WILLKIE FARR & GALLAGHER LLP

JEFFREY B. KORN
[redacted]

787 Seventh Avenue
New York, NY 10019-6099
Tel: 212 728 8000
Fax: 212 728 8111

October 15, 2018

VIA EMAIL

Brent J. Fields, Secretary
U.S. Securities and Exchange Commission
100 F. Street, N.E.
Washington, D.C. 20549-1090

Re: Re-Approval of the OCC Capital Plan (File No. SR-OCC-2015-02)

Dear Mr. Fields,

In connection with the above-referenced proceeding, the Options Clearing Corporation ("OCC") respectfully submits the attached Expert Rebuttal Report of Marc J. Brown (the "Rebuttal Report"), Global Valuation Service Practices Coordinator at Alix Partners, which responds to the report submitted on behalf of Petitioners by Professor Peter Easton. Putting aside the fact that Professor Easton lacks practical relevant experience, as explained in the Rebuttal Report, his opinions are "specious and misguided" and nothing he says alters any of Mr. Brown's conclusions or caused him to reconsider them.

In addition, along with Professor Easton's report, Petitioners submitted a 14-page letter arguing that the Exchange Act requires the rejection of OCC's Capital Plan. None of these arguments is new and OCC has extensively responded to them in prior submissions, demonstrating that the Capital Plan protects investors and the public interest, imposes no burden on competition, does not unfairly discriminate among participants, and complies with OCC's own rules.[1]

With respect to the first Exchange Act requirement, Petitioners claim that the Capital Plan does not serve investors and the public interest because they assert (1) OCC did not need to raise any capital at all (pp. 4-5); (2) OCC did not need to raise capital from shareholder exchanges (pp. 6-7); and (3) the dividends shareholders received under the plan were unreasonable in both their rate and their structure (pp. 7-10).

---

[1] Petitioners make much of the fact that a former Willkie Farr partner, Howard Kramer, represented clients opposed to the Capital Plan in 2015. Petitioners fail to mention, however, that Mr. Kramer left Willkie Farr in early 2016 and is currently a Partner at Murphy & McConigle, P.C.

Petitioners also argue without any basis that the Capital Plan is responsible for "explosive growth" in OCC's expenses (pp. 2-4).

None of these claims stands up to scrutiny. Petitioners' first claim – that OCC needed only $117 million of capital to comply with Rule 17Ad-22(e)(15) – ignores the plain text of the rule, which requires OCC to maintain "liquid net assets funded by equity equal to *the greater of* either six months of [its] current operating costs *or the amount determined by the board of directors* to be sufficient to ensure a recovery or orderly wind-down of critical operations and services" (emphasis added). At the OCC Board's behest, Oliver Wyman conducted a rigorous analysis to determine how much capital OCC needed to hold against its operational, business, and pension risks, and concluded that amount was $247 million. Petitioners concede that the $117 million figure represents only six months' worth of OCC's operating expenses and does not account for the additional capital needed "to ensure a recovery or orderly wind-down" in the face of such risks.

Further, Petitioners are wrong that OCC could have raised money from other investors or retained excess net income until it met its target capital requirement. Petitioners do not contest that OCC's shareholders had anti-dilution and veto rights, which were approved by the SEC at OCC's inception and are protected under Delaware law, that prevented (and still prevent) OCC from raising equity from others. Petitioners have offered no solution that recognizes these legal rights of OCC's shareholders. And OCC's Board extensively considered, with the aid of expert analysis, the option of retaining net income. Barclays advised that this option would result in significant fee increases and tax inefficiencies. Nothing in Petitioners' efforts to second-guess the Board's expert advisors with their own conclusory assertions about how much capital OCC needed to raise and how it might have done so indicates that the Board's conclusions were unreasonable.

Finally, Petitioners argue that the dividend rate is unreasonable and that the "structure" of the dividend has harmed investors by increasing OCC's expenses. Mr. Brown's reports address the reasonableness question on an *ex ante* basis, as OCC's Board did at the time, without the benefit of the *ex post* realizations Professor Easton improperly relies on in his report. Furthermore, Petitioners offer absolutely no evidence that the dividend's "structure" is responsible for OCC's increased expenses. OCC's expenses have risen both because of its SIFMU designation and because of pressing needs to improve its operational and technological infrastructure, after years of refunding all fees in excess of expenses and leaving itself no resources for capital improvements. To the extent the Commission has concerns in the future about increasing fees, the proper avenue to address those concerns is pursuant to Section 19(b). As the Commission noted in its 2016 Order, the filing requirements for fee increases under Section 19(b) and Rule 19b-4 "provide appropriate protection against future fee increases despite commenters' assertions to the contrary."

