UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 19422 / January 12, 1983

OPTIONS CLEARING CORPORATION ("OCC")
File No. SR-OCC-82-8

ORDER APPROVING PROPOSED RULE CHANGE

On April 27, 1982, OCC filed with the Commission, pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934, 15 U.S.C. §78s(b)(1), (the "Act") and Rule 19b-4 thereunder, a proposed rule change that would add Interpretations and Policies to OCC Rule 604 (i) formalizing certain of OCC's criteria for approving domestic banks as issuers of letters of credit for margin purposes; and (ii) allowing OCC to accept, for the first time, letters of credit issued by foreign banks.[1] Notice of the proposed rule change, together with the terms of substance of the proposed rule change, was given by publication of Securities Exchange Act Release No. 18721 (May 10, 1982), 47 FR 21170 (May 17, 1982). No letters of comment were received.

I. DESCRIPTION OF THE PROPOSED RULE CHANGE

The proposal would permit OCC to approve as an issuer of letters of credit for margin purposes any non-United States-based financial institution ("foreign bank"), provided that the bank (i) is organized under the laws of a country other than the United States and has a Federal

1 OCC 's margin requirements should be distinguished from customer margin requirements in Regulation T (12 CFR §220.1 et seq.). Regulation T governs, among other things, the amount of money that a broker-dealer's customer can borrow to purchase securities and the amount and type of collateral that those customers must deposit to secure their obligations. In contrast, OCC's daily margin requirements are imposed on OCC's clearing members with respect to the positions that they maintain at OCC and help insure that those members meet their daily obligations to OCC.

Currently, OCC holds approximately $3 billion worth of letters of credit as margin, representing about 90% of all margin held by OCC. In addition to letters of credit, OCC participants may deposit margin in the form of cash, certified checks, government securities, or common stocks underlying outstanding classes of options. OCC Rule 604.

or state branch or agency, as defined in the International Banking Act of 1978,[2] located in New York, New York or Chicago, Illinois; (ii) has, at the time of approval, and continuously thereafter, shareholders' equity in excess of U.S. $200,000,000; (iii) has its principal executive office located in a country that (a) is rated "AAA" by Moody's Investor Service ("Moody's") and/or Standard & Poor's Corporation ("Standard & Poor's") or (b) has been approved by OCC's margin committee as a "AAA"-equivalent country, based on the committee's consultations with at least two entities which, in the margin committee's opinion, are experienced in international banking and finance; and (iv) issues commercial paper and other short-term obligations rated "P-1" by Moody's or "A-1" by Standard & Poor's.[3]

The proposal would further restrict OCC's acceptance of foreign bank letters of credit in the following ways: (i) no more than 50% of a participant's margin obligation to OCC could be secured by such letters of credit; (ii) no greater than 20% of a participant's OCC margin obligation could be secured by letters of credit from any one foreign bank; and (iii) the total amount of letters of credit that one foreign bank may issue for any one participant may not exceed 10% of the foreign bank's worldwide shareholders' equity.[4] In addition, a letter of credit issued by a foreign bank on behalf of a participant would have to be issued and payable at a Federal or state branch or agency of that bank.[5]

In addition, the proposal would formalize OCC's policy of approving a domestic financial institution ("domestic bank") as an issuer of letters of credit, provided that the bank (i) is organized under the laws of the United States or a state thereof; (ii) is regulated and examined by Federal or state authorities having regulatory authority over banks or trust companies; and

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2 Pub. L. No. 95-309, 92 Stat. 607 (the "IBA"). Sections 1(b)(1), (3), (5), (6), (11) and (12) of the IBA respectively define the terms "agency," "branch," "Federal agency," "Federal branch," "state agency," and "state branch."

3 Moody's commercial paper ratings represent Moody's "opinions of the ability of issuers to repay punctually" their short-term debt obligations. The ratings include, in order of preference, Prime 1, Prime 2, Prime 3, and Not Prime. Prime 1 issuers have a "superior capacity for repayment of short-term promissory obligations." Moody's Bond Rec., Dec. 1982, at 80. Similarly, Standard & Poor's commercial paper ratings indicate the likelihood of timely repayment of the instrument. Commercial paper is rated A, B, C, or D, with A being the highest rating and D being the lowest. These ratings are further divided into categories 1, 2, and 3, with 1 being the highest subclassification. Accordingly, an A-1 rating is Standard & Poor's highest rating for commercial paper and "indicates that the degree of safety regarding timely payment is very strong." Standard & Poor's Corp., Standard & Poor's Ratings Guide 331 (1979).

