

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-47691; File No. SR-OCC-2002-10]

### Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing of Proposed Rule Change Relating to Market-Maker Account Agreements

April 17, 2003.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> notice is hereby given that on May 21, 2002, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") and on October 18, 2002, amended the proposed rule change described in Items I, II, and III below, which items have been prepared primarily by OCC. The Commission is publishing this notice to solicit comments on the proposed rule change from interested parties.

#### I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The proposed rule change will amend OCC's By-Laws and Rules to eliminate the requirement that a clearing member must obtain a specified form of account agreement from each market-maker for whom it carries an account and submit the agreement to OCC for approval. The proposed rule change will also add two new interpretive statements to Article VI, Section 3 of OCC's By-Laws to clarify the application of certain amendments to Article 8 and Article 9 of the Uniform Commercial Code to OCC clearing accounts and to clarify the application of OCC's lien on clearing member account positions and clearing member obligations.

#### II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, OCC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. OCC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of these statements.<sup>2</sup>

#### (A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

The purpose of the proposed rule change is to amend Article VI, Section 3 of OCC's By-Laws and Chapter XI, Rule 1105 of OCC's Rules to eliminate the requirement that a clearing member must obtain and must submit to OCC for approval a specified form of account agreement from each market-maker for whom it carries an account. OCC believes that such submissions are no longer necessary to perfect its security interest in clearing members' market-maker accounts under the Uniform Commercial Code ("UCC") and are administratively burdensome for OCC and its clearing members. In order to incorporate the changes to Article IV, Section 3 into its rules, OCC proposes to make conforming changes to Rule 1105.

The proposed rule change also includes two interpretive statements. The first interpretive statement is intended to clarify the application to OCC clearing accounts of certain UCC amendments to Article 8 and to Article 9, which were adopted in 1994 and 1995. The other is intended to clarify that OCC's lien on positions in clearing member accounts extends to short security futures positions, as well as all other assets, and that OCC's lien secures clearing member obligations on long security futures positions, as well as all other obligations arising from the applicable account or accounts.

##### 1. Background

Article VI, Section 3, of OCC's By-Laws specifies the types of clearing accounts that a clearing member may have at OCC, including accounts (referred to collectively herein as "market-maker accounts") in which a clearing member may carry positions of market professionals such as options market-makers, JBO participants,<sup>3</sup> and stock specialists (referred to collectively herein as "market-makers"). Clearing members that maintain market-maker accounts at OCC must, according to the current provisions of Section 3, obtain

and submit to OCC for approval certain agreements from each market-maker whose funds and positions are included in such market-maker accounts.

The principal reason for requiring the filing of these agreements was to ensure that OCC's security interest in and setoff rights against long option positions and assets deposited as margin in market-maker Accounts would be protected under the UCC as it existed prior to the UCC amendments in the event of a clearing member insolvency. The contents of the required agreements vary depending upon the type of market-maker Account. In all cases, however, the agreements provide that OCC has: (a) A lien on positions and margin in the account as security for obligations of the clearing member to OCC arising in the account; (b) the right to net writing and purchase transactions in the account (*i.e.*, to carry positions "net"); and (c) the right to close out positions and apply proceeds without notice. In addition, market-makers whose assets are carried at OCC in combined accounts with other market-makers are required to consent to the commingling of their positions with the positions of other market-makers. Because OCC's lien on all assets in a combined market-makers' Account covers any obligation arising from the commingled account, assets attributable to one market-maker may be used by OCC to offset obligations of the clearing member that are attributable to the activity of a different market-maker.

OCC currently requires that a clearing member file with OCC a specified form of account agreement, executed by the clearing member and each market-maker included in the account, containing the required consents for the applicable type of market-maker account. OCC reviews the agreement and executes the agreement under the caption "Approved." The procedure is cumbersome and imposes administrative burdens on both clearing members and OCC staff. Moreover, OCC believes that there may be potential for confusion in the legal relationships established through these documents. Although the agreements are not intended to create contractual privity between OCC and the market-maker, OCC believes it might be possible to misinterpret the agreements as doing so.

##### 2. Proposed Changes

As a result of the UCC amendments, OCC believes it is no longer necessary to require clearing members to file market-maker account agreements with OCC in order to protect OCC's security interest in and setoff rights against funds and positions in market-maker

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> The Commission has modified the text of the summaries prepared by OCC.

