

## Options and Margin Requirements

### SEC Approves Amendments to FINRA Rule 2360 (Options) and FINRA Rule 4210 (Margin Requirements) in Connection With Over-the-Counter Options Cleared by the OCC

Effective Date: November 7, 2013

#### Executive Summary

The SEC approved amendments to treat over-the-counter (OTC) options cleared by The Options Clearing Corporation (OCC) as conventional options for purposes of FINRA Rule 2360 (Options) and as listed options for purposes of FINRA Rule 4210 (Margin Requirements).<sup>1</sup> Accordingly, OCC cleared OTC options will be considered conventional options for purposes of position limit and reporting requirements and delivery of certain disclosure documents and will be considered listed options for purposes of margin requirements, including maintenance margin requirements and portfolio margin requirements. The effective date is November 7, 2013.

The amended rule text is set forth in Attachment A.

Questions concerning this *Notice* or FINRA Rule 2360 should be directed to:

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#### Notice Type

- ▶ Rule Amendment

#### Suggested Routing

- ▶ Compliance
- ▶ Institutional
- ▶ Internal Audit
- ▶ Legal
- ▶ Margin
- ▶ Operations
- ▶ Options
- ▶ Risk
- ▶ Senior Management
- ▶ Systems
- ▶ Trading

#### Key Topics

- ▶ Conventional Options
- ▶ Listed Options
- ▶ Margin
- ▶ Options Clearing Corporation (OCC)
- ▶ Options Disclosure Document (ODD)
- ▶ Over-the-Counter (OTC) Options
- ▶ Standardized Options

#### Referenced Rules & Notices

- ▶ FINRA Rule 2360
- ▶ FINRA Rule 4210

## Background & Discussion

The SEC recently approved amendments to FINRA rules on options and margin requirements to address new rules established by OCC to clear and guarantee OTC options on the S&P 500 index.<sup>2</sup> Because OCC-cleared OTC options have aspects similar to both standardized and conventional options, FINRA amended Rule 2360 (Options) and Rule 4210 (Margin Requirements), as discussed below, to provide for the proper application of the rules to OCC cleared OTC options.

### Rule 2360 (Options)

FINRA Rule 2360 covers, among other things, the definitions, position limits, exercise limits, reporting, suitability and disclosure requirements related to options and options trading. The rule generally classifies options as either standardized<sup>3</sup> or conventional.<sup>4</sup> Historically, all standardized options have been traded on an exchange, and all conventional options have been traded OTC. To provide clarity and consistent treatment with OTC options more generally, FINRA amended Rule 2360 to treat OCC cleared OTC options as conventional options.

FINRA amended several definitions to clarify this treatment. Specifically, FINRA defined an OCC cleared OTC option as “any put, call, straddle or other option or privilege that meets the definition of an ‘option’ under Rule 2360(a)(21) and is cleared by The Options Clearing Corporation, is entered into other than on or through the facilities of a national securities exchange, and is entered into exclusively by persons who are ‘eligible contract participants’ as defined in the Exchange Act.”<sup>5</sup> FINRA also clarified that the definitions of conventional option and conventional index option include OCC cleared OTC options.<sup>6</sup> FINRA further amended the definitions of standardized equity option, standardized index option and FLEX equity option to specifically exclude OCC cleared OTC options.<sup>7</sup> Finally, FINRA made minor amendments to the definition of expiration date in Rule 2360(a)(14) to reflect that the expiration date of OCC cleared OTC options may be customized by the parties to the trade in accordance with the rules of the OCC.

Accordingly, for position limits and reporting requirements that differentiate between conventional and standardized options, OCC cleared OTC options will be considered conventional options. In addition, as with other conventional options, OCC cleared OTC options will not be subject to the requirement to deliver the Options Disclosure Statement (ODD) and the Special Statement for Uncovered Options Writers (Special Written Statement). FINRA amended Rule 2360(b)(11)(A) and Rule 2360(b)(16) to provide that the ODD and Special Written Statement are not required to be delivered by firms effecting a transaction in OCC cleared OTC options.

