment of insolvency or bankruptcy or any other relief under any bankruptcy or insolvency law or other similar law affecting creditors' rights, or a petition is presented for its winding up or liquidation, and, in the case of any such proceeding or petition presented against it, such proceeding or petition results in a judgment of insolvency or bankruptcy or the entry of an order for relief or the making of an order for the Corporation's winding-up or liquidation, or (iii) takes corporate action to authorize any proceeding or petition described in clause (ii) above, the Corporation or its representative shall promptly notify the Securities and Exchange Commission, the Commodity Futures Trading Commission, all Clearing Members, any clearing organizations with which the Corporation has cross-margining or cross-guarantee arrangements, and all Exchanges, futures markets and security futures markets for which the Corporation clears Exchange transactions.

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[1] The Prior Netting Filing proposed to number this section as Section 26, but a different Section 26 has been added to Article VI of the By-Laws in the interim.

(b) *Notice of Termination.* Upon the occurrence of any event described in clause (i) through (iii) of paragraph (a), a Clearing Member that is neither suspended nor in default with respect to any obligation owing to the Corporation may notify the Corporation in writing of its intention to terminate all cleared contracts and stock loan and borrow positions in all accounts of such Clearing Member; provided that a notice based on the Corporation's failure to comply with an obligation described in clause (i) may only be made by the Clearing Member to whom such obligation is owed. The Corporation shall promptly forward any such notice, specifying the date of receipt thereof, to the Securities and Exchange Commission, the Commodity Futures Trading Commission, all Clearing Members, any clearing organizations with which the Corporation has cross-margining or cross-guarantee arrangements, and all Exchanges, futures markets and security futures markets for which the Corporation clears Exchange transactions. Such notice shall have the effects hereinafter described in this Section with respect to all Clearing Members, without the necessity of a similar notice being sent by any other Clearing Member. As of the close of business on the third business day following the Corporation's receipt of such notice or such other termination time as may be established by the United States Bankruptcy Code in the case of a proceeding governed by such Code (the "Termination Time"), the Corporation shall accept no more Exchange transactions for clearing, and all pending transactions, positions in cleared contracts and stock loan and borrow positions remaining in all accounts of all Clearing Members at the Termination Time shall be valued as of the Termination Time and liquidated in accordance with this Section. Such liquidated positions shall be netted to the maximum extent permitted by law and the By-Laws and Rules, and settlement of the net amounts shall be effected in the manner provided by this Section in satisfaction of all obligations owing between the Corporation and Clearing Members in respect of such positions. The provisions of this Section, other than paragraph (l) below, shall not apply to the disposition of assets and liabilities in any X-M account provided for in Article VI, Section 24 of the By-Laws. From and after the Termination Time the rights of Clearing Members against the Corporation shall be limited to those set forth in this Section. In the event that a Clearing Member is suspended by the Corporation pursuant to Chapter 11 of the Rules or the Corporation suffers a loss from any cause that is chargeable against the Clearing Fund in accordance with the By-Laws and Rules, whether such suspension or loss occurs before or after the Corporation gives a notice under this paragraph (a), the provisions of paragraph (m) below shall apply.

(c) *Valuation.* As promptly as reasonably practicable, but in any event within thirty days of the Termination Time, the Corporation shall fix a U.S. dollar amount (the "close-out value") to be paid to or received from the Corporation with respect to each short or long position in cleared contracts and each stock loan and borrow position in each account of each Clearing Member. In fixing close-out values, the Corporation shall exercise its discretion, acting in good faith and in a commercially reasonable manner, in adopting methods of valuation expected to produce reasonably accurate substitutes for the values that would have been obtained from the relevant market if it were operating normally, including but not limited to the use of pricing models to determine a value for a cleared contract based on the market price of the underlying interest or the market prices of its components. In determining a close-out amount, the Corporation may consider any information that it deems relevant, including, but not limited to, any of the following:

(1) prices for underlying interests in recent transactions, as reported by the market or markets for such interests;

(2) quotations from leading dealers in the underlying interest, setting forth the price (which may be a dealing price or an indicative price) that the quoting dealer would charge or pay for a specified quantity of the underlying interest;

(3) relevant historical and current market data for the relevant market, provided by reputable outside sources or generated internally; and

(4) values derived from theoretical pricing models using available prices for the underlying interest or a related interest and other relevant data.