<sup>3</sup> Under Article I, Section 1 of OCC's By-Laws, a "JBO participant" is a registered broker-dealer that "(i) maintains a joint back office arrangement with a clearing member pursuant to the requirements of Regulation T promulgated by the Board of Governors of the Federal Reserve System; (ii) meets the requirements applicable to JBO participants as specified in exchange rules; and (iii) consents to having his exchange transactions cleared and positions carried in a JBO participants account." Unless the context requires otherwise, a JBO Participant is a Market-Maker for purposes of OCC's By-Laws and all of OCC's Rules except for Chapter IV.

accounts.<sup>4</sup> The UCC amendments established new rules specifically tailored to govern the “indirect holding system” for securities and certain other investment property. Under these rules, OCC may obtain an automatically perfected, first-priority security interest in assets in market-maker accounts through provisions in OCC’s By-Laws or Rules. No grant of a security interest from the market-maker to OCC is required.

Under the UCC amendments, OCC and its clearing members are “securities intermediaries,”<sup>5</sup> and an OCC-issued option is a “financial asset.”<sup>6</sup> A person acquires a “security entitlement”<sup>7</sup> and becomes an “entitlement holder”<sup>8</sup> when a securities intermediary credits a financial asset to that person’s account.<sup>9</sup> Thus, OCC’s clearing members acquire security entitlements against OCC when OCC credits positions to the clearing members’ accounts. Similarly, the clearing members’ customers (including market-makers) acquire security entitlements against the clearing member with respect to positions carried for the accounts of those customers on the books of the clearing member. In the first case, the clearing member is the entitlement holder, and OCC is the securities intermediary. In the second case, the customer (or market-maker) is the entitlement holder, and the clearing member is the securities intermediary. In this instance, the customers’ security entitlement against the clearing member is a different item of property from the clearing member’s security entitlement against OCC.<sup>10</sup>

In order for OCC to acquire a perfected security interest in clearing members’ security entitlements, OCC must obtain “control” over the entitlements or the “securities account”

<sup>4</sup> OCC did not propose to eliminate the requirement that clearing members file market-maker account agreements with OCC immediately after the adoption of the UCC amendments because that requirement was not inconsistent with the UCC amendments and because the UCC amendments were not immediately adopted in all U.S. jurisdictions. Because OCC is expecting an increase in Market-Maker account openings as a result of security futures trading, it is now a business priority for OCC to eliminate the requirement in order to relieve administrative burdens for both OCC and its clearing members.

<sup>5</sup> UCC 8–102(a)(14).

<sup>6</sup> UCC 8–102(a)(9)(ii) and 8–103(e).

<sup>7</sup> UCC 8–102(a)(17).

<sup>8</sup> UCC 8–102(a)(7).

<sup>9</sup> UCC 8–501(b)(1).

<sup>10</sup> Prefatory Note to UCC Article 8, Section III.C. states, “For purposes of Article 8 analysis, the customer’s security entitlement against the broker or bank custodian is a different item of property from the security entitlement of the broker or bank custodian against the clearing corporation.”

in which they are held.<sup>11</sup> UCC 8–106(e) provides that the securities intermediary has control “[i]f an interest in a security entitlement is granted by the entitlement holder to the entitlement holder’s own securities intermediary.” As proposed, the revised rule would state that the clearing member (*i.e.*, the entitlement holder) agrees, and represents that it has obtained the agreement of each market-maker whose positions and transactions are included in the account and that OCC (*i.e.*, the securities intermediary) has a lien on long positions and margin in each market-maker account. Consequently, OCC will have a security interest perfected by control in the security entitlements in each market-maker account whether or not it has obtained a signed agreement from each market-maker.

Furthermore, OCC’s security interest has priority over any competing interests. “A security interest in a security entitlement or a securities account<sup>12</sup> granted to the debtor’s own securities intermediary has priority over any security interest granted by the debtor to another secured party.”<sup>13</sup>

Because it remains the case that as between a clearing member and its customers (including a market-maker), the clearing member has a duty to obtain the customer’s consent before subjecting the customer’s securities to a security interest or taking certain other actions potentially affecting the customer’s interests,<sup>14</sup> the proposed rule continues to require clearing members

<sup>11</sup> UCC 9–314(a) and 9–106(a).

