

For other clearing members, however, the margin offset or hedging aspect of the Hedge Program is of little or no benefit. For these clearing members, the nature of their business or the organization of their business within the firm is such that they rarely if ever have stock loan/borrow transactions that provide any significant offset against their options positions. These firms may nevertheless desire to use the Hedge Program because of its other benefits. The participation of these clearing members, which tend to be the larger clearing members, is desirable from OCC's perspective because they contribute liquidity to the program and facilitate inclusion in the program of the hedging activity of some of OCC's less well-capitalized clearing members. It reduces OCC's risk when a market maker clearing firm, for example, carries stock loan/borrow positions in the same OCC account as the positions that the loan/borrow positions hedge.⁵ However, in order to do that, the clearing firm must find a stock loan counterparty that is willing to submit the transaction to OCC for clearance. If the counterparty is not itself entering into the transaction for hedging purposes, it may be willing to clear the transaction through OCC only if it can do so on a margin-ineligible basis to avoid additional cost.

For those clearing members whose stock loan/borrow positions are not ordinarily offset by options positions, clearing stock loan/borrow activity through the Hedge Program increases rather than reduces their risk margin requirement at OCC. In the stock loan market, collateral (usually equal to 100% or 102% of the value of the loaned stock) is provided by the borrower to the lender to secure the lender's obligation to return the stock. Daily mark-to-market payments between the borrower and lender maintain the collateral at that level. The same is true when stock loan activity is cleared through the Hedge Program. However, in addition to the collateral that is passed by OCC between the borrowing and lending clearing members, OCC's TIMS system also assesses both the

borrower and the lender an amount of risk margin equal to one day's anticipated maximum market movement in order to protect OCC against a default by the borrower or the lender in its mark-to-market obligations. Because this risk margin is collected only for stock loan transactions that are submitted to OCC, clearing these transactions through OCC imposes additional costs on some clearing members.

In order to address this issue, the Hedge Program permits clearing members to elect to carry stock loan and borrow transactions on a margin-ineligible basis. If a clearing member designates an account as margin-ineligible, OCC will exclude any stock loan or borrow positions in that account when calculating the regular margin requirement for the account. OCC, however, relies on other elements of its protection systems⁶ to assess its potential exposure with respect to positions carried in a margin-ineligible account. Margin will be required for positions carried in a margin-ineligible account if predefined concentration monitoring parameters are exceeded.

OCC believes that permitting clearing members to carry stock loan and borrow positions on a margin-ineligible basis is appropriate, safe, and essential to the competitiveness of the Hedge Program. However, in recognition of the fact that this alternative does create uncollateralized risk for OCC, OCC has conducted a study of credit practices in the stock loan market generally and has determined to implement certain measures to reduce its risk.

Although OCC's current risk management practices are consistent with industry standards, OCC is nevertheless proposing elevated financial standards for clearing members wishing to designate accounts as margin-ineligible for purposes of the Hedge Program. Clearing members would be required to maintain excess net capital of at least \$75 million in order to carry margin-ineligible accounts with OCC.⁷ OCC believes this requirement is sufficient to ensure strong participant credit standing

without unduly hindering program participation.

The excess net capital requirement would be supplemented by a profitability standard. A clearing member would not be permitted to maintain a margin-ineligible account if it has: (i) Losses in one month equal to or exceeding 50 percent of its excess net capital; (ii) cumulative losses over two consecutive months equal to or exceeding 60 percent of its excess net capital; or (iii) cumulative losses over three consecutive months equal to or exceeding 70 percent of its excess net capital. These excess net capital and profitability standards would be ongoing tests and would have to be met at all times by a clearing member wishing to carry stock loan or borrow positions in any account on a margin-ineligible basis. Clearing members falling out of compliance with these standards would be precluded from clearing opening transactions in a margin-ineligible account while out of compliance.

The rationale for these requirements is that unlike a participant in the regular stock loan market, which has the ability to consider the impact of new transactions on counterparty credit limits before entering into them, OCC becomes a counterparty solely at the discretion of the lender and borrower without the ability to approve or disapprove individual loans on a credit basis before they are accepted for clearance. OCC's excess net capital and profitability standards should substitute for a transaction-by-transaction credit review. Using these straightforward requirements instead of a credit limit or activity cap makes it unnecessary for OCC to reserve the right to reject completed transactions in cases where acceptance would put one of the parties above its cap.

As an additional safety measure, OCC is proposing to amend the definition of "Eligible Stock" to exclude non-option stocks from the program subject to limited exceptions.⁸ Loans for non-option stocks will be permitted to be maintained (i) if the loan was accepted prior to the implementation of the restriction or (ii) if the stock is deliverable upon exercise of an

XXI of the By-Laws stating that OCC will provide notice to its clearing members when this feature becomes operative.

⁵ As an economic matter, option and security futures positions are hedged not by a clearing member's stock loan or borrow positions, but by its related long or short positions in the underlying stock. However, it is the stock loan/borrow positions that generate cash mark-to-market payments when the market moves against the member's options or futures positions. When the loan/borrow positions are carried in the Hedge Program, OCC is able to capture those payments. This is what enables OCC to reduce its margin requirements for the account in which the positions are carried.

⁶ OCC especially relies on its concentration monitoring system, known as ConMon, which provides a comparison of the capital and net worth of each OCC clearing member to the market risk associated with the clearing member's positions. Securities Exchange Act Release No. 40083 (June 11, 1998), 63 FR 33424 (June 18, 1998) [File No. SR-OCC-98-3].

⁷ Clearing members currently maintaining margin-ineligible accounts would be given a one-year grace period in which to conform to the minimum excess net capital requirement. If a clearing member is not in compliance at the end of that period, OCC would thereafter treat all of the clearing member's accounts as margin-eligible.

⁸ As originally filed, the proposed rule change sought to amend the definition of "Eligible Stock" to require that non-option stocks that are the subject of program transactions have a price per share of at least \$10.00 at the time the transaction is submitted to clearance. The September 26, 2002, amendment proposes to exclude non-option stocks from the program subject to limited exceptions in order to more closely align the use of the Hedge Program with its primary objective of recognizing the intermarket hedges between a participant's stock and options positions.