THE FOUNDATION
FOR SECURE
MARKETS

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March 27, 2019

VIA EMAIL

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

Re: File No. SR-OCC-2019-001 Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Revise The Options Clearing Corporation's Schedule of Fees

Dear Mr. Fields:

The Options Clearing Corporation ("OCC") respectfully submits this response to the comment letter of Susquehanna International Group, LLP ("SIG") dated March 20, 2019 ("SIG Letter") regarding the Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Revise The Options Clearing Corporation's Schedule of Fees ("Proposed Fee Change"). SIG's objections to the Proposed Fee Change disregard the administrative record, mischaracterize the Commission's February 13, 2019 Order ("Disapproval Order"), fundamentally ignore the requirements of Rule 17Ad-22(e)(15), and demonstrate a lack of understanding of the vital role in the financial marketplace of a systemically important financial market utility ("SIFMU"). The Proposed Fee Change is necessary to allow OCC to meet its regulatory requirements and should be approved.

I. The Target Capital Requirement Is Reasonable and Supported by Substantial Evidence.

SIG objects to the Proposed Fee Change on the grounds that OCC's Target Capital Requirement is not justified, particularly in light of the decisions by the D.C. Circuit Court of Appeals and the Commission. (SIG Letter at 3-4.) This objection mischaracterizes those decisions and ignores the text of Rule 17Ad-22(e)(15), as well as the substantial evidence submitted by OCC in support of its Target Capital Requirement.

A. The Target Capital Requirement Complies with Rule 17Ad-22(e)(15).

SIG fundamentally ignores the requirements imposed by Rule 17Ad-22(e)(15) when it argues that OCC has sufficient capital in light of its "required $117 million equity capital level" and seeks another $130 million "above the requisite amount." (SIG Letter at 3, 6.) $117 million was never OCC's Target Capital Requirement, but rather represented six months of OCC's operating expenses five years ago. This figure does not represent sufficient capital to comply with Rule 17Ad-22(e)(15).

Rule 17Ad-22(e)(15) requires clearing agencies to maintain "sufficient liquid net assets funded by equity to cover potential general business losses so that the covered clearing agency can continue operations and services as a going concern if those losses materialize." This requirement includes, but is not limited to, the specific requirements of subsections (i) and (ii). Thus, in addition to the general requirement in Rule 17Ad-22(e)(15), OCC must, at minimum, comply with subsection (ii) which requires clearing agencies to maintain "the greater of" six months operating expenses or "the amount determined by the board of directors to be sufficient to ensure a recovery or orderly wind-down[.]" Furthermore, CFTC Rule 39.11(a)(2) requires a derivative clearing organization to maintain financial resources sufficient to "enable the derivatives clearing organization to cover its operating costs for a period of at least one year, calculated on a rolling basis."[1]

In light of these requirements, the OCC Board reasonably determined that the amount of capital it needed to maintain under the regulation was the amount necessary to cover potential losses associated with its operational and pension risks so that OCC could continue to operate as a going concern if those risks materialized.[2] This amount was greater than the $117 million figure which represented six months' operating expenses and, under the regulation, this larger amount was OCC's capital requirement.

Contrary to SIG's assertion, the D.C. Circuit made no findings as to whether the Target Capital Requirement was reasonable. Rather, the D.C. Circuit concluded that the Commission's Approval Order did not sufficiently set forth the Commission's basis for concluding that the target was reasonable. *Susquehanna v. SEC*, 866 F.3d 442, 449 (D.C. Cir. 2017). The Court found that the record lacked an indication that the Commission knew which experts OCC consulted for purposes of

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[1] Under 17 C.F.R. § 39.11(b)(vi), the CFTC has discretion to determine what kind of financial resources count towards this requirement.

[2] The SEC has approved the capital policies of another clearing agency that likewise interprets Rule 17Ad-22(e)(15) to require calculation of the amount of capital to be held based on the clearing agency's general risk profile. The National Securities Clearing Corporation ("NSCC") calculates the amount of capital required by Rule 17Ad-22(e)(15) based on *the greater of* (i) an amount based on its general business risk profile, (ii) and amount based on its estimated cost to execute its recovery and orderly wind-down plan, and (iii) an amount based on its estimated operating expenses for a six month period. The SEC approved NSCC's capital policy that relied on this interpretation of Rule 17Ad-22(e)(15)'s requirements on July 7, 2017. (Securities and Exchange Comm'n, Order Approving Proposed Rule Changes, as Modified by Amendments No. 1, to Adopt the Clearing Agency Policy on Capital Requirements and the Clearing Agency Capital Replenishment Plan, Release No. 34-81105 (July 7, 2017).)