With respect to the remaining Exchange Act requirements, Petitioners again make no new arguments. On the question of burdens on competition, Petitioners ignore that stockholder exchanges have lost market share since the Capital Plan became effective, as well as the lack of *any* evidence that they have reduced fees or increased incentives.[2] Petitioners suggest that the acquisition of Bats Global Markets, a former

[2] OCC's annual reports in the years subsequent to the adoption of the Capital Plan demonstrate the decreasing combined market share of the stockholder exchanges. The Options Clearing Corp., 2017 Annual Report at 3 (2018); The Options Clearing Corp., 2016 Annual Report at 3 (2017); The Options Clearing Corp., 2015 Annual Report at 3 (2016); The Options Clearing Corp., 2014 Annual Report at 9 (2015).

petitioner in this matter, by CBOE Holdings was the result of the Capital Plan, pointing to Bats's statement that it "believes that the capital plan has the potential" to "stifl[e] future competition in the options market." It is, however, entirely unsurprising that Bats would make the same assertion about competition that it previously made as a petitioner in this proceeding to convince its shareholders to approve a sale. Further, despite Petitioners' insinuation that the Capital Plan has harmed competition by causing Bats's sale, the statement Petitioners cite was a small component of *one* of over *thirty* risk factors Bats identified. According to Bats, it faced numerous other competitive disadvantages, such as its small size vis-à-vis competitors, its limited product offerings, competitors' ability to offer unique products not offered by Bats, and competitors' greater name recognition.[3]

On the question of unfair discrimination, Petitioners again ignore that it is in no way inequitable to treat stockholder exchanges differently from non-stockholder exchanges based on the former's capital contributions and obligations to provide replenishment capital. By Petitioners' reasoning, any payment of dividends to stockholder exchanges would constitute unfair discrimination.

On the question of compliance with OCC's by-laws, Petitioners ignore the affirmative and subjective nature of the determination required before any obligation to share information with non-stockholder exchanges arises under the by-laws. They also disregard the deference due to the OCC Board's interpretation of its own by-laws. Finally, they offer no explanation of why a hypothetical failure to comply with a procedural requirement in the OCC by-laws requires a wholesale invalidation of the Capital Plan, given the ample and repeated opportunities for non-stockholder exchanges to register their objections to the plan notwithstanding any original lack of notice.

Petitioners' last argument is that rejection of the Capital Plan would not have negative consequences, because OCC can raise capital in other ways and will not need to significantly increase fees. OCC, however, has explained in detail why it has limited options to raise capital and cannot simply force the stockholder exchanges to accept new terms in the various ways Petitioners suggest. OCC has also provided a detailed analysis of the size and duration of fee increases that would be necessary to comply with the capital requirements of Rule 17Ad-22(e)(15). Market participants will bear these costs and the associated tax inefficiencies, as petitioners cannot dispute.

For the reasons explained above and in prior submissions, OCC's Capital Plan is consistent with all requirements of the Exchange Act and should be approved.

Sincerely,

Jeffrey B. Korn

Encl.

---

[3] CBOE Holdings & Bats Global Markets, Inc., Joint Proxy Statement/Prospectus at 53-78 (Dec. 9, 2016), available at https://goo.gl/iY27jP.

BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	)
The Options Clearing Corporation	) File No. SR-OCC-2015-02
For an Order Granting the Approval of	)
Proposed Rule Change Concerning a Proposed Capital Plan for Raising Additional Capital That Would Support The Options Clearing Corporation's Function as a Systemically Important Financial Market Utility (File No. SR-OCC-2015-02)	)

EXPERT REBUTTAL REPORT OF MARC J. BROWN, CFA

October 15, 2018

<u>Table of Contents</u>

I. Introduction

1. I previously issued an expert report dated August 23, 2018, which was submitted to the SEC in this proceeding (the "Brown Report").[1] In the Brown Report, I assessed the reasonableness of the expected returns of the Stockholder Exchanges for their regulatory capital investment in OCC under the Capital Plan contemporaneous with the OCC's approval of the Capital Plan. Counsel has asked that I review and respond to the September 24, 2018 report submitted by Professor Peter Easton (the "Easton Report") in response to the Brown Report.