<sup>12</sup> UCC 8–501(a) defines “securities account” to mean “an account to which a financial asset is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the financial asset.” UCC 9–102(a)(14) defines “commodity account” as an account maintained by a commodity intermediary in which a commodity contract is carried for a commodity customer.” Accounts established under Section 3 of OCC’s By-Laws would ordinarily be “securities accounts,” but certain accounts might be construed as commodity accounts or as both securities accounts and commodity account given that OCC may clear commodity contracts and security futures as well as security options. In any case, the Article 9 rules governing perfection and priority of security interests in commodity accounts and assets contained therein are substantively identical to those governing securities accounts and assets therein because all are included in the UCC 9–102(a)(49) definition of “investment property” to which those rules apply. To the extent that an account if a “commodity account,” OCC will fail within the definition of a “commodity intermediary” under UCC 9–102(a)(17).

<sup>13</sup> UCC 9–328(3).

<sup>14</sup> See UCC 8–504(b), which states that a securities intermediary may not grant any security interests in a financial asset is it obligated to maintain on behalf of an entitlement holder except as otherwise agreed by the entitlement holder.

to contain specified agreements from market-maker and also to require them to represent to OCC that such agreements have in fact been obtained. Those clearing members that choose to continue to use an existing form of market-maker account agreement will be permitted to do so, but OCC will also permit the agreement required under Section 3 of Article VI of its By-Laws to be incorporated into a clearing member’s own forms of account agreements to the extent that the clearing member chooses to do so.

OCC also proposes to add two new items to the Interpretations and Policies to Article VI, Section 3 of its By-Laws. The first sentence of proposed Interpretation .02 sets forth a representation and warranty that the clearing member has obtained the agreement of each person for whom a transaction is effected in any account of the clearing member at OCC pursuant to provisions of Section 3, including the security interest in the account that is granted by the clearing member to OCC, and that the inclusion of the person’s transactions and positions in that type of account is otherwise permitted by applicable law. This representation would apply not only to market-maker accounts and JBO participant accounts<sup>15</sup> but also to the firm account, pledge accounts, securities customer accounts, cross-margining accounts, and segregated futures accounts that are provided for under paragraphs (a) and (d) through (g) of Section 3, respectively. OCC has never required that a specified form of agreements be obtained by clearing members from persons whose transactions are included in these other types of accounts. Nevertheless, Rule 15c3–3 and the Commission’s hypothecation rules, Rule 8c–1 and Rule 15c2–1, as well as certain state laws require that certain consents and agreements be obtained, such as consent to the commingling of a customer’s securities with the securities of another customer. These comments are included in the account documentation normally obtained by brokers from their customers and are the responsibility of the broker.

The final sentence of Interpretation .02 is intended to make clear that the rights of OCC, including its security interest, in any account of the clearing member with OCC are enforceable in

<sup>15</sup> Under Article I, Section 1, of OCC’s By-Laws a “JBO participant account” means an account established by a clearing member which is confined to exchange transactions cleared and positions carried by the clearing member on behalf of JBO participants for whom the clearing member has filed a JBO participant account agreement with OCC.

accordance with their terms even if the clearing member fails in its obligations to obtain required consents or agreements from customers. This is consistent with the provision of UCC 8-503(e), which provides that an action based on an entitlement holder's property interest with respect to a financial asset held for its account by a securities intermediary, whether framed in conversion, replevin, constructive trust, equitable lien, or other theory, may not be asserted against any purchaser of the financial asset or an interest therein (which would include lien holders) who gives value, obtains control, and does not act in collusion with the securities intermediary in violating the securities intermediary's obligations to maintain the property for the entitlement holder. OCC's security interest is protected under this provision.<sup>16</sup>

The first sentence of proposed Interpretation .03 is intended to clarify that OCC's lien extends to all assets in the market-maker accounts and JBO participant accounts. Article VI, Sections 3(b), (c), and (h) of OCC's By-Laws governs such accounts and uses the same language to describe OCC's lien's over those assets.<sup>17</sup> This language has always been intended and understood to describe the scope of OCC's lien as extending to all assets in the accounts. "Long positions" were specifically referred to in Section 3 because in the case of options only long positions have asset value. Short option positions represent only a liability. However, as OCC begins clearing security futures, it seems prudent to clarify that OCC's lien extends to all positions that represent an asset in the account, including short futures positions, which may have asset value if the market has moved in their favor since the most recent mark-to-market payment. Thus, the first sentence of proposed Interpretation .03 clarifies that the "long positions, securities, margin and other funds" over which OCC's lien extends includes any "investment property," as defined in Article 9 of the UCC,<sup>18</sup> including long and short

positions in security futures as well as any other asset.