determining the Target Capital Requirement, "what analysis he or she conducted, or what additional analysis OCC performed," reflecting a "lack of reasoned decision-making" by the Commission. *Id.*

OCC fully addressed this evidentiary gap on remand, submitting to the Commission presentations which memorialized the expert analysis conducted by Oliver Wyman and relied upon by the Advisory Group in setting the Target Capital Requirement. These materials included a 17-page Oliver Wyman presentation dated September 12, 2014 and a 67-page Oliver Wyman presentation dated September 15, 2014.[3] These presentations detail the process by which OCC and Oliver Wyman determined the amount of capital necessary to meet the requirements under Rule 17Ad-22(e)(15).[4]

After OCC submitted the Oliver Wyman materials, the Commission issued its Order in response to the remand by the D.C. Circuit. The Commission ultimately disapproved the Capital Plan for two reasons: (i) because the Commission determined that it lacked sufficient information to conclude that OCC complied with its own rules regarding the determination that the Capital Plan was not competitively significant; and (ii) because the Commission determined that it lacked sufficient information to determine that the Capital Plan, specifically the Dividend Policy, imposes no burden on competition. (Disapproval Order at 1-2.) The Commission did not disapprove the Capital Plan on the basis that the Target Capital Requirement was unreasonable, nor did it make any such finding.

SIG's implication that the Target Capital Requirement is unreasonable because the Capital Plan was disapproved for other reasons finds no support in the Commission's Disapproval Order. OCC has submitted substantial evidence demonstrating the reasonableness of the Target Capital Requirement and there is nothing in the Commission's Disapproval Order that supports a contrary conclusion.

B. <u>OCC Reviews The Target Capital Requirement Annually to Ensure Ongoing Compliance.</u>

Guided by a proper interpretation of Rule 17Ad-22(e)(15), as well as consideration of CFTC Rule 39.11(a)(2), to which OCC is also subject as a derivatives clearing organization, OCC Management reevaluates the Target Capital Requirement on an annual basis and provides a

[3] Because these materials contain confidential and proprietary business and financial information, OCC requested that these materials, among others, be afforded confidential treatment pursuant to 17 C.F.R. 200.83 and 5 U.S.C. § 552(b)(4). The Commission granted this request. (Disapproval Order at 9 n.32 ("The Commission is not required to make public statements filed with the Commission in connection with a proposed rule change of a self-regulatory organization if the Commission could withhold the statements from the public in accordance with the Freedom of Information Act ("FOIA"), 5 U.S.C. 552. The Commission has reviewed the documents for which OCC requests confidential treatment and concludes that they could be withheld from the public under the FOIA.").)

[4] Oliver Wyman conducted a "bottom-up" analysis of OCC's risks to quantify the appropriate amount of capital to be held against each risk, including consideration of credit, market, pension, operational, and business risks, as required by Rule 17Ad-22(e)(15). With OCC, Oliver Wyman identified 92 risk events and analyzed 23 different scenarios in which these risks might materialize. Oliver Wyman then aggregated these loss events and conducted loss modeling at or above the 99% confidence level to determine the amount of capital required to address OCC's operational risks. This amount totaled $226 million, which, when added to pension risks of $21 million, was used to establish the Target Capital Requirement of $247 million.

recommendation to the OCC Board. This process ensures that OCC remains in compliance with all of its regulatory obligations in light of changing operating expenses and risks.

In 2018, OCC Management recommended, and the OCC Board approved, maintaining the Target Capital Requirement at $247 million. OCC Management's analysis included results consistent with Oliver Wyman's bottom-up approach. The updated analysis estimated operational risks, before adjustment for insurance, at $257 million (as discussed in Section IV, *infra*, insurance policies do not qualify as "funded by equity"). OCC Management also considered factors based on OCC's other regulatory obligations. For example, OCC must comply with CFTC Rule 39.11(a)(2), which requires a derivative clearing organization to maintain financial resources sufficient to "enable the derivatives clearing organization to cover its operating costs for a period of at least one year, calculated on a rolling basis." The Board therefore also reasonably considered OCC's projected twelve-month operating expenses, which were estimated as $262 million, in evaluating the Target Capital Requirement.

In light of these multiple and concurrent regulatory requirements, it was entirely reasonable for the OCC Board to maintain the Target Capital Requirement at $247 million. Therefore, OCC should be permitted to raise fees necessary to meet that Target Capital Requirement as required by Rule 17Ad-22(e)(15).