4 OCC's proposed ten percent requirement is stricter than the comparable current Federal lending limitation of 15% of shareholders' equity. See Pub. L. No. 97-320, 96 Stat. 1510.

5 Letter Amendment to the staff dated December 1, 1982, from Marc L. Berman, Executive Vice President and General Counsel of OCC.

(iii) has, at the time of approval by OCC and continuously thereafter, shareholders' equity of at least $100,000,000.

Finally, the proposal would establish several requirements that apply to both foreign and domestic banks. First, each bank applying to OCC for approval as an issuer of letters of credit would have to provide OCC with a copy of its most recent annual financial report.[6] Second, a bank approved by OCC would have to provide OCC with copies of its annual reports and quarterly financial statements at the time of their issuance. Third, each bank would have to provide, in written form satisfactory to OCC, the names of individuals authorized to sign letters of credit on behalf of the bank and a statement of the bank's legal authority to issue letters of credit. Fourth, the proposal would provide that OCC would reserve the right, in its sole discretion, to refuse to approve, or to revoke the approval of, any bank as an issuer of letters of credit at any time.[7]

II. OCC'S RATIONALE FOR THE PROPOSED RULE CHANGE

In its filing, OCC stated that because of recent developments affecting the availability of unsecured letters of credit,[8] OCC wants to expand the forms of margin available to OCC participants to include letters of credit from foreign banks. OCC represented that domestic banks, for a short time, reduced their issuance of, and increased their fees for, margin-related letters of credit. Also, such banks increasingly have been requiring letters of credit to be partially or fully collateralized by the banks' customers. In response to these developments, OCC now desires to include foreign banks in the universe of banks eligible as issuers of letters of credit, which should increase the supply of letters of credit available to OCC's participants and should reduce OCC's dependence on letters of credit issued by domestic banks.

Despite that desire, OCC believes that it should not accept letters of credit issued by foreign banks for margin purposes unless OCC has adopted strict criteria, which those foreign banks must meet, to compensate for differences in bank regulation between the United States and other countries and to insure that OCC approves only foreign banks it reasonably believes to be financially responsible. For example, OCC's proposal makes eligible only those foreign banks

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6 If the applicant bank's annual financial report was issued more than 90 days prior to the date of its application to OCC, the bank also would have to provide OCC with its most recent published quarterly financial statements.

7 OCC has informed the Commission staff that, if OCC revoked the approval of any issuing bank, affected participants would be required to supply substitute margin in accordance with OCC's rules. Because OCC monitors continuously its approved banks to detect banks experiencing difficulties, OCC ordinarily could advise affected participants at an early stage and thereby facilitate orderly margin substitution.

8 For example, Chase Manhattan Bank, N.A. stopped issuing unsecured letters of credit to broker-dealers after incurring losses during the insolvencies of Drysdale Government Securities, Inc. and Lombard-Wall, Inc., two government-securities firms. See Wall St. J., September 1, 1982, at 4.

that have an office in New York City or Chicago to enable OCC to litigate disputes in American courts and to insure that foreign banks doing business in the United States will be subject to domestic banking regulations, with which OCC is familiar. Also, because OCC states that it is not familiar with foreign regulations respecting foreign bank parent organizations, the proposal will allow OCC, in part, to rely on ratings assigned to foreign countries by nationally-known independent rating services in determining whether to approve a foreign bank. Furthermore, OCC's proposal includes important concentration and aggregate lending limitations that are designed to preclude dependence by OCC and its participants on any one foreign bank. OCC's proposal will formalize various criteria for approval of banks as issuers of letters of credit.

III. DISCUSSION

Although OCC has allowed its participants to satisfy their margin obligations to OCC with letters of credit since OCC's inception in 1973, the Commission has not had the opportunity to review OCC's letter of credit program prior to the filing of this proposed rule change.[9] Accordingly, in reviewing OCC's filing pursuant to Section 19(b) of the Act, the Commission believes it appropriate to assess the proposal in light of OCC's entire program of financial safeguards to assure the proposal's consistency with the requirements of the Securities Acts Amendments of 1975, and in particular, with Section 17A of the Act.

