

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-74387; File No. SR-OCC-2014-813)

February 26, 2015

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of No Objection to Advance Notice Filing, as Modified by Amendment No. 1, 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

On December 29, 2014, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") the advance notice File No. SR-OCC-2014-813 pursuant to Section 806(e)(1)(A) of the Payment, Clearing, and Settlement Supervision Act of 2010 ("Payment, Clearing and Settlement Supervision Act")¹ and Rule 19b-4(n)(1)(i) under the Securities Exchange Act of 1934 ("Act").² On January 14, 2015, OCC filed Amendment No. 1 to the advance notice.³ The advance

¹ 12 U.S.C. 5465(e)(1)(A). The Financial Stability Oversight Council designated OCC a systemically important financial market utility on July 18, 2012. *See* Financial Stability Oversight Council 2012 Annual Report, Appendix A, <http://www.treasury.gov/initiatives/fsoc/Documents/2012%20Annual%20Report.pdf>. Therefore, OCC is required to comply with the Payment, Clearing and Settlement Supervision Act and file advance notices with the Commission.

² 17 CFR 240.19b-4(n)(1)(i). As the Commission noted in the notice of filing of the advance notice, as modified by Amendment No. 1, OCC stated that the purpose of this proposal is, in part, to facilitate compliance with proposed Commission rules and address Principle 15 of the Principles for Financial Market Infrastructures ("PMFIs"). The proposed Commission rules are pending. *See* Securities Exchange Act Release No. 71699 (March 12, 2014), 79 FR 29508 (May 22, 2014) (S7-03-14). Therefore, the Commission has evaluated this advance notice under the Payment, Clearing and Settlement Supervision Act and the rules currently in force thereunder. *See* Securities Exchange Act Release No. 74202 (February 4, 2015), 80 FR 7056 (February 9, 2015) (SR-OCC-2014-813) at note 3.

³ According to OCC, OCC filed Amendment No. 1 to: (i) update OCC's plan for raising additional capital ("Capital Plan") in connection with negotiations between OCC and the options exchanges that own equity in OCC ("Stockholder Exchanges" or "stockholders") and that would contribute additional capital under

notice was published for comment in the Federal Register on February 9, 2015.⁴ The Commission received eight comment letters on OCC's proposal.⁵ This publication serves as a notice of no objection to proposal discussed in the advance notice.

the Capital Plan, (ii) correct typographical errors, and (iii) update the Term Sheet included as an exhibit, which summarizes material features of the Capital Plan.

⁴ Securities Exchange Act Release No. 74202 (February 4, 2015), 80 FR 7056 (February 9, 2015) (SR-OCC-2014-813). In conjunction with this advance notice, OCC filed a corresponding proposed rule change seeking approval of changes to its By-Laws, Certificate of Incorporation and relevant agreements, including its Stockholders Agreement, necessary to implement the Capital Plan. This proposed rule change was published in the Federal Register on January 30, 2015. Securities Exchange Act Release No. 74136 (January 26, 2015), 80 FR 5171 (January 30, 2015) (SR-OCC-2015-02).

⁵ See Letter from Eric Swanson, General Counsel & Secretary, BATS Global Markets, Inc., (February 19, 2015) ("BATS Letter"); Letter from Tony McCormick, Chief Executive Officer, BOX Options Exchange, (February 19, 2015) ("BOX Letter"); Letter from Howard L. Kramer on behalf of Belvedere Trading, CTC Trading Group, IMC Financial Markets, Integral Derivatives, Susquehanna Investment Group, and Wolverine Trading, (February 20, 2015) ("MM Letter"); Letter from Ellen Greene, Managing Director, Financial Services Operations, SIFMA, (February 20, 2015) ("SIFMA Letter"); Letter from James E. Brown, General Counsel, OCC, (February 23, 2015) (responding to BATS Letter and BOX Letter) ("OCC Letter I"); Letter from James E. Brown, General Counsel, OCC, (February 23, 2015) (responding to MM Letter) ("OCC Letter II"); Letter from Barbara J. Comly, Executive Vice President, General Counsel & Corporate Secretary, Miami International Securities Exchange, LLC (February 24, 2015) ("MIAX Letter"); Letter from James E. Brown, General Counsel, OCC, (February 24, 2015) (responding to SIFMA Letter) ("OCC Letter III"). Since the proposal was filed as both an advance notice and proposed rule change, the Commission considered all comments received on the proposal, regardless of whether the comments were submitted to the proposed rule change or advance notice. In its assessment of the advance notice, the Commission assessed whether the issues raised by the commenters relate to the level or nature of risks presented to OCC by the Capital Plan. See comments on the advance notice (File No. SR-OCC-2014-813), <http://www.sec.gov/comments/sr-occ-2014-813/occ2014813.shtml> and comments on the proposed rule change (File No. SR-OCC-2015-02), <http://www.sec.gov/comments/sr-occ-2015-02/occ201502.shtml>.