Amounts stated in a currency other than U.S. Dollars shall be converted to U.S. Dollars at the current rate of exchange, as determined by the Corporation. A position having a positive close-out value shall be an "asset position" and a position having a negative close-out value shall be a "liability position."

(d) *Netting Within Accounts*. The Corporation shall net the close-out values of positions in each account of each Clearing Member to determine the net asset position or net liability position in each account as follows:

(1) Aggregate the close-out values of all asset positions (excluding segregated long option positions in a securities customers' account or firm non-lien account and long option positions in any account that have been pledged pursuant to Rule 614 and not released), aggregate the (negative) close-out values of all liability positions, and net the aggregate asset position against the aggregate liability position.

(2) The aggregate close-out value of segregated long option positions in a securities customers' account or firm non-lien account shall be identified as constituting the property of the securities customers of the Clearing Member and held for distribution to the persons entitled thereto in accordance with applicable law. The aggregate close-out value of long option positions that have been pledged to a bank or other third party under Rule 614 shall be held for the benefit of the pledgee as provided in Rule 614.

(e) *Netting Across Accounts*. The Corporation shall determine the total net asset position or the total net liability of the Clearing Member by netting across the Clearing Member's accounts as follows:

(1) A net asset position in the firm account, a proprietary Market-Makers' account or any other proprietary account (other than a firm non-lien account or a proprietary X-M account) may be netted against a net liability in any other account or any other obligation of the Clearing Member to the Corporation.

(2) A net liability in a firm account, proprietary Market-Makers' account or any proprietary account may be netted against a net asset position in any other proprietary account (other than a firm non-lien account or a proprietary X-M account).

(3) A net asset position in a combined non-proprietary Market-Makers' account or a separate non-proprietary Market-Maker's account shall not be netted against a net liability position in any other account and shall be identified as the property of securities customers of the Clearing Member and held for distribution to the persons entitled thereto in accordance with applicable law.

(4) A net asset position in the segregated futures account may be netted against a net liability in a segregated futures professional account and vice versa, but a net asset position in such accounts shall not be netted against a net liability in any other account and shall be segregated and identified as property of the futures customers of the Clearing Member and held for distribution to the persons entitled thereto in accordance with applicable law.

(5) A net asset position in the internal non-proprietary cross-margining account shall not be netted against a net liability in any other account and shall be segregated and identified as property of the futures customers of the Clearing Member and held for distribution to the persons entitled thereto in accordance with applicable law.

The result of all permitted netting shall be the total net asset position or total net liability position of the Clearing Member with respect to its positions in cleared contracts and stock loan and borrow positions with the Corporation before application of margin assets as provided in paragraph (f) hereof.

(f) *Application of Cash Margin Assets*. Any restricted margin deposited by a Clearing Member in the form of cash shall be applied to the reduction of any net liability in the account or accounts of the Clearing Member to which such margin may be applied in accordance with the applicable restrictions, and the Clearing Member's total net liability position shall be reduced accordingly. The Clearing Member's total net liability position shall be further reduced by the amount of unrestricted cash margin deposited by the Clearing Member in respect of all of its accounts other than segregated futures accounts and X-M accounts. The resulting net amount shall be the Clearing Member's total net asset position or total net liability position (as the case may be) after application of cash margin assets. As used in this Section, the term "restricted margin" means any margin asset, whether in the form of cash, securities or a letter of credit, the use of which is limited to specified obligations of the Clearing Member either under the By-Laws and Rules, by any other agreement between the Corporation and the Clearing Member or by applicable law.

(g) *Liquidation Settlement*.

(1) A liquidation settlement date shall occur as promptly as practicable following the Termination Time.

(2) Any liquidated obligations of a Clearing Member to the Corporation, and any liquidated obligations of the Corporation to the Clearing Member, not included in the foregoing determination of the Clearing Member's total net asset position or total net liability position shall be reduced by netting to a single amount owed by the Clearing Member to the Corporation or by the Corporation to the Clearing Member. The resulting net amount shall be netted with the Clearing Member's total net asset position or total net liability position, as the case may be, to obtain a Net Settlement Amount.