II. Summary of Opinions

- **There is nothing in the Easton Report that causes me to reconsider the opinions I expressed in the Brown Report.**
- **The bases for Professor Easton's opinions and, ultimately, his opinions are fundamentally flawed.**

2. The opinions presented in this report are based on my analyses of information provided in this matter, publicly available information and my experience, training, education and expertise as a financial and valuation consultant.

III. Easton Report

A. Flaws with Easton Report Opinions 1 and 2

3. The first opinion proffered in the Easton Report is that "[t]he Shareholder Exchanges' investment in OCC is exceptionally low risk. A number of indicia suggest that that a reasonable rate of return is near five percent."[2] In order to illustrate his point, Professor Easton (i) points to a December 28, 2017 report from Standard and Poor's ("S&P") which included OCC's

[1] For convenience, I continue to use the same defined terms as in the Brown Report without redefining them here.
[2] Easton Report, ¶¶14, 19-26.

credit rating, (ii) discusses OCC's prior performance, and (iii) discusses the Depository Trust and Clearing Corporation ("DTCC") and its subsidiaries, including the dividend rate on preferred stock issued by the DTCC.[3] All of the anecdotal evidence presented by Professor Easton misses the mark.

4. First, S&P is a credit-ratings agency, not an equity-ratings agency. Its reports are issued in the context of the credit-worthiness of OCC; it does not assess the required return of a potential equity investor. There is a contractual obligation that a debtholder be paid any indicated interest and repaid the full amount of principal that it lent to the company by the maturity date. Debtholders have a priority claim (above that of equity holders) to the company's assets if the company defaults. Equity holders, on the other hand, are the residual claimants of the assets of the corporation. As such, equity capital is riskier then debt capital, and to equate a company's debt rating and its return on equity is misguided. This is even more so the case in this instance where the OCC regulatory equity capital is trapped capital and, unlike debt, the principal cannot be returned by the company.

5. In addition, this S&P report, which was issued at the end of 2017 (i.e., well after the Capital Plan was approved), also contains certain disclaimers about S&P's assumptions about OCC and its business and regulatory risks that Professor Easton did not include in his report. These additional comments that Professor Easton ignores highlight that there are more risks inherent in the OCC, particularly as it relates to residual equity claimants, than he acknowledges in his report. For example, the S&P report stated that: "[t]he outlook on Options Clearing Corp. (OCC) is stable because S&P Global Ratings expects the company to implement the new financial safeguards in 2018, provided it receives regulatory approval" and that "[w]e could lower the [credit] ratings if

---

3 Easton Report, ¶¶19-26.

OCC scales back its plan or if the plan does not receive regulatory approval. We could also lower the ratings if estimated peak liquidity outflows in a stress scenario structurally increase so that the back-testing performance of the proposed liquidity framework weakens."[4] Further, the same S&P report stated: "[t]here is a high degree of operating leverage because revenues are variable, unpredictable, and dependent on the volume of options trading activity, while expenses are generally fixed."[5] S&P also commented on the global regulatory environment and its potential impact on the OCC when the authors wrote:[6]

> For OCC's EU bank-affiliate clearing members to preserve existing capital treatment for exposures to OCC, OCC must receive recognition from the European Securities and Markets Authority (ESMA). If EU bank-affiliate clearing members are unable to preserve existing capital treatment for exposures to OCC, these clearing members' aggregate regulatory risk-weighted assets (with respect to their exposures to OCC) would increase significantly, requiring them to maintain large amounts of additional capital. This would most likely prompt EU clearing members to reduce trading U.S. equity options and place pressure on OCC revenues.