II. The Proposed Fee Change Is Necessary for OCC to Meet the Requirements of Rule 17Ad-22(e)(15) in Light of the Commission's Disapproval Order.

SIG states that "OCC is proposing to increase fees in order to fund an equity target amount that *exceeds* the level required by Rule 17Ad-22(e)(15)." (SIG Letter at 2, 6-7 (emphasis added).) As explained above, the Target Capital Requirement was developed to comply with the requirements of Rule 17Ad-22(e)(15), and OCC has provided the Commission with a robust record substantiating the process by which it was developed. SIG seems to argue that any effort to raise capital above this bare minimum required is *per se* unreasonable. This criticism ignores the plain language of the regulation.

Rule 17Ad-22(e)(15) requires OCC to "hold sufficient liquid net assets funded by equity to cover potential general business losses[.]" It establishes a minimum level of capital which covered clearing agencies are required to hold at all times or risk being out of compliance with the regulation.[5] Reflecting this intent is Rule 17Ad-22(e)(15)(iii)'s requirement that covered clearing agencies "[m]aintain[] a viable plan, approved by the board of directors and updated at least annually, for raising additional equity should its equity fall **close to or below** the amount required under paragraph (e)(15)(ii) of this section." (emphasis added.) The Proposed Fee Change ensures that OCC's liquid net assets do not fall below the Target Capital Requirement and provides for only a modest buffer above the Target Capital Requirement (equal to approximately two months' operating expenses).

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[5] Indeed, capital requirements are construed as minimum thresholds that must be maintained at all times. *See, e.g.,* 17 C.F.R. § 240.15c3-1(a) ("Every broker or dealer must at all times have and maintain **net capital no less than the greater of the highest minimum requirement applicable** to its ratio requirement under paragraph (a)(1) of this section, or to any of its activities under paragraph (a)(2) of this section. . .") (emphasis added).

The OCC Board considered several factors in determining how best to meet the Target Capital requirement, including "(i) projected average daily contract volumes consistent with the assumptions used in OCC's 2019 annual budget; (ii) projected expenses and known cash flows based on OCC's 2019 budget; (iii) an operating margin based on an analysis of five-year historical volumes; (iv) the retention of refund and dividend payments for 2018; (v) the retention of $40 million of the initial capital contribution from the shareholder exchanges; and (vi) known capital needs to replace and modernize OCC's technology infrastructure." (Proposed Fee Change at 7.) Based on these factors and after robust discussion and consideration of alternative increase levels, the OCC Board determined in its business judgment that a 10% fee increase was the most reasonable method of ensuring that OCC meet its regulatory obligations on a timely basis. OCC accepted the Stockholder Exchanges' offer to allow OCC to retain $40 million of their Capital Contribution, which was intended to ensure that OCC could maintain liquid net assets funded by equity sufficient to exceed the Target Capital Requirement and further helped keep the necessary increase in fees as minimal as possible. OCC is currently above its $247 million Target Capital Requirement as a result of retaining the $40 million. Using projected volumes, which are subject to change, and assuming a fee increase effective on April 1, OCC expects to be able to remain above the Target Capital Requirement during all of 2019 and return the $40 million by the end of the year.

SIG implies that the regulation requires OCC to maintain capital in an amount that equals the Target Capital Requirement and not a penny more. But it is a practical impossibility to set fees at a level where OCC's capital would meet but never exceed the Target, as that would greatly increase the likelihood that OCC falls short of the Target with even the slightest variation in volume projections. As discussed *infra*, S&P has already placed OCC on a credit-watch negative, and it is entirely foreseeable that OCC's rating would be adversely affected should OCC's capital begin to approach the minimum threshold set by the Target Capital Requirement.

Because both the regulation itself and common business sense require that OCC have a plan to both meet and exceed the Target Capital Requirement, SIG's assertion that OCC's proposal "must be reviewed critically" for this reason should be disregarded.

III. As a SIFMU, OCC Must Raise Capital "As Quickly As Reasonably Possible" to Ensure the Stability of the Financial Markets.

SIG objects to the Proposed Fee Change because "[OCC] has not explained what target date it has set for the accumulation of equity through the fee increase, let alone how and why such date was set." (SIG Letter at 4-5.) SIG also suggests the Commission's offer to provide OCC with an exemption from compliance with the capital requirements of Rule 17Ad-22(e)(15) for a limited time should reduce the urgency for OCC to come into compliance as quickly as reasonably possible. (SIG Letter at Note 21.) This argument minimizes the importance of the capital requirement and ignores OCC's vital role in the financial markets.