(3) If a Clearing Member has a positive Net Settlement Amount, it has a claim against the Corporation for the value of that amount as of the Termination Time and, as a general unsecured creditor of the Corporation, may file a claim for the amount thereof in the Corporation's bankruptcy case.

(4) If a Clearing Member has a negative Net Settlement Amount after application of available cash margin as described above, it shall pay the value of such position to the Corporation on the liquidation settlement date. If the Clearing Member fails to pay the full amount of any negative Net Settlement Amount on the liquidation settlement date, the provisions of paragraph (h) hereof shall apply.

(h) *Failure of Clearing Member to Pay Net Settlement Amount—Application of Non-cash Margin Assets.* If a Clearing Member fails to pay any Net Settlement Amount to the Corporation when due, the Corporation shall liquidate all non-cash margin deposits as needed and shall apply the proceeds thereof to reduce the deficit; provided, however, that if the issuer of a letter of credit shall agree in writing to extend the irrevocability of its commitment thereunder in a manner satisfactory to the Corporation, the Corporation may, in lieu of demanding immediate payment of the face amount of the letter of credit, but reserving its right to do so, demand only such amounts as it may from time to time deem necessary to meet anticipated disbursements. Proceeds of any restricted margin deposited by a Clearing Member in a form other than cash shall be applied only to the reduction of any net liability arising from the account or accounts of the Clearing Member to which such margin may be applied in accordance with the applicable restrictions. If any portion of the Net Settlement Amount remains unsatisfied after application of margin deposits, the Corporation shall seek to satisfy the remaining deficit as follows: (i) first, apply the Clearing Member's clearing fund contribution (including any amounts obtained from the Clearing Member in satisfaction of its obligation to make good on any charges against its Clearing Fund contribution); and (ii) second, make a pro rata charge against the Clearing Fund contributions of other Clearing Members in accordance with the By-Laws and Rules.

(i) *Disposition of Remaining Margin Assets.* If the Clearing Member is solvent and has not been suspended pursuant to Chapter 11 of the Rules, then any remaining restricted or unrestricted margin deposited by the Clearing Member and remaining after all permissible applications provided for above, shall be released to the Clearing Member to be treated and dealt with by the Clearing Member in accordance with applicable law. If the Clearing Member has been suspended by the Corporation pursuant to Chapter 11, then any restricted margin deposited by a Clearing Member and remaining after application of restricted margin to the full extent provided above shall be segregated to the extent required and held by the Corporation under an appropriate designation for distribution to the persons entitled thereto in accordance with

applicable law. Any unrestricted margin remaining shall be held for distribution to the persons entitled thereto under applicable law.

(j) *Clearing Fund.* Any unused portion of a Clearing Member's Clearing Fund contribution shall be returned to the Clearing Member or held for distribution to the persons entitled thereto under applicable law, as appropriate, at such time as the Corporation has determined (1) that it has been fully reimbursed for losses and expenses arising from any of the circumstances detailed in Article VIII, Section 5(a) and, subject to the restriction set forth therein, Section 5(b); and (2) that it is extremely unlikely that the Corporation will incur additional losses and expenses reimbursable from the Clearing Fund.

(k) *Interpretation in Relation to FDICIA.* The Corporation intends that certain provisions of this Section be interpreted in relation to certain terms (identified by quotation marks) that are defined in the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), as amended, as follows:

(1) The Corporation is a "clearing organization."

(2) An obligation of a Clearing Member to make a payment to the Corporation, or of the Corporation to make a payment to a Clearing Member, subject to a netting agreement, is a "covered clearing obligation" and a "covered contractual payment obligation."

(3) An entitlement of a Clearing Member to receive a payment from the Corporation, or of the Corporation to receive a payment from a Clearing Member, subject to a netting contract, is a "covered contractual payment entitlement."

(4) The Corporation is a "member," and each Clearing Member is a "member."

(5) The amount by which the covered contractual payment entitlements of a Clearing Member or the Corporation exceed the covered contractual payment obligations of such Clearing Member or the Corporation after netting under a netting contract is its "net entitlement."

(6) The amount by which the covered contractual payment obligations of a Clearing Member or the Corporation exceed the covered contractual payment entitlements of such Clearing Member or the Corporation after netting under a netting contract is its "net obligation."