The second sentence of proposed Interpretation .03 is also motivated by security futures, although it more broadly clarifies that OCC's lien acts as security for all obligations of the clearing member to OCC with respect to separate or combined market-maker accounts, customer accounts, or segregated futures accounts. OCC uses similar language in Sections 3(b), (c), (e), and (f) of Article VI of OCC's By-Laws, which governs such accounts, to indicate that OCC has a lien on all long positions, margins, and other funds in the market-maker account with OCC as security for the clearing member's obligations to OCC in respect of all exchange transactions effected through such an account, short positions maintained in such an account, and exercise notices assigned to such an account. When OCC begins clearing security futures, its lien will also secure the clearing member's obligations with respect to long security futures positions in the account, which unlike long options which are always an asset may be a liability if the market has moved against those positions since the last mark-to-market payment. In order to avoid any confusion caused by reference to short positions but not to long positions, the proposed Interpretation .03 clarifies that obligations to OCC with respect to all exchange transactions should be read broadly to encompass, where applicable, obligations arising from long or short positions, obligations to make payments or delivery under cleared contracts, and obligations with respect to fees and charges associated with such transactions.

OCC has determined to clarify the language in Section 3 through the addition of Interpretation .03 rather than through an amendment to the text of Section 3 because OCC wants to avoid any possible inference that it is making a substantive change from the language that is Section 3, which language is currently used in outstanding market-maker account agreements.

Changes to Rule 1105(b) are intended merely to conform to the changes in Article VI, Section 3. Rather than refer to the market-maker account agreement, the rule would now refer directly to the applicable provisions in Article VI, Section 3, of the By-Laws which are required to be incorporated into an agreement between the clearing member and the market-maker.

OCC believes the proposed rule change is consistent with the requirements of Section 17A of the

Act<sup>19</sup> and the rules and regulations thereunder applicable to OCC because it will promote the prompt and accurate clearance and settlement of securities transactions, fosters cooperation and coordination with persons engaged in the clearance and settlement of securities transactions, remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions, and, in general, protect investors and the public interest.

*(B) Self-Regulatory Organization's Statement on Burden on Competition*

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

*(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants or Others*

Written comments were not and are not intended to be solicited with respect to the proposed rule change, and none have been received.

**III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action**

Within thirty-five days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to ninety days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) By order approve such proposed rule change or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

**IV. Solicitation of Comments**

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Comments may also be submitted electronically at the following e-mail address: [rule-coments@sec.gov](mailto:rule-coments@sec.gov). All comment letters should refer to File No. SR-OCC-2002-10. This file number should be included on the subject line if e-mail is used. Copies of the

<sup>16</sup> See also UCC 8-511(b), which provides that a claim of a creditor (OCC) of a securities intermediary (the failed clearing member) that is perfected by control has priority over the claims of the securities intermediary's entitlement holders.

<sup>17</sup> Article VI, Sections 3(b), (c), and (h) contain language to indicate that OCC has a lien on all long positions, securities, margin, and other funds in such accounts.

<sup>18</sup> UCC 9-102(a)(49) defines "investment property" to mean a "security, whether certified or uncertified, security entitlement, securities account, commodity contract, or commodity account."

<sup>19</sup> 15 U.S.C. 78q-1.

submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW., Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of OCC. All submissions should refer to File No. SR-OCC-2002-10 and should be submitted by May 15, 2003.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>20</sup>

**Margaret H. McFarland,**  
Deputy Secretary.

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## DEPARTMENT OF STATE

[Public Notice 4342]

### Bureau of Educational and Cultural Affairs Request for Grant Proposals: International Sports Programming Initiative

**SUMMARY:** The Office of Citizen Exchanges of the Bureau of Educational and Cultural Affairs announces an open competition for an "International Sports Programming Initiative." Public and private non-profit organizations meeting the provisions described in Internal Revenue Code section 26 U.S.C. 501(c)(3) may submit proposals to discuss approaches designed to enhance and improve the infrastructure of youth sports programs in the following countries: Jordan, Morocco, Saudi Arabia, and Turkey. To be eligible for consideration under this competition, proposals *must* provide a minimum of 50 percent cost sharing of the amount of grant funds sought from ECA, although proposals with higher cost sharing levels are welcome. The Office expects to make approximately three (3) full grants of no more than \$135,000 each under this competition, covering all thematic areas outlined below.