The purpose of Rule 17Ad-22(e)(15) is to ensure stability in the financial markets. In adopting this Rule, the Commission stated that one of its objectives was "to promote robust risk management, promote safety and soundness, reduce systemic risks, and support the stability of the broader financial system." Standards for Covered Clearing Agencies, Release No. 34-78961 at 30 (Dec. 12, 2016) (citing to the Clearing Supervision Act, 12 U.S.C. § 5464(b), (c)). Specifically with respect to Rule 17Ad-22(e)(15), the Commission stated that "the loss of clearing services due to general business losses would likely result in major market disruption." Standards for Covered Clearing Agencies, Release No. 34-78961 at 355 (Dec. 12, 2016).

Even assuming the SEC grants OCC a temporary exemption from compliance with Rule 17Ad-22(e)(15), nothing is to say that the potential losses contemplated in the calculation of OCC's Target Capital Requirement will not materialize. Furthermore, following the Commission's Disapproval Order, S&P placed OCC on credit-watch negative, pending the development of an alternative viable plan to meet its equity requirements.[6] It is arguably OCC's obligation to the marketplace to ensure compliance with Rule 17Ad-22(e)(15) "as quickly as reasonably possible"; in any event, it certainly is eminently reasonable for OCC to attempt to do so.

To this end, OCC anticipates presenting to its Board for review and approval a capital management policy, inclusive of a replenishment plan, that will allow OCC to continue to meet its regulatory obligations while minimizing to the extent possible the duration and size of fee increases. We expect that the Commission will publish that policy for comment and that market participants will have the opportunity to comment on the comprehensive basis on which OCC plans to determine and maintain its capital on a going-forward basis.

IV. The Alternatives Proposed by SIG Ignore the Stockholders Exchanges' Rights and Attempt to Circumvent the Purpose of Rule 17Ad-22(e)(15).

SIG again objects to the Proposed Fee Change on the grounds that SIG would offer to provide OCC with a loan, despite the requirements of Rule 17Ad-22(e)(15) that OCC maintain sufficient liquid net assets *funded by equity*. In an effort to re-characterize its offer of a loan, SIG claims that it could meet the funded-by-equity requirement of Rule 17Ad-22(e)(15) by issuing capital as a loan to the Stockholder Exchanges, which would then invest that capital in OCC as equity, for which SIG would receive the Treasury bill rate of return. SIG claims to offer $250 million under this proposal (SIG Letter at 5), which misses the purpose of the Proposed Fee Change. OCC does not need to *raise* $247 million to meet its Target Capital Requirement. Rather, it needs to *maintain* its capital at the level of the Target Capital Requirement and must do so taking into account its By-Laws and Rules and the regulatory obligation not to fall below this threshold, as discussed in Section II, *supra*. Once again, SIG's offer ignores the rights of the Stockholder Exchanges and disregards the purpose of Rule 17Ad-22(e)(15).

First, the Stockholder Exchanges have no obligation or incentive to accept a loan from SIG under these circumstances. SIG's proposal is based on a false assumption that the Stockholders lack capital to invest; on the contrary, the Stockholders simply have no incentive to invest their capital in OCC below their cost of capital. SIG offers absolutely no explanation of why Stockholder Exchanges would pay SIG interest in order to invest capital with no meaningful return. SIG's proposal places all risk to the capital firmly with the Stockholder Exchanges, as it will be the Stockholder Exchanges' equity

[6] Prateek Nanda & Thierry Grunspan, S&P Global Ratings, "Options Clearing Corporation Corp. 'AA+' Rating Placed on Credit Watch Negative Following Disapproval Of Its Capital Plan By The SEC" (Feb. 21, 2019).

investment in OCC that would be drawn upon in the event that the business or operational risks materialize. It would be the Stockholder Exchanges that are obligated to repay the loan, with interest, to SIG, even if this equity investment deteriorates. OCC has no mechanism to coerce its Stockholders to enter into such transactions against their will, particularly in light of the Stockholder Exchanges' fiduciary duties to their own shareholders.