(7) The By-Laws and Rules of the Corporation, including this Section, are a "netting contract."

(l) *Cross-Margining Agreements.* If an event of insolvency of the type referred to in paragraph (a) of this Section occurs, the Corporation shall immediately seek to exercise its authority under each Participating CCO Agreement to which it is a party to cause the immediate liquidation of all assets and liabilities in all X-M accounts of Clearing Members subject to such agreements and to reduce such account to a single net obligation to or from the Clearing Member or Pair of Affiliated Clearing Members to be settled in accordance with the terms of the applicable Participating CCO Agreement.

(m) *Clearing Member Suspensions; Charges Against the Clearing Fund.* In the event that a Clearing Member is suspended by the Corporation pursuant to Chapter 11 of the Rules after a notice has been provided to the Corporation pursuant to paragraph (b) of this Section or prior to the time when the Corporation has completed the liquidation of a previously suspended Clearing Member's accounts as provided in Chapter 11, the Corporation shall liquidate, or continue to liquidate, the Clearing Member's accounts as provided in Chapter 11 to the extent practicable and not inconsistent with this Section; and any amounts owing between the Corporation and the Clearing Member as a result of such actions shall be included in determining the Clearing Member's Net Settlement Amount under this Section. If the Corporation suffers a loss as the result of such a Clearing Member liquidation pursuant to Chapter 11 or from any other cause that is chargeable against the Clearing Fund in accordance with the By-Laws and Rules, whether such loss occurs before or after the Corporation receives the notice under paragraph (b), such loss shall be chargeable against the Clearing Fund as and to the extent provided in the By-Laws and Rules notwithstanding the giving of such notice, and any obligations of Clearing Members resulting from a pro rata charge to the Clearing Fund, including any obligation to make good any deficiency in the Clearing Member's Clearing Fund contribution as the result of a pro rata charge, shall also be included in determining the Clearing Member's Net Settlement Amount.

Item 2. **Procedures of the Self-Regulatory Organization**

The proposed rule change was approved by the Board of Directors of OCC at meetings held on July 27, 2004 and September 26, 2006.

Questions regarding the proposed rule change should be addressed to Jean Cawley, First Vice President and Deputy General Counsel, at (312) 322-6269.

Item 3. **Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Action**

Background

OCC has been asked by several of its Clearing Members to consider adopting a rule that would allow for close-out netting of obligations running between OCC and Clearing Members in the event of an OCC default or insolvency. Such a rule can reduce applicable capital requirements for a Clearing Member's parent company where the parent is a U.S. or non-

U.S. bank or part of a CSE. The absence of a "netting agreement" that would apply in a default or insolvency of OCC can cause the minimum capital requirement applicable to such a parent company and its subsidiaries on a consolidated basis to be substantially larger than it would otherwise be. In the absence of a netting agreement, applicable banking regulations generally prohibit offsetting the Clearing Member's obligations to OCC on short positions in options and other obligations against the Clearing Member's credit exposure to OCC in respect of long options positions and other obligations to the Clearing Member. In addition, as noted below, OCC believes that a close-out netting rule would clarify the accounting treatment of obligations among OCC and its Clearing Members.

It is OCC's understanding that the capital rules applicable to most banks, following guidelines under the Basel Netting Standards, require that an enforceable netting agreement be in place in order for mutual obligations between a Clearing Member that is a bank affiliate and a counterparty, such as OCC, to be treated on a net basis. The policy behind this requirement is to ensure that obligations that are treated on a net basis for capital purposes can actually be offset against one another in the event of the failure of the counterparty. In the absence of an enforceable netting agreement, there is concern that the representative of the failed counterparty, *i.e.*, OCC, in this scenario, might be able to "cherry pick" under applicable insolvency law by assuming the benefit of contracts representing an asset to the bankruptcy estate while rejecting contracts representing a liability, forcing the non-defaulting counterparty, *i.e.*, the Clearing Member, to perform in full on its liabilities while sharing with other unsecured creditors in any amounts available for distribution from the bankruptcy estate to satisfy its claims. An enforceable netting agreement providing for so-called "close-out netting" in the event of a default or insolvency of OCC would avoid this potential result.