A. The Commission's General Policy Concerns Regarding the Use of Letters of Credit by Clearing Agencies

The Commission has approved the controlled use of letters of credit by clearing agency participants in a related context. In August 1981, the Commission approved a proposal submitted by National Securities Clearing Corporation ("NSCC") that enabled NSCC's participants to secure their clearing fund obligations with letters of credit issued by banks approved by NSCC.[10] In reviewing NSCC's proposal, the Commission noted several factors relevant to its determination that a clearing agency's letter of credit program could promote the safeguarding of securities and funds in the custody or control of the clearing agency or for which it is responsible. See Section 17A(b)(3)(F) of the Act. A number of the most relevant factors are discussed below.

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9 Before Congress's enactment in 1975 of Section 17A of the Act, clearing agencies were not subject to pervasive direct regulation by the Commission. With the adoption of Section 17A, however, clearing agencies must apply for registration with the Commission, and the Commission must review those applications for compliance with the Act. The Commission currently is reviewing OCC's application. Absent the filing of the proposed rule change, the Commission's analysis of OCC's letter of credit program would be limited to review in the context of that application.

10 Securities Exchange Act Release No. 18052 (August 21, 1981), 46 FR 43341 (August 27, 1981).

First, the Commission believes that a clearing agency should take measures to ensure that it accepts letters of credit only from banks that are likely to be financially responsible. Accordingly, a clearing agency should adopt reasonable criteria to determine whether a bank is financially responsible ("bank standards"), including, for example, those that (i) would prevent a bank from issuing amounts of letters of credit disproportionate to the bank's size[11] and (ii) would allow the clearing agency to accept letters of credit from issuer banks with high ratings by a recognized financial rating service.[12] Second, the Commission further believes that a clearing agency should have sufficient liquidity in its systems for safeguarding funds and securities to protect itself and its participants if payment of a letter of credit is delayed or refused. If a participant becomes insolvent and cannot meet its settlement obligations, and if payment on the participant's letters of credit is delayed by the issuing bank,[13] the clearing agency must have access to other liquid assets that could be used to satisfy the defaulting participant's settlement obligations. Accordingly, the Commission believes it important that clearing agencies adopt measures insuring liquidity in their back-up systems in the event a letter of credit is not paid promptly or is dishonored by an issuing bank ("liquidity requirements").[14] Third, the Commission believes that a clearing agency should not become excessively dependent upon any

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11 The Commission anticipates that, as a general matter, a clearing agency may safely accept larger amounts of letters of credit from larger banks because the value of those letters of credit would constitute a smaller percentage of the larger bank's total liabilities and total assets.

12 See, e.g., File No. SR-NSCC-80-15. For example, NSCC generally will not approve a domestic or a foreign bank as an issuer of letters of credit unless its commercial paper is highly rated by a national rating service and/or the bank has a specified amount of assets.

13 The essential characteristic of an irrevocable letter of credit is that the obligation of the issuer to pay the beneficiary is independent of any contract between the beneficiary and the bank's customer. See, e.g., N.Y.U.C.C. §5-114(1) (McKinney). In general, the only defenses that an issuing bank has against paying a letter of credit are fraud, forgery, or prior payment to a holder in due course. Sztejn v. J. Henry Schroder Banking Corp., 177 Misc. 719, 31 N.Y.S. 2d 631 (Sup. Ct. 1941). See also KMW Int'l v. Chase Manhattan Bank, N.A., 602 F.2d 10 (2d Cir. 1979). Thus, unless a clearing agency were a party to a fraud or forgery, a clearing agency would routinely be entitled to draw down on a letter of credit without delay. That entitlement exists even when the participant is bankrupt. Westinghouse Credit Corp. v. Page (In re Page), 18 B.R. 713 (D.D.C. 1982). But see Twist Cap, Inc. v. Southeast Bank of Tampa (In re Twist Cap, Inc.), 18 B.R. 284 (D. Fla. 1979).

14 For example, NSCC (i) requires a participant using letters of credit to increase the minimum cash contribution to the clearing fund and (ii) has authority to pledge a solvent participant's letters of credit to obtain a loan to NSCC in the event payment on a letter of credit is delayed. In addition, NSCC has other significant systems for safeguarding securities and funds, such as the authority (i) to reverse certain securities deliveries; (ii) to mark-to-the-market failed trades; and (iii) to require participants to provide further assurances of operational and financial stability.

one bank as an issuer and, for that reason, believes that a clearing agency should adopt measures insuring the diversification of each participant's letters of credit and the clearing agency's letters of credit among a number of banks ("concentration requirements").[15]

The Commission does not believe, however, that all clearing agencies that wish to establish letters of credit programs must have uniform bank standards, liquidity requirements, and concentration requirements. Indeed, because the Act recognizes that legitimate variations may exist among different clearing agencies, the Commission believes it appropriate to examine all of the facts and circumstances surrounding a clearing agency's proposal for the use of letters of credit to determine whether the proposed program, in the context of that clearing agency's other systems for safeguarding funds and securities, are consistent with the requirements of the Act.