6. Second, Professor Easton attempts to paint the fact that the OCC has never needed to access shareholders' equity and that it issued substantial refunds at the height of the economic crisis as evidence of the safety of the Stockholders Exchanges' investment in the OCC.[7] However, Professor Easton ignores that the entire reason for the Capital Plan at issue in this matter was in response to proposed increased standards that were being contemplated by the SEC due to the OCC being designated in July 2012 as a Systematically Important Financial Market Utility by the Financial Stability Oversight Counsel. If the OCC was so immune to any potential downturns, then there would have been no reason for the OCC to be required to raise the additional funds and for the numerous board members from member firms to approve the Capital Plan.

[4] S&P Global Ratings, Options Clearing Corp., December 28, 2017, at 2.
[5] S&P Global Ratings, Options Clearing Corp., December 28, 2017, at 3.
[6] S&P Global Ratings, Options Clearing Corp., December 28, 2017, at 4.
[7] Easton Report, ¶21.

7. Moreover, though the OCC did make refunds during the 2008-2009 timeframe, OCC's revenues have nonetheless shown some instability, and OCC has experienced some downturns since the year 2000. For example, revenue fell by 5.7%, 5.4%, and 4.9% in 2005, 2008, and 2011, respectively.[8] Indeed, as the December 28, 2017 S&P report cited by Professor Easton pointed out: "[t]here is a high degree of operating leverage because revenues are variable, unpredictable, and dependent on the volume of options trading activity, while expenses are generally fixed."[9]

8. Third, Professor Easton attempts to support his conclusion by looking at the preferred dividend rate on securities issued by the Depository Trust & Clearing Corporation (the "DTCC"), along with other DTCC capital raises, and the lack of dividends paid by the DTCC's wholly-owned subsidiaries, the National Securities Clearing Corporation ("NSCC") and the Fixed Income Clearing Corporation ("FICC"), to DTCC.[10] Unlike the Stockholder Exchanges' shared ownership of the common stock of the OCC, NSCC and FICC are wholly-owned operating subsidiaries of the DTCC. As such, the DTCC has total control over these subsidiaries, whereas the Stockholder Exchanges are each only minority owners of OCC and do not control OCC.

9. Further, the comparison with DTCC's common and preferred stock issuances is inapposite for several other reasons. For instance, preferred stock is different from common stock in that it typically has a higher priority in the capital structure. The preferred stock that has been issued by DTCC, while perpetual, has liquidation preferences at specified prices per share.[11] Moreover, unlike the OCC, DTCC's net income was $154 million in 2013 compared with OCC's net income of only $1.6 million, and DTCC's book value of shareholders' equity on its balance

---

8 *See, e.g.,* OCC 2005 Annual Report at 23, OCC 2008 Annual Report at 14, and OCC 2011 Annual Report at 22.
9 S&P Global Ratings, Options Clearing Corp., December 28, 2017, at 3.
10 Easton Report, ¶¶23-24.
11 DTCC 2017 Consolidated Financial Statements at 43-44.

sheet as of December 31, 2013 was $1.0 billion, an amount almost 40 times larger than the OCC's equity base of $25.4 million at the end of 2013 (prior to raising the equity capital under the Capital Plan and retaining earnings in 2014).[12] Thus, unlike DTCC, which has retained profits, OCC has traditionally not retained substantial profits, but has returned most of the excess fees it collected to its clearing members. The DTCC also has much more diverse revenue streams, including revenue generating services such as data and matching services and wealth management services.[13]

10. Fourth, the Easton Report attempts to characterize Susquehanna International Group's (SIG) offer to provide the OCC with up to $150 million in capital at the Federal Funds Rate as somehow dispositive of the low-risk nature of an investment in the OCC.[14] However, the offer was made in August 2017, which was in the middle of this dispute, and not at the time that the OCC was developing the Capital Plan. Moreover, the original offer, which was for a fee of LIBOR + 3.0%, did not specify how SIG would effectuate this transaction, but only that "[SIG] will work with OCC to ensure that the transaction is structured in a manner fully compliant with all applicable regulatory guidelines, including, among other possible structures, *lending* the funds to the Shareholder Exchanges for down-streaming into OCC as equity."[15] Thus, SIG was apparently willing to give a loan to the Stockholders Exchanges at LIBOR + 3.0% that the Stockholder Exchanges could use to infuse funds into the OCC.[16] As I explained above, debt has a much different risk profile than equity.