Chapter XI of OCC's rules provides in considerable detail for liquidation of the accounts of an insolvent Clearing Member, including provisions for close-out netting of the Clearing Member's obligations against its assets to the extent permitted by customer protection rules under the Securities Exchange Act of 1934 (the "Exchange Act") and the Commodity Exchange Act (the "CEA"). However, OCC's rules do not presently contain any provisions that specifically permit close-out netting in the event of a default or insolvency of OCC. Indeed, an OCC default or insolvency has always been considered so unlikely that OCC's rules do not contain any provisions whatever contemplating such events. OCC's management does not believe that an OCC default or insolvency has become any more likely. On the contrary, OCC's long track record of safe operation and continually improved methods of risk management suggest that such an event is more remote than ever. Nevertheless, the Basel Netting Standards make it desirable for OCC to put in place such a netting provision in order to clarify the capital requirements applicable, on a consolidated basis, to parent companies of Clearing Members that are subject to the Basel Netting Standards.

The Basel Netting Standards are not directly applicable to the determination of net capital requirements for broker-dealers under SEC Rule 15c3-1. However, some Clearing Members are subsidiaries of banks or bank holding companies that are subject to the Basel Netting Standards when computing capital requirements on a consolidated basis. In addition, several of OCC's largest Clearing Members have volunteered to participate in the SEC's voluntary, alternative method of computing net capital using mathematical models to calculate market and derivatives-related credit risk. A broker-dealer using the alternative method of computing net capital is subject to enhanced risk management, reporting and other requirements, and is treated as part of a CSE that must consent to group-wide SEC supervision subject to,

among other things, the Basel Netting Standards. Finally, as noted below, OCC believes that a close-out netting rule would also clarify the accounting treatment of obligations among OCC and its Clearing Members under FIN 39.

The Basel Netting Standards and FIN 39 (collectively, the "Netting Standards") are stated in general terms and do not contain detailed requirements. The proposed close-out netting procedures would, in the event of an OCC default or insolvency, expressly permit Clearing Members to treat their obligations to OCC on a net basis to the fullest extent consistent with the Commission's customer protection rules. However, the proposed rule change is also intended to protect the clearing system from being thrown out of balance or forced into a disorderly liquidation by a single Clearing Member's exercise of netting rights. Unlike typical, purely bilateral OTC derivatives relationships, OCC's contractual rights and obligations—while bilateral between OCC and any individual Clearing Member—represent a balanced structure in which every obligation owed by OCC to a Clearing Member is in turn matched by a corresponding obligation of a Clearing Member to OCC. The creation of individually exercisable netting rights that could be exercised independently by each Clearing Member in the event of an OCC default or insolvency could result in unfairness if no coordination is imposed.

The Basel Netting Standards

The Basel Netting Standards are contained in the International Convergence of Capital Measurement and Capital Standards: A Revised Framework, adopted by the Basel Committee on Banking Supervision of the Bank for International Settlements in November 2005 (the "Basel II Accord"). The Basel Netting Standards provide that a bank[2] may net transactions

[2] These same standards are also applied to bank holding companies.

subject to any legally valid form of bilateral netting, including netting of bilateral obligations arising from novation, if the bank satisfies its national supervisor that it has a netting contract with the counterparty "which creates a single legal obligation, covering all included transactions, such that the bank would have either a claim to receive or obligation to pay only the net sum of the positive and negative mark-to-market values of included individual transactions in the event a counterparty fails to perform due to any . . . default, bankruptcy, liquidation or similar circumstances."[3]

The Basel Netting Standards also require that the bank have certain "written and reasoned legal opinions that, in the event of a legal challenge, the relevant courts and administrative authorities would find the bank's exposure to be the net amount. The national supervisor must be satisfied that the netting is enforceable under the laws of each relevant jurisdiction. The proposed close-out netting procedures are intended to support such an opinion.