Second, SIG's backdoor proposal for converting a loan into equity is an effort to circumvent the requirement of Rule 17Ad-22(e)(15) that capital be funded by equity. The same is true of SIG's assertion that OCC could have covered certain risks with insurance, rather than accounting for them in the Target Capital Requirement. (SIG Letter at 4.) Insurance policies, loans, and lines of credit do not meet Rule 17Ad-22(e)(15)'s requirement for capital "funded by equity" sufficient to cover potential general business losses. Indeed, while the Commission was considering the equity requirement of the Proposed Rule 17Ad-22(e)(15) and before the Capital Plan was adopted, certain commenters, including OCC, argued that other forms of capital, "such as a contingent capital arrangement requiring clearing members to contribute funds," should meet the requirement. Standards for Covered Clearing Agencies, Release No. 34-78961 at 195 (Dec. 12, 2016) (citing to the Comment Letter of James E. Brown, Executive Vice President, The Options Clearing Corporation (May 27, 2014).) The Commission rejected this suggestion, finding that those forms of capital "do not provide certainty that a covered clearing agency can continue to perform its obligations when general business losses arise because the assets may be unavailable to satisfy business losses." *Id.* at 196. Insurance coverage and lines of credit are not a viable source of capital for the same reason.

Moreover, SIG's loan offer does not provide a better solution than the near-term liquidity management efforts approved by OCC's Board of Directors and the Stockholder Exchanges. The Stockholder Exchanges agreed to leave $40 million of the initial $150 million capital infusion invested until such time as the $40 million can be withdrawn without OCC's liquid net assets funded by equity falling close to or below the Target Capital Requirement.

V. OCC Is Not Entitled to Recoup the Dividends Paid to the Stockholder Exchanges Pursuant to the Capital Plan.

SIG suggests that OCC does not need to raise capital to meet its Target Capital Requirement because OCC can recoup the $78 million in dividends paid out to the Stockholder Exchanges, characterizing this as "free money" to the Exchanges. (SIG Letter at 5-6.) Once again, SIG objects to the Proposed Fee Change based on the theory that OCC has other hypothetical sources of capital which do not, in fact, exist.

SIG now claims that the retention of the dividends is improper because it "maintains a condition that was expressly not found to be allowable." (SIG Letter at 6.) But the fact that the Capital Plan has now been disapproved does not undo the risks to which the Stockholders' capital was exposed. Nor is it the case that dividends paid out in the past on an investment are returned if that investment is withdrawn. The Commission's Disapproval Order did not require the return of the dividends paid out while the Capital Plan was in effect, and OCC has no basis on which it can require the Stockholder Exchanges to return the dividend payments.

In addition to its failure to articulate a legal basis upon which OCC could demand return of the dividends from the Stockholders, SIG fails to explain why the disapproval would not also require OCC to recoup the $268 million of refunds paid to the industry while the Capital Plan was in effect, even though the payment of refunds required by the Plan should be just as "void" as the payment of dividends under SIG's theory. While the Capital Plan was in effect, payments of refunds and dividends were on equal legal footing; the terms of the Capital Plan *required* OCC to issue each type of payment. SIG argues that OCC had issued refunds to clearing members on a voluntary basis *prior* to the inception of the Capital Plan (a practice that would no longer be permissible in light of the policies and procedures requirements applicable to Covered Clearing Agencies), but that is not a reason why the disapproval would require OCC to recoup one required set of payments and not the other. (SIG Letter at Note 24.) There is no legal theory under which OCC is entitled to have used and benefited from the Stockholder Exchanges' capital without providing any return.

The dividends already received by Stockholder Exchanges were compensation for the real risks to their investment during the time that the Capital Plan was in effect. They had contributed the $150 million in capital, which could have been drawn upon if operational risks had materialized. They also were obligated to provide Replenishment Capital to OCC during the time the Capital Plan was in effect, a risk for which the dividends were intended to compensate. The dividends were paid to the Stockholder Exchanges pursuant to a valid Capital Plan, which was approved by the Commission three times. Even following the D.C. Circuit's opinion remanding the Capital Plan to the Commission, the Commission denied SIG's motion to stay the Capital Plan, which specifically sought a stay of the payment of the dividends. Corrected Order Denying Motion for Stay, Release No. 81628 (Sept. 14, 2017) 82 Fed. Reg. 44238 (Sept. 21, 2017). The Commission rejected SIG's arguments that the payment of dividends following the remand would "distort[] the competitive landscape" and, in doing so, the Commission "note[d] that petitioners made these same arguments regarding competitive harm before the D.C. Circuit, yet the court did not stay or vacate the Plan." *Id*.

Accordingly, OCC respectfully requests that the Commission approve the Proposed Fee Change because it complies with the requirements of the Exchange Act and is necessary to allow OCC to meet its Target Capital Requirement as required by Rule 17Ad-22(e)(15).

Sincerely,

Joseph P. Kamnik

Chief Regulatory Counsel