THE FOUNDATION FOR SECURE MARKETS

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September 20, 2019

VIA EMAIL

Vanessa Countryman, Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-2000

Re: File No. SR-OCC-2019-007: Notice of Filing of Proposed Rule Change Concerning a Proposed Capital Management Policy That Would Support The Options Clearing Corporation's Function as a Systemically Important Financial Market Utility ("Capital Management Policy Proposal")

Dear Ms. Countryman:

The Options Clearing Corporation ("OCC")[1] hereby respectfully submits this response to the comment letter from the Futures Industry Association ("FIA"), dated September 17, 2019. Many of the points raised in the FIA comment letter reflect timely policy discussions, and we appreciate the opportunity to respond.

As described in the Capital Management Policy Proposal, OCC has proposed a Capital Management Policy that would: (a) determine the amount of shareholder's equity as shown on OCC's Statement of Financial Condition ("Equity") sufficient for OCC to meet its regulatory obligations and to serve market participants and the public interest ("Target Capital Requirement"); (b) monitor Equity and liquid net assets funded by equity ("LNAFBE") levels to help ensure adequate financial resources are available to meet general business obligations; and (c) manage Equity levels, including by (i) adjusting OCC's fee schedule, as appropriate, and (ii) establishing a plan for accessing additional capital should OCC's Equity fall below certain thresholds ("Replenishment Plan"). The Capital Management Policy also introduces a layer of OCC funds to contribute to both default losses and non-default losses ("Skin-in-the-Game"). FIA's comments focus on: (i) Skin-in-the-Game, (ii) the allocation of the capital shortfall through the Operational Loss Fee, (iii) governance, and (iv) the mechanism for allocating non-default losses. We address each of the comments in turn below.

1. **Skin-in-The-Game**

First, we note that the SEC does not impose a Skin-in-the-Game requirement on its registered clearing agencies. Nevertheless, OCC believes it is prudent to align incentives of the clearing agency and the broader industry with respect to the management of risks faced by the clearing agency. As a result, OCC will provide a layer of Skin-in-the-Game to be used for *both* default

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[1] OCC is registered as a clearing agency with the SEC and as a derivatives clearing organization with the Commodity Futures Trading Commission. The Financial Stability Oversight Council has designated OCC as a systemically important financial market utility ("SIFMU").

losses and non-default losses under the Capital Management Policy. The Skin-in-the-Game is a combination of two sources: (i) current and retained earnings of OCC (in the case of default losses, a requirement of 110% of the Target Capital Requirement with the discretion for more), and (ii) available funds in OCC's Executive Deferred Compensation Plan ("EDCP"). We acknowledge that, since it is determined based on a function of available funds at a specific point in time, the amount of Skin-in-the-Game is unknown up until the time of an operational loss event. However, we believe the Skin-in-the-Game, particularly with respect to the EDCP funds that are a direct contribution from OCC management, is sufficient to ensure the alignment of incentives for risk management between OCC and the clearing member community.

Finally, FIA requests clarification whether Equity above 100% or 110% of the Target Capital Requirement would be available as Skin-in-the-Game for default losses. We clarify that, as stated in proposed Rule 1006(e)(i) and as explained in the "*Use of Current and Retained Earnings for Default Losses*" section of the Capital Management Policy Proposal, OCC would be *required* to use current or retained earnings above 110% of the Target Capital Requirement for default losses. OCC is proposing to retain its existing discretion to use current or retained earnings above 100% but below 110% of the Target Capital Requirement.

2. **Allocation of Capital Shortfall Through Operational Loss Fee**

We note that the Standards for Covered Clearing Agencies do not impose a requirement on the source of the funding other than the funds be "equity" of the clearing agency.[2] In other words, the Commission did not direct that funds to replenish the capital of a clearing agency come from then-existing shareholders. Furthermore, OCC originally proposed a plan for replenishment funding to come from then-existing shareholders, but this plan was disapproved by the SEC as inconsistent with the Exchange Act in part because there was no way to demonstrate the reasonableness of the rate of return to shareholders for the ex ante agreement to provide replenishment funding.