The Basel Netting Standards have been incorporated in applicable bank regulatory laws or regulations in various jurisdictions. For example, the substance of this standard appears in Article 12f of the Swiss Banking Ordinance. It has also been incorporated into the capital guidelines for various U.S. financial institutions.[4]

FDICIA and Bankruptcy Code

The proposed close-out netting procedures are designed to take advantage of the netting provisions of FDICIA and the Bankruptcy Code. Section 404 of FDICIA generally

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[3] *See* Basel Committee on Banking Supervision, Basel Capital Accord: Treatment of Potential Exposure for Off-Balance Sheet Items (April 1995), at Annex, p.4. The relevant bi-lateral netting standards under this 1995 publication were not overridden by the Basel II Accord. *See* Basel II Accord at p.213.

[4] See, *e.g.*, Regulations of the Office of the Comptroller of the Currency applicable to national banks set forth at 12 C.F.R. Part 3, Appendix A (adopted July 1, 2002), section (3)(b)(5)(ii)(B).

validates netting contracts among members of clearing organizations notwithstanding any other provision of law. In order to qualify for this benefit, the "netting contract" must be between "members" of a "clearing organization," as each of these terms is defined in FDICIA. OCC meets the definition of "clearing organization" under FDICIA, and both it and its Clearing Members meet the definition of "members." Under FDICIA, the rules of a clearing organization are expressly included within the definition of "netting contract." Accordingly, under Section 404 of FDICIA, the netting provisions of OCC's By-Laws and Rules, including the proposed revised netting procedures, will be given effect in the event of OCC's default or insolvency.

Section 362(b) of the Bankruptcy Code exempts from the automatic stay provisions of the Code the setoff by, among other parties, stockbrokers, commodity brokers or clearing agencies, of mutual debts or claims under commodity or securities contracts. This section preserves OCC's ability to net obligations between OCC and a suspended Clearing Member, and similarly would protect the ability of Clearing Members to net obligations under the proposed netting procedures in the event of OCC's default or insolvency. In addition, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") added a new subsection 362(o) to the Bankruptcy Code which provides that the right of setoff and other relevant rights may not be stayed by any order of a court or administrative agency in any proceeding under the Bankruptcy Code. This was a significant expansion of the protections for financial contracts under the Bankruptcy Code.

Prior Netting Filing and Clearing Member Comments

After reviewing the Prior Netting Filing, some Clearing Members questioned whether the netting procedures set forth in that filing satisfied the Netting Standards. Specifically, Clearing Members questioned whether:

- the definition of insolvency in the Prior Netting Filing, which covered only voluntary or involuntary cases under Chapter 7, needed to be expanded to include other types of bankruptcies, particularly Chapter 11 cases, and non-bankruptcy defaults;
- the procedures set forth in the Prior Netting Filing complied with the Netting Standards in light of the inability of the Clearing Members, as the non-defaulting parties, to initiate the netting process; and
- the proposed procedures gave Clearing Members the ability to promptly net and close out positions as required to comply with the Netting Standards given the degree of control that OCC reserved to itself in the process.

After considering the Clearing Members' comments, OCC made modifications to the netting provisions reflected in the current filing. The primary differences between the currently-proposed close-out netting procedures and those contained in the Prior Netting Filing is that the currently-proposed procedures:

- significantly expand the definition of insolvency to include non-bankruptcy defaults, specifically any failure by OCC to comply with an undisputed obligation to deliver money or property to a Clearing Member for a period of thirty days after the obligation becomes due, and to include bankruptcy or insolvency proceedings under statutory provisions other than Chapter 11 of the United States Bankruptcy Code (the "Bankruptcy Code");

- provide that upon the occurrence of an event of default or insolvency, any Clearing Member that is neither suspended nor in default with regard to an obligation of OCC may provide a notice to OCC of its intention to terminate all cleared contracts and stock loan and borrow positions in all of its accounts; and

- establish a fixed termination time for all cleared contracts and stock loan and borrow positions, which would be the close of business on the third business day after OCC's receipt of the prescribed notice from a Clearing Member, unless a different time is mandated by the Bankruptcy Code, and to provide that the liquidation settlement date will occur as promptly as practicable after the termination time; (the original provisions granted OCC the discretion to establish the termination time and provided that the liquidation settlement date would occur no earlier than the business day following the termination date).

OCC believes that the above modifications address the Clearing Members' concerns while still permitting the liquidation process to proceed in an orderly manner and for the clearance system to remain in balance.