**Rule 4210 (Margin Requirements)**

For purposes of margin treatment, FINRA amended Rule 4210 to treat OCC cleared OTC options as it treats other cleared and guaranteed options, which to date have always been listed options,<sup>8</sup> in light of the clearing and guaranteeing functions performed by the OCC. The beneficial margin treatment for an OCC cleared OTC option may only be applied by a firm after the OTC option has been accepted for clearing and guaranteed by the OCC.<sup>9</sup>

Specifically, FINRA provided that a listed option means an option that is traded on a national securities exchange or issued and guaranteed by a registered clearing agency and shall include an OCC cleared OTC option as defined in FINRA Rule 2360. FINRA also amended the definition of OTC to provide that OTC options shall not include an OCC cleared OTC option. FINRA also made conforming amendments regarding portfolio margin requirements to provide that a listed option means an option that is traded on a national securities exchange or issued and guaranteed by a registered clearing agency and shall include an OCC cleared OTC option. Finally, FINRA amended Rule 4210(g)(2)(H) to clarify that an unlisted derivative would include, among other things, an index-based option that is neither traded on a national securities exchange nor issued or guaranteed by a registered clearing agency and shall not include an OCC cleared OTC option.

The amendments are effective on November 7, 2013.

## Endnotes

1. See Securities Exchange Act Release No. 70619 (October 7, 2013), 78 FR 62722 (October 22, 2013) (SEC Order Approving File No. SR-FINRA-2013-027).
2. See Securities Exchange Act Release No. 68434 (December 14, 2012), 77 FR 75243 (December 19, 2012) (Order Approving Proposed Rule Change, as Modified by Amendment No. 1 Thereto, and Notice of No Objection to Advance Notice, Modified by Amendment No. 1 Thereto, Relating to the Clearance and Settlement of Over-the-Counter Options; File No. SR-OCC-2012-14). The OCC has not yet implemented clearing of OTC options on the S&P 500 index.
3. A standardized equity option is “any equity options contract issued, or subject to issuance, by The [OCC] that is not a FLEX Equity Option.” See FINRA Rule 2360(a)(31). See also FINRA Rule 2360(a)(32) for the definition of standardized index option.
4. A conventional option is “any option contract not issued, or subject to issuance, by The [OCC].” See FINRA Rule 2360(a)(9). See also FINRA Rule 2360(a)(8) for the definition of conventional index option.
5. The definition reflects the OCC requirement that counterparties to OCC cleared OTC options must be “eligible contract participants” as defined in the Act. See note 2 and Section 6(f), Article XVII of the OCC By-Laws.
6. See amended FINRA Rule 2360(a)(8) and (a)(9), respectively.
7. See re-numbered FINRA Rule 2360(a)(32), (a)(33) and (a)(16), respectively.
8. See FINRA Rule 4210(f)(2)(A)(xxiv) and FINRA Rule 4210(g)(2)(A) for the definition of “listed” and “listed option,” respectively.
9. The OCC intends that the trade data for an OTC option trade be submitted to an approved OCC vendor that will process the trade and submit it as a confirmed trade to OCC for clearing. The OCC then will confirm if the OTC option trade meets OCC’s validation requirements and will notify the vendor, which will notify the submitting parties. FINRA understands that, if the option trade is rejected for clearing, the option remains subject to any applicable agreement between the original parties to the transaction, which may provide that (1) such rejected transaction shall remain a bilateral transaction between the parties subject to such agreement or other documentation as the parties have entered into for that purpose or (2) may be terminated. See note 2 and interpretation .02 of Section 6, Article VII of the OCC By-Laws. If the OTC option was rejected for clearing, but the option contract was not terminated by the parties and remained an OTC option contract, the firm would be required to apply the applicable OTC option margin requirements, not the listed option margin requirements. See FINRA Rule 4210(f)(2)(E)(iii).

## Attachment A

New language is underlined; deletions are in brackets.

### 2360. Options

#### (a) Definitions

The following terms shall, unless the context otherwise requires, have the stated meanings:

(1) through (7) No Change.

(8) Conventional Index Option — The term “conventional index option” means any options contract not issued, or subject to issuance, by The Options Clearing Corporation, or an OCC Cleared OTC Option, that, as of the trade date, overlies a basket or index of securities that:

(A) through (B) No Change.