**Announcement Name and Number:** All correspondence with the Bureau concerning this RFGP should reference the "Open Competition for International Sports Programming Initiative" and

reference number: ECA/PE/C/WHAEAP-03-49. Please refer to title and number in all correspondence or telephone calls to the Office of Citizen Exchanges.

#### FOR FURTHER INFORMATION CONTACT:

Interested organizations/institutions may contact the Office of Citizen Exchanges, room 216, SA-44, U.S. Department of State, 301 4th Street, SW., Washington, DC 20547, telephone number 202/260-5491, fax number 202/260-0440, or [rharvey@pd.state.gov](mailto:rharvey@pd.state.gov) to request a Solicitation Package. The Solicitation Package contains detailed award criteria, required application forms, specific budget instructions, and standard guidelines for proposal preparation. Please specify Bureau Program Officer, Raymond H. Harvey, on all other inquiries and correspondence.

**To Download a Solicitation Package Via Internet:** The entire Solicitation Package also may be downloaded from the Bureau's Web site at <http://exchanges.state.gov/education/RFGPs>. Please read all information before downloading.

#### Program Information

**Overview:** The Office of Citizen Exchanges welcomes proposals that directly respond to the following thematic areas. Given budgetary limitations, projects for other themes and other countries will not be eligible for consideration under the FY-2003 International Sports Program Initiative.

**Training Sports Coaches:** The World Summit on Physical Education (Berlin, 1999) stated that a "quality physical education helps children to develop the patterns of interest in physical activity, which are essential for healthy development and which lay the foundation for healthy, adult lifestyles." Coaches are critical to the accomplishment of this goal. A coach not only needs to be qualified to provide the technical assistance required by young athletes to improve, but must also understand how to aid a young person to discover how success in athletics can be translated into achievement in the development of life skills and in the classroom.

Projects submitted in response to this theme would be aimed at aiding youth, secondary school and university coaches in the target countries in the development and implementation of appropriate training methodologies, through seminars and outreach. The goal is to ensure the optimal technical proficiency among the coaches participating in the program while also emphasizing the role sports can play in

the long-term economic well being of youth.

**Youth Sports Management Exchange:** Exchanges funded under this theme would help American and foreign youth sport coaches, adult sponsors, and sports and civic organization officials share their experience in managing and organizing youth sports activities, particularly in financially challenging circumstances, and would contribute to better understanding of the role of sports as a significant factor in educational success. Program should be designed to convey to the foreign counterparts the importance of linking success in sports to educational and leadership achievement and how these factors can contribute to short-term and long-term economic prospects.

**Youth with Disability:** Exchanges supported by this theme are designed to promote and sponsor sports, recreation, fitness and leisure events for children and adults with physical disabilities. Project goals include improving the quality of life for people with disabilities by providing affordable inclusive sports and recreational experiences that build self-esteem and confidence, enhancing active participation in community life and making a significant contribution to the physical and psychological health of people with disabilities. Programs should be structured to ensure that physically and developmentally challenged individuals be fully included in the sports and recreation opportunities in their communities.

**Sports and Health:** Projects funded under this category will focus on effective and practical ways to use sport personalities and sports health professionals to increase awareness among young people of the importance of following a healthy life style to reduce illness, prevent injuries and speed the rehabilitation and recovery. Emphasis will be on the responsibility of the broader community to support healthy behavior. The project goals are to promote and integrate scientific research, education, and practical applications of sports medicine and exercise science to maintain and enhance physical performance, fitness, health, and quality of life. (Actual medical training and dispensing of medications are outside the purview of this theme.)

**Guidelines:** The Office seeks proposals that provide professional experience and exposure to American life and culture through internships, workshops and other learning-sharing experiences hosted by local institutions. The experiences also will provide Americans the opportunity to learn

<sup>20</sup> 17 CFR 200.30-3(a)(12).