Overview of Proposed Rule Change

The proposed rule change consists of a single new Section 27 of Article VI of OCC's By-Laws. Consistent with the requirements of the Basel Netting Standards, the netting provision would be applicable in the event that OCC fails to perform its obligations with respect to cleared contracts as the result of defaults by OCC in performing its obligations under its rules, or as the result of bankruptcy, a liquidation of OCC or similar circumstances. The proposed close-out netting procedures are drafted in such a way that they would only be triggered by an event of default, as defined in new Section 27(a). The rule would not be triggered by any delay in

performance that is permitted under OCC's By-Laws or Rules. For example, Article VI, Section 19 permits OCC to take specified actions, including suspension of settlement obligations, in the event of a shortage of underlying securities. These delays would not be considered an event of default under Section 27 and therefore would not allow a Clearing Member to initiate the close-out netting procedures. In the event of such delays OCC would notify Clearing Members of the reason for the delay.

Under the proposed close-out netting procedures, in the event of a default or insolvency by OCC, OCC would be required to provide notice of the default or insolvency to the Commission, the CFTC, all Clearing Members, any clearing organizations with which OCC has cross-margining or cross-guarantee agreements, and all markets for which OCC clears transactions. The proposed procedures further provide that in the event of an OCC default, any Clearing Member, so long as it is not suspended or in default, may provide a written notice to OCC of its intent to initiate the liquidation process with regard to its own contracts and stock loan and borrow positions. This notice would, however, trigger a liquidation of cleared contracts and positions of all Clearing Members. This procedure is necessary because liquidating contracts and positions of less than all Clearing Members would result in an imbalance of the clearing system and therefore be unworkable. The proposed procedures establish the close of business on the third business day after OCC's receipt of the liquidation notice from a Clearing Member as the termination time, unless the Bankruptcy Code prescribes a different time.

The proposed close-out netting procedures provide that, when a triggering event occurs, rights and obligations within and between accounts of each Clearing Member will be netted to the same extent as if the Clearing Member had been suspended and its accounts were being liquidated under Chapter XI of the Rules. This is an appropriate result in that those rules

generally provide for the netting of assets against liabilities to the extent permitted under applicable law, including the customer protection rules referred to above. Assets remaining after all legally permissible offsets would be returned to the Clearing Member entitled to them, and the Clearing Member would remain obligated to OCC only to the extent of any remaining net liabilities following such permitted offsets.

If close-out netting were ever required because of the default or insolvency of OCC, it seems likely that there would be no market available in which to liquidate positions in cleared contracts through market transactions. Accordingly, the proposed procedures contain a provision for valuation of open cleared contracts based upon market values of underlying interests and provide a reasonable means for OCC to fix all necessary values of assets and liabilities for purposes of the netting. Under the procedures, OCC is to provide valuations as promptly as practicable, but in any event within thirty days of the termination time. Valuations would be based upon available market information.

FIN 39: Offsetting of Amounts Related to Certain Contracts

In addition to the potential benefit of the proposed close-out netting procedures with respect to capital requirements applicable to certain Clearing Members and their affiliates on a consolidated basis under the Basel Netting Standards, OCC believes that the proposed close-out netting procedures should also clarify the accounting treatment of mutual obligations running between OCC and its Clearing Members. OCC's Clearing Members most commonly prepare their financial statements using United States generally accepted accounting principles ("US GAAP"). FIN 39, responds to certain questions relating to the circumstances in which assets and liabilities may be treated as offsetting in financial statements. APB Opinion No. 10 states: "it is

a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists." FIN 39 provides a definition of a right of setoff and a statement of the conditions under which a right of setoff exists. The definition is as follows: "A right of setoff is a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor." FIN 39, paragraph 5 contains the following four conditions under which a right of setoff exists:

(a) Each of *two* parties owes the other determinable amounts. [Emphasis in original.]

(b) The reporting party has the right to set off the amount owed with the amount owed by the other party.

(c) The reporting party intends to set off.

(d) The right of setoff is enforceable at law.

It is the obligation of Clearing Members to determine their application of US GAAP but we expect that proposed new Section 27 will allow them to conclude that conditions (a), (b) and (d) will be met. (Condition (c) deals with intent which is a factual question.)