(9) Conventional Option — The term “conventional option” shall mean: (A) any option contract not issued, or subject to issuance, by The Options Clearing Corporation; or (B) an OCC Cleared OTC Option.

(10) through (13) No Change.

(14) Expiration Date — The term “expiration date” of an option contract issued by The Options Clearing Corporation means the day and time fixed [by] in accordance with the rules of The Options Clearing Corporation for the expiration of [all]such option contract[s having the same expiration month as such option contract]. The term “expiration date” of all other option contracts means the date specified thereon for such.

(15) No Change.

(16) FLEX Equity Option — The term “FLEX Equity Option” means any options contract issued, or subject to issuance by, The Options Clearing Corporation, other than an OCC Cleared OTC Option, whereby the parties to the transaction have the ability to negotiate the terms of the contract consistent with the rules of the exchange on which the options contract is traded.

(17) through (18) No Change.

(19) OCC Cleared OTC Option – The term “OCC Cleared OTC Option” means any put, call, straddle or other option or privilege that meets the definition of an “option” under Rule 2360(a)(21), and is cleared by The Options Clearing Corporation, is entered into other than on or through the facilities of a national securities exchange, and is entered into exclusively by persons who are “eligible contract participants” as defined in the Exchange Act.

(19) through (21) renumbered as (20) through (22).

~~[(22)]~~(23) Options Contract — The term “options contract” means any option as defined in paragraph (a)~~[(20)]~~(21). For purposes of paragraphs (b)(3) through (12), an option to purchase or sell common stock shall be deemed to cover 100 shares of such stock at the time the contract granting such option is written. If a stock option is granted covering some other number of shares, then for purposes of paragraphs (b)(3) through (12), it shall be deemed to constitute as many option contracts as that other number of shares divided by 100 (e.g., an option to buy or sell five hundred shares of common stock shall be considered as five option contracts). A stock option contract that, when written, grants the right to purchase or sell 100 shares of common stock shall continue to be considered as one contract throughout its life, notwithstanding that, pursuant to its terms, the number of shares that it covers may be adjusted to reflect stock dividends, stock splits, reverse splits, or other similar actions by the issuer of such stock.

(23) through (30) renumbered as (24) through (31).

~~[(31)]~~(32) Standardized Equity Option — The term “standardized equity option” means any equity options contract issued, or subject to issuance by, The Options Clearing Corporation that is not a FLEX Equity Option and not an OCC Cleared OTC Option.

~~[(32)]~~(33) Standardized Index Option — The term “standardized index option” means any options contract issued, or subject to issuance, by The Options Clearing Corporation that is based upon an index and is not an OCC Cleared OTC Option.

(33) through (38) renumbered as (34) through (39)

**(b) Requirements****(1) Applicability**

This Rule shall be applicable to the extent appropriate unless otherwise stated herein: (A) to the conduct of accounts, the execution of transactions, and the handling of orders in exchange-listed options by members that are not members of an exchange on which the option executed is listed; (B) to the conduct of accounts, the execution of transactions, and the handling of orders in conventional options by all members; and (C) to other matters related to options trading.

Subparagraphs (3) through (12) shall apply only to standardized and conventional options on common stock. Subparagraphs (13) through (24) shall apply to transactions in all options as defined in paragraph (a)(20)(21), including common stock unless otherwise indicated herein.

(2) through (10) No Change.

**(11) Delivery of Current Disclosure Documents**

(A)(i[1]) Characteristics and Risks of Standardized Options (the “ODD”). Every member shall deliver the current ODD to each customer at or prior to the time such customer’s account is approved for trading options issued by The Options Clearing Corporation, other than an OCC Cleared OTC Option. Thereafter, a copy of each amendment to the ODD shall be distributed to each customer to whom the member previously delivered the ODD not later than the time a confirmation of a transaction in the category of options to which the amendment pertains is delivered to such customer.

(ii[2]) Special Statement for Uncovered Option Writers (“Special Written Statement”). In the case of customers approved for writing uncovered short options transactions, the Special Written Statement required by paragraph (b)(16) shall be in a format prescribed by FINRA and delivered to customers in accordance with paragraph (b)(16). A copy of each new or revised Special Written Statement shall be distributed to each customer having an account approved for writing uncovered short options not later than the time a confirmation of a transaction is delivered to each customer who enters into a transaction in options issued by The Options Clearing Corporation, other than an OCC Cleared OTC Option.