---

12 DTCC 2014 Consolidated Financial Statements at 3-4; OCC 2013 Annual Report at 19-20.
13 DTCC 2017 Consolidated Financial Statements at 4.
14 Easton Report, ¶25.
15 Letter from David M. Pollard, Head of Strategic Planning and Special Counsel, SIG to OCC Board of Directors, August 25, 2017. (Emphasis added.)
16 Interestingly, rather than providing the Stockholder Exchanges a typical equity return incentive to infuse essentially permanent capital into the OCC, SIG sought to charge them a fee for this debt capital, and thus make a return for SIG at the expense of the Stockholder Exchanges.

11. Professor Easton's second opinion simply builds on his first opinion that the "return and expected return on the Shareholder Exchanges' investment in OCC is not commensurate with the riskiness of the investment."[17] It is premised on Professor Easton's misguided assumptions and assertions about the risk profile of an equity investment in the OCC, which I discuss above, and is meritless.[18] In my professional opinion, it dramatically understates the returns that investors such as the Stockholder Exchanges would require as compensation in order to commit $150 million of regulatory capital to OCC's balance sheet, nor does it take into account the fact that, incremental to this capital infusion, the Stockholder Exchanges also committed to provide up to an additional $200 million to OCC should its regulatory capital become depleted (*i.e.*, at the worst possible time to provide additional equity). The Easton Report completely ignores this capital call.

B. Flaws with Easton Report Opinion 3

12. The third opinion proffered in the Easton Report is that "[t]he private equity investments to which the Brown report refers are quite different from and much riskier than the Shareholder Exchanges' investment in OCC."[19] I did say that there are certain common characteristics between the permanent equity capital that was required to be infused into the OCC and private equity investments, such as illiquidity and long-term nature of an investment, but I did not make the argument that these are equivalent investments. Instead, I based my calculations and opinion on the more traditional CAPM model supplemented with a discount for lack of marketability which reflects the highly illiquid nature of the capital infusion that the Stockholder Exchanges were asked to make.

---

[17] Easton Report, ¶¶15, 27.

[18] I also note that Professor Easton repeatedly claims that the Brown Report gives him the basis to state that the expected 2018 dividend is $45.8 million. (See Easton Report, ¶ 27 and ¶39). Yet, I did *not* provide such a number in the Brown Report. Moreover, I focused on expectations at the time of the adoption of the Capital Plan rather than any *ex post* realization.

[19] Easton Report, ¶16.

13. Furthermore, Professor Easton investigates *ex post* returns in private equity. Of course, these returns have a wide dispersion. Yet, when one makes an investment decision, the ex ante, or expected, cash flows are what one estimates. Further, part of Professor Easton's focus is mistakenly on venture capital funds. The article I cited specifically states "the private equity investors in our sample are primarily buyout and growth equity investors, <u>not venture capital investors</u>."[20] As discussed in the Brown Report, given the common characteristics of the Stockholder Exchanges' investment with private equity investments, the returns seen in such investments corroborate my conclusions regarding the range of returns expected here. Nothing Professor Easton says in his report changes my opinions.

C. Flaws with Easton Report Opinion 4

14. Professor Easton's fourth opinion is that "[t]he CAPM should not be used to calculate a cost of capital for the Shareholders Exchanges' investment in OCC."[21] To begin with, Professor Easton's views are directly contrary to those expressed by the finance professors who previously filed an *Amici Curiae* brief on behalf of SIG. Those finance professors previously estimated the cost of capital by using the CAPM (which as Professor Easton noted, economist William Sharpe developed and for which, in large part, was awarded the Nobel Prize in Economics) when they stated "[w]e can compute the Shareholder Exchanges' required return on equity capital using the traditional Capital Asset Pricing Model (CAPM)."[22]

15. Professor Easton's argument belies his contention about the low-risk nature of the investment. Professor Easton correctly states that the core assumption of the CAPM is that the

---

[20] Gompers, Paul, Steven N. Kaplan, Vladimir Mukharlyamov, "What Do Private Equity Firms Say They Do?" *Harvard Business School*, Working Paper 15-081, April 2015, at 11. (Emphasis added.)

[21] Easton Report, ¶17.