B. Determination of Whether OCC's Proposal Is Consistent with the Requirements of the Act

The Commission believes that OCC's proposed rule change includes concentration requirements and eligibility criteria that should enable OCC to control safely and effectively the use of letters of credit issued by foreign banks. As noted, the proposal includes eligibility standards for foreign banks that should reduce significantly the likelihood that a foreign bank issuer will be unwilling or unable to pay a letter of credit. Moreover, the proposal includes effective concentration prevent OCC or any of its participants from becoming unduly dependent on foreign banks generally or one foreign bank in particular. As noted above, OCC can approve, as foreign bank issuers, sizable, highly-rated institutions having domestic branches in OCC's principal locations. In addition, OCC's proposal would limit in important respects the percentage of participants' margin obligations that can be secured by the use of bank letters of credit.[16] Finally, by accepting letters of credit from foreign banks, OCC will expand the universe

15 For example, NSCC's rules limit the aggregate value of letters of credit that any bank may issue in favor of NSCC. NSCC's rules also require that no one bank issue more than a maximum stated percentage of the clearing fund, absent NSCC's board of director's express approval.

16 In particular, under the proposed rule change, OCC will not accept with respect to any OCC participant letters of credit from any one foreign issuer to secure more than twenty percent of that participant's margin obligation. Therefore, as a practical matter, OCC will always have letters of credit from a variety of foreign banks for each participant that makes full use of foreign bank letters of credit. While that arrangement does not directly increase the liquidity of OCC's margin collateral, it does reduce the risk associated with a particular issuing bank's insolvency.

of banks approved as issuers of letters of credit, which should reduce OCC's dependence on domestic issuers.[17]

The Commission further believes that OCC's proposal includes various additional safeguards, applicable to both foreign and domestic banks, that should further reduce the risks associated with the use of letters of credit. For example, as part of its continuous monitoring program, OCC periodically will receive financial reports from approved banks. Moreover, OCC maintains a substantial clearing fund consisting only of liquid assets. In the event of participant solvency, OCC clearing fund rules enable it to pledge clearing fund assets in exchange for cash that OCC can apply to participant defaults.[18]

III. CONCLUSION

Because the proposal provides significant benefits to OCC and its participants and furthers the purposes and requirements of the Act, including in particular, Section 17A of the Act, the Commission believes that the proposal should be approved.

Accordingly, IT IS THEREFORE ORDERED, pursuant to Section 19(b) of the Act, that the proposed rule change (SR-OCC-82-8) be, and hereby is, approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.

George A. Fitzsimmons
Secretary

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17 Recently, the Commission approved a rule change filed by OCC that enables participants to meet their OCC margin obligations by pledging common stocks underlying outstanding option classes. Securities Exchange Act Release No. 18994 (August 20, 1982), 47 FR 37731 (August 26, 1982). OCC anticipates that this rule change will reduce significantly its dependence on letters of credit.

Although the proposal contains concentration requirements for foreign banks, OCC's existing rules do not preclude OCC from becoming unduly dependent upon any one one domestic issuer. By letter dated January 3, 1983, from Marc L. Berman of OCC to the staff, OCC agreed to study its letter of credit program to determine whether any additional regulatory limitations are necessary to insure the safeguarding of funds and securities at OCC. The Commission welcomes this commitment by OCC and urges it to complete its study promptly.

18 Under OCC's rules, letters of credit cannot be used for clearing fund purposes.

SEC NEWS DIGEST
SELF-REGULATORY ORGANIZATIONS

The Commission has approved a proposed rule change (SR-OCC-82-8) filed by The Options Clearing Corporation ("OCC"), pursuant to Securities Exchange Act Rule 19b-4, that (i) would formalize certain criteria for approving domestic banks as issuers of letters of credit for margin purposes; and (ii) would adopt criteria allowing OCC, for the first time, to approve foreign banks as issuers of letters of credit issued for those purposes. (Release No. 34-19422)