(iii[3]) FINRA will advise members when a new or revised current disclosure document meeting the requirements of SEA Rule 9b-1 is available.

(B) through (C) No Change.

(12) through (15) No Change.

**(16) Opening of Accounts**

(A) through (C) No Change.

(D) Account Agreement

Within fifteen (15) days after a customer's account has been approved for options trading, a member shall obtain from the customer a written agreement that the customer is aware of and agrees to be bound by FINRA rules applicable to the trading of option contracts and, if he desires to engage in transactions in options issued by The Options Clearing Corporation, other than solely for OCC Cleared OTC Options, that the customer has received a copy of the current disclosure document(s) required to be furnished under this subparagraph (16) and that he is aware of and agrees to be bound by the rules of The Options Clearing Corporation. In addition, the customer shall indicate on such written agreement that he is aware of and agrees not to violate the position limits established pursuant to paragraph (b)(3) and the exercise limits established pursuant to paragraph (b)(4).

(E) No Change.

(17) through (24) No Change.

(c) No Change.

**••• Supplementary Material: -----**

.01 through .03 No Change.

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## 4210. Margin Requirements

(a) through (e) No Change.

### (f) Other Provisions

(1) No Change.

### (2) Puts, Calls and Other Options, Currency Warrants, Currency Index Warrants and Stock Index Warrants

#### (A) Definitions.

Except where the context otherwise requires or as defined below, the definitions contained in section (a) of Rule 2360, "Options," shall apply to the terms used in this Rule.

(i) through (xxiii) No Change.

(xxiv) The term "listed" as used with reference to a call or put option contract means an option contract that is traded on a national securities exchange or[and] issued and guaranteed by a registered clearing agency and shall include an OCC Cleared OTC Option (as defined in Rule 2360).

(xxv) through (xxvi) No Change.

(xxvii) The term "OTC" as used with reference to a call or put option contract means an over-the-counter option contract that is not traded on a national securities exchange and is issued and guaranteed by the carrying broker-dealer and shall not include OCC Cleared OTC Option (as defined in Rule 2360).

(xxviii) through (xxxvi) No Change.

(B) through (N) No Change.

(3) through (10) No Change.

### (g) Portfolio Margin

As an alternative to the "strategy-based" margin requirements set forth in paragraphs (a) through (f) of this Rule, members may elect to apply the portfolio margin requirements set forth in this paragraph (g) to all margin equity securities,<sup>1</sup> listed options, security futures products (as defined in Section 3(a)(56) of the Exchange Act), unlisted derivatives, warrants, stock index warrants and related instruments (as defined in paragraph (g)(2)(D)), provided that the requirements of paragraph (g)(6)(B)(i) of this Rule are met.

1. No Change.

In addition, a member, provided that it is a Futures Commission Merchant (“FCM”) and is either a clearing member of a futures clearing organization or has an affiliate that is a clearing member of a futures clearing organization, is permitted under this paragraph (g) to combine an eligible participant’s related instruments with listed index options, unlisted derivatives, options on exchange traded funds (“ETF”), stock index warrants and underlying instruments and compute a margin requirement for such combined products on a portfolio margin basis.

The portfolio margin provisions of this Rule shall not apply to Individual Retirement Accounts (“IRAs”).

(1) No Change.

**(2) Definitions**

For purposes of this paragraph (g), the following terms shall have the meanings specified below:

(A) The term “listed option” means any equity-based or equity index-based option traded on a registered national securities exchange or issued and guaranteed by a registered clearing agency and shall include an OCC Cleared OTC Option (as defined in Rule 2360).

(B) through (G) No Change.

(H) The term “unlisted derivative” means any equity-based or equity index-based [unlisted] option, forward contract, or security-based swap that can be valued by a theoretical pricing model approved by the SEC and that is neither traded on a national securities exchange, nor issued and guaranteed by a registered clearing agency and shall not include an OCC Cleared OTC Option (as defined in Rule 2360).

(3) through (15) No Change.

(h) No Change.

••• **Supplementary Material:** -----

.01 No Change