Discussion of Specific Provisions of Section 27

The text of proposed new Section 27 of Article VI of the By-Laws is largely self-explanatory in light of the foregoing discussion of its purpose. A few comments may nevertheless be helpful.

Under Sections 27(a) and (b), if OCC should ever give notice of its default or insolvency and a Clearing Member in turn provide a notice of termination, the termination time may be later

than the time at which a Clearing Member's liquidation notice is given.[5] (This leaves open at least the theoretical possibility that, if there are trading days or hours left between the time the notice is given and the Termination Time, market participants could attempt to engage in closing transactions at prices determined in the market to avoid being subject to a forced liquidation at prices fixed by OCC.)[6]

Proposed Section 27(b) provides that in the event of a default or insolvency and the requisite notice by a Clearing Member, positions of all Clearing Members will be liquidated to the maximum extent permitted by law and the By-Laws and Rules. The limitations on netting under OCC's By-Laws and Rules are in general those mandated by applicable law, such as the Commission's Rule 15c3-3. For example, where a Clearing Member carries both proprietary and customer accounts, netting across accounts could cause the Clearing Member to be in violation of Rule 15c3-3 and other customer protection rules. Accordingly, Section 27 generally provides for netting within and not across different accounts, with specific exceptions set forth in Section 27(d). In addition, CEA segregation rules require separate segregation of customer funds of futures customers. Accordingly, netting across futures segregated funds accounts and other accounts is also generally prohibited. Otherwise, the provisions of Section 27(d) are intended to maximize netting where consistent with customer protection rules. While securities market makers and specialists are generally not customers within the meaning of Rule 15c3-3,

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[5] Under proposed Section 27(b), the termination time would be the close of business on the third business day following a Clearing Member's liquidation notice, unless the Bankruptcy Code prescribes a different time. Under Section 502(b) of the Bankruptcy Code, claims against a debtor are valued as of the date of the filing of the bankruptcy petition, and accordingly in the event of a bankruptcy the termination time would be on the date of the filing of the petition.

[6] This activity of market participants could start at the time of OCC's default notice rather than the time of the liquidation notice, although as a practical matter a liquidation notice would likely closely follow the default notice.

they are ordinarily "customers" within the meaning of the Commission's hypothecation rules .[7] OCC has historically not permitted setoff between market-maker accounts and the customers' account in which positions of other securities customers are carried. This separation has been preserved in Section 27(d)(3).

* * *

The proposed rule change is consistent with Section 17A of the Securities Exchange Act of 1934, as amended (the "Act"), because it (x) promotes the safeguarding of securities and funds and (y) reduces costs to persons facilitating transactions by and on behalf of investors by providing clearing members that are a part of a consolidated supervised entity with the opportunity to reduce their applicable capital requirements. In addition, the proposed rule change would clarify the accounting treatment of obligations among OCC and its clearing members. The proposed rule change is not inconsistent with the rules of OCC, including any rules proposed to be amended.

Item 4. **Self-Regulatory Organization's Statement on Burden on Competition**

OCC does not believe that the proposed rule change would impose any burden on competition.

Item 5. **Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participant Exchanges, or Others**

OCC received comments on the Prior Netting Filing from certain Clearing Members via telephone. These comments are discussed in Item 3 above under the heading

[7] Rules 8c-1 and 15c2-1.

"Prior Netting Filing and Clearing Member Comments." A draft of the proposed rule change was submitted to the Dealer Accounting Committee of the Securities Industry Association for review, and the rule change as filed reflects certain comments made by the Committee. OCC has not otherwise solicited written comments on the Prior Netting Filing or this filing, and none have been received.

Item 6. **Extension of Time Period for Commission Action**

OCC does not consent to an extension of the time period specified in Section 19(b)(2) of the Act.

Item 7. **Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)**

Not applicable.

Item 8. **Proposed Rule Change Based on Rules of Another Regulatory Organization or of the Commission**

The proposed rule change is not based on a rule of another self regulatory organization or of the Commission.

Item 9. **Exhibits**

Exhibit 1 Completed notice of the proposed rule change for publication in the Federal Register.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, The Options Clearing Corporation has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

THE OPTIONS CLEARING CORPORATION

By: William H Navin

William H. Navin
Executive Vice President and
General Counsel