FIA comments that OCC "should be working toward building its own capital reserves rather than relying solely on members" as a way to accumulate replenishment funds. We respectfully note that OCC has, in fact, increased its capital reserves approximately tenfold since December 31, 2013, and that OCC is not stating in the Capital Management Policy Proposal that it needs funds in order to meet its Target Capital Requirement. Rather, the Operational Loss Fee is OCC's proposal to raise additional capital that meets regulatory requirements in the event it needs to invoke its replenishment plan. Raising this additional capital through the accumulation of retained earnings over a number of years would still source the funds from clearing members, but would do so in a manner to pre-fund the replenishment obligation. This would result in OCC accumulating the same amount of capital from clearing members that OCC may receive through imposition of the Operational Loss Fee, but do so (i) irrespective of whether OCC needs

[2] See Standards for Covered Clearing Agencies, 17 CFR § 240.17Ad-22(e)(15) (2016).

replenishment capital, and (ii) without a policy for OCC to return the funds to the extent OCC's Equity returns to an appropriate level.

FIA also requests clarification with respect to how OCC would return funds that it had received pursuant to an Operational Loss Fee, to the extent it deems it appropriate to do so, in *equal share* up to the amount charged through the Operational Loss Fee. For the avoidance of doubt, if an Operational Loss Fee were charged and OCC's Equity subsequently exceeded 110% of the Target Capital Requirement such that OCC determined to return funds received pursuant to the charge, OCC would return the funds to clearing members in equal share to each clearing member that paid the Operational Loss Fee until such time as the aggregate amount of the Operational Loss Fee was returned. By way of example, if OCC charged an Operational Loss Fee of $1 million and was later in a position to return $1,500,000 to its clearing members, the first $1,000,000 returned would be apportioned in equal shares to clearing members that paid the fee. The remaining $500,000 would be allocated based upon cleared volume, as OCC has historically paid its refunds.

Finally, FIA requests clarification on why OCC would charge an Operational Loss Fee so that it is at 110% of the Target Capital Requirement rather than 100% of the Target Capital Requirement. The reason for this is embedded in the requirement itself: OCC's replenishment plan is to be used when OCC's Equity falls "*close to* or below the [Target Capital Requirement]."[3] In order to comply with this provision, OCC believes the baseline amount of Equity it should maintain is 110% of the Target Capital Requirement.

3. **Governance**

While OCC agrees that it is important that the clearing member community is represented in the governance of OCC's affairs, we do not agree that decisions that may result in the imposition of an Operational Loss Fee should first be vetted with clearing members. First, OCC believes decisions to implement an Operational Loss Fee (which would be based upon conditions beyond OCC's control or previous actions taken) must be made quickly, and as such they will not lend themselves to consideration by the clearing member community before being charged. We strongly believe that part of the viability of a plan to replenish capital is the speed with which that replenishment capital is accessible if needed.

Second, we believe a view informed by the clearing member community is *already built in* to OCC's governance process. To this point, we note that the Exchange Act requires that the rules of OCC "assure a fair representation of its shareholders (or members) and participants in the selection of its directors and the *administration of its affairs*" (emphasis added).[4] In furtherance of this requirement, OCC ByLaws state that nine of the twenty directorships are reserved for

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[3] Notice of Filing of Proposed Rule Change Concerning a Proposed Capital Management Policy, Securities Exchange Act Release No. 86725, p.1 (Aug. 21, 2019), 84 FR 44944 (Aug. 27, 2019) (SR-OCC-2019-007).
[4] Exchange Act, Section 17A(b)(3)(C).

representatives of OCC clearing members.[5] In addition, five of the twenty directorships are reserved for public directors, who are charged with representing the interests of all stakeholders.[6] In total, more than two-thirds of OCC's directors are either clearing member directors or public directors.

Furthermore, we have augmented our governance structure with a variety of formal and informal mechanisms to solicit clearing member and other interested stakeholder feedback. These mechanisms include: (i) the Financial Risk Advisory Committee; (ii) the Operations Roundtable; (iii) multiple letters and open calls with clearing members and other interested stakeholders; and (iv) routine in-person meetings with trade groups and individual firms. By virtue of our clearing member and public director representation on our Board and our formal and informal mechanisms to solicit industry feedback, we believe that the Capital Management Policy Proposal under review by the Commission has been constructed with the benefit of the perspective of the clearing member community, and any further discussions at the Board will benefit from this same perspective.

4. **Mechanism for Allocating Non-Default Losses**

FIA comments that the Capital Management Policy Proposal permits OCC to shift the burden of operational loss to clearing members because it "effectively relies on members to address non-default losses." While we recognize this is an important, ongoing policy discussion within the industry and to which we plan to continue to contribute, we respectfully disagree with FIA's comment as it applies to OCC's current proposal.

First, OCC firmly believes it is capitalized to absorb reasonably anticipated non-default losses. As described in the Capital Management Policy Proposal, OCC conducts an annual analysis of capital required to address OCC's operational risks by analyzing and aggregating potential losses from individual operational risk scenarios, aggregating the loss events, and conducting loss modeling at or above the 99% confidence level ("Potential Loss Amount"). The Target Capital Requirement, which is the amount of funds OCC maintains without regard for the Operational Loss Fee, is set in consideration of this Potential Loss Amount. The Capital Management Policy Proposal contains a provision whereby if OCC's Equity falls to below 110% of that Target Capital Requirement, OCC's Board will evaluate whether to raise fees or lower expenses to remain at or above the 110% threshold. If, notwithstanding this initiative, OCC's Equity remains below 100% of the Target Capital Requirement for a period of ninety consecutive days or falls below 90% of the Target Capital Requirement, OCC will then use its available Skin-in-the-Game to cure such loss. OCC will charge the Operational Loss Fee only in the event these measures are insufficient to return OCC's Equity to 110% of the Target Capital Requirement. In other

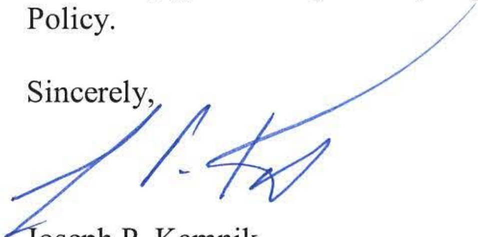
[5] See OCC ByLaws, Article III, Section 1.
[6] See Securities Exchange Act Release No. 78961, p. 71 (Sept. 28, 2016), 81 FR 70786, 70803 (Oct. 13, 2016), ("[T]he inclusion of [public] directors on the board may be one mechanism for helping to ensure that relevant views [of all stakeholders] are presented and considered . . . .").

words, OCC would source replenishment funds through the Operational Loss Fee, not strictly funds to cover non-default losses.
Second, OCC points out that it sought replenishment funding from its shareholders through the disapproved Capital Plan.[7] The SEC requires replenishment funds to count as "equity" of the company. As a result, funding vehicles that are not direct investments from OCC's shareholders or the result of the accumulation of fees would not meet the requirement of the rule.[8] Furthermore, shareholders of Delaware companies have unalienable rights against forced dilution of ownership;[9] in other words, there is no mechanism by which OCC can compel its current shareholders to dilute their ownership stake by accepting new shareholders that are willing to provide replenishment funds for the company, and even if they were, OCC would be confronted with the vexing problem of demonstrating the reasonableness of the rate of return for such a commitment.

Finally, FIA states that the "application of retained earnings to address non-default losses remains discretionary." This is a misunderstanding.[10] In fact, OCC *must* use its current and retained earnings to cover any OCC operational losses, otherwise there would be no trigger for the Operational Loss Fee. As stated above, it is only in the event that the use of current or retained earnings (i) reduces OCC's Equity to (x) below 90% of its Target Capital Requirement, or (y) below 100% of its Target Capital Requirement for ninety consecutive days, and (ii) application of funds available in OCC's Executive Deferred Compensation Plan are insufficient to bring Equity levels back above those thresholds, that OCC would charge the Operational Loss Fee to replenish its Equity. Without exception, OCC will first apply its current and retained earning and funds available in the EDCP before charging an Operational Loss Fee.

Accordingly, OCC respectfully requests that the Commission approve the Capital Management Policy.

Sincerely,



Joseph P. Kamnik
Senior Vice President and Chief Regulatory Counsel

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[7] See Order Disapproving Proposed Rule Change Concerning OCC's Capital Plan, Securities Exchange Act Release No. 85121 (Feb. 13, 2019), 84 FR 5157 (Feb. 20, 2019) (SR-OCC-2015-02).
[8] With the Commission's February 2019 disapproval of the Capital Plan, shareholder invested capital thereunder will have been returned by the end of 2019, and the shareholder dividend under the Capital Plan has been eliminated.
[9] OCC also has no means to compel existing shareholders to make additional equity investments in the company, either with or without an economic incentive to do so.
[10] OCC is proposing that it retain discretion to use current or retained earnings for losses that *result from a bank or other clearing organization failure*, which is distinct from an OCC operational loss.