I. Description of the Advance Notice

Pursuant to this advance notice, OCC is implementing a Capital Plan under which the Stockholder Exchanges will make an additional capital contribution and commit to replenishment capital (“Replenishment Capital”) in circumstances discussed below, and will receive, among other things, the right to receive dividends from OCC. In addition to the additional capital contribution and Replenishment Capital, the main features of the Capital Plan include: (i) a policy establishing OCC’s clearing fees at a level that would be sufficient to cover OCC’s estimated operating expenses plus a “business risk buffer” as described below (“Fee Policy”), (ii) a policy establishing the amount of the annual refund to clearing members of OCC’s fees (“Refund Policy”), and (iii) a policy for calculating the amount of dividends to be paid to the options exchanges owning equity in OCC (“Dividend Policy”). OCC stated that it intends to implement the Capital Plan on or about February 27, 2015, subject to all necessary regulatory approvals.⁶

OCC states in its proposal that it is implementing this Capital Plan, in part, to increase significantly OCC’s capital in connection with its increased responsibilities as a systemically important financial market utility. OCC’s proposal includes an infusion of substantial additional equity capital by the Stockholder Exchanges to be made prior to February 27, 2015, subject to regulatory approval, that when added to retained earnings accumulated by OCC in 2014 will significantly increase OCC’s capital levels as compared to historical levels. Additionally, the proposed change includes the Replenishment Capital commitment, which will provide OCC with access to additional

⁶ OCC filed a proposed rule change seeking approval of changes to its By-Laws, Certificate of Incorporation and relevant agreements, including its Stockholders Agreement, necessary to implement the Capital Plan. *See supra* note 4.

equity contributed by the Stockholder Exchanges should OCC's equity fall close to or below the amount that OCC determines to be appropriate to support its business and manage business risk.

A. Background

OCC is a clearing agency registered with the Commission and is also a derivatives clearing organization ("DCO") regulated in its capacity as such by the Commodity Futures Trading Commission ("CFTC"). OCC is a Delaware business corporation and is owned equally by the Stockholder Exchanges, five national securities exchanges for which OCC provides clearing services.⁷ In addition, OCC provides clearing services for seven other national securities exchanges that trade options ("Non-Stockholder Exchanges"). In its capacity as a DCO, OCC provides clearing services to four futures exchanges. OCC also has been designated systemically important by the Financial Stability Oversight Council pursuant to the Payment, Clearing and Settlement Supervision Act, and the Commission is OCC's "Supervisory Agency" under Section 803(8) of the Payment, Clearing and Settlement Supervision Act.⁸

According to OCC, it has devoted substantial efforts during the past year to: 1) develop a 5-year forward looking model of expenses; 2) quantify maximum recovery and wind-down costs under OCC's recovery and wind-down plan; 3) assess and quantify OCC's operational and business risks; 4) model projected capital accumulation taking into account varying assumptions concerning business conditions, fee levels, buffer margin levels and refunds; and 5) develop an effective mechanism that provides OCC

⁷ The Stockholder Exchanges are: Chicago Board Options Exchange, Incorporated; International Securities Exchange, LLC; NASDAQ OMX PHLX LLC; NYSE MKT LLC; and NYSE Arca, Inc.

⁸ 12 U.S.C. 5462(8).

access to replenishment capital in the event of losses. Incorporating the results of those efforts, the Capital Plan is intended to provide OCC with the means to