[22] *Pro Se* Brief of Robert Jennings and Robert Battalio as *Amici Curiae* in Support of Petitioners, in the United States Court of Appeals for the D.C. Circuit, *Susquehanna International Group, LLP, et al., v. Securities and Exchange Commission*, No. 16-1061, at 4-5.

investor holds a diversified portfolio. By holding a diversified portfolio, the investor can diversify away unsystematic risk and the investor is left only with systematic risk. Therefore, if the investor is unable to diversify away the unsystematic risk and is holding both systematic and unsystematic risk, the investment is riskier. Thus, by using only the CAPM to calculate the cost of equity for an investor that is undiversified, the cost of equity will be understated. Indeed, valuation and corporate finance textbooks suggest ways of increasing the cost of equity if the marginal investor is undiversified.[23] According to Professor Easton's own argument, the investment in OCC by the undiversified Stockholder Exchanges is even riskier than I initially estimated; indeed, by increasing their equity investment in the OCC the Stockholder Exchanges are effectively *decreasing* their diversification and *increasing* the risk of their portfolio. All else equal, as risk increases, so does required return to compensate for this risk.

16. Moreover, even assuming counterfactually that the CAPM is inappropriate to use in this instance (which it is not), Professor Easton provides no alternative for calculating the cost of equity other than providing what at best can be considered an unsupported and misplaced cost of debt capital figure.

D. Flaws with Easton Report Opinion 5

17. Finally, Professor Easton's fifth opinion is that the "[l]ack of marketability is not a material risk factor for the Shareholder Exchanges' investment in OCC."[24] On the surface, Professor Easton's statement defies logic. All else equal, having restrictions from exiting any investment causes the investment to be worth less than it would otherwise be.

---

23 *See, e.g.*, Pratt, Shannon P. and Roger J. Grabowski, Cost of Capital, Fifth Edition, *Wiley*, Hoboken, NJ, at 706-709 (2014).

24 Easton Report, ¶18.

18. Professor Easton first tries to argue that regulatory capital is an operating asset and compares the regulatory capital to airplanes for airlines.[25] An airline can sell some or all its fleet of airplanes, while the OCC's regulatory capital is a permanent unproductive asset on the OCC's balance sheet that cannot be sold. Whether it is an operating asset is irrelevant to the materiality of the marketability risk, since the regulatory capital must remain on the OCC's books.

19. Professor Easton then tries to argue that a recent *Wall Street Journal* article somehow diminishes the concern about a lack of marketability.[26] Even though the article vaguely reported *rumors* that the NYSE *considered* selling its stake in the OCC and that the DTCC has considered a merger with the OCC, this does not address the likelihood of those scenarios taking place nor does it specify the number and/or types of potential buyers.

20. As discussed previously in the Brown Report, there are meaningful restrictions preventing a Stockholder Exchange from selling its equity stake in the OCC. Putting aside whether an investment is inherently risky or not, an investor who is unable to cash out the investment must be compensated for the lack of liquidity. Thus, illiquidity raises the cost on the investment.[27]

21. Finally, Professor Easton attempts to question my opinions concerning the lack of marketability by looking at *ex post* realizations.[28] However, my evaluation of the reasonableness of the capital plan was done on an *ex ante* basis, not with hindsight, as Professor Easton is using in his analysis. The OCC Board, of which the Stockholder Exchanges represented a voting minority, decided on the Capital Plan based on *ex ante* expectations with the assistance of multiple third-party advisors.

---

[25] Easton Report, ¶36.

[26] Easton Report, ¶37.

[27] Pratt, Shannon P and Alina V. Niculita, Valuing a Business, Fifth Edition, *McGraw-Hill* Companies, New York, NY, at 416 (2008). According to Dr. Pratt, "[a]ll other things being equal, an ownership interest in a business is worth more if it is readily marketable. An ownership interest in a business is worth less if it is not readily marketable. This is because business owners – and all investors – prefer liquidity to illiquidity."

[28] Easton Report, ¶¶39-40.

IV. Conclusion

22. As discussed above, the bases for Professor Easton's opinions and, ultimately, his opinions are fundamentally flawed. There is nothing in the Easton Report that causes me to reconsider the opinions I expressed in the Brown Report.

Marc J. Brown, CFA
October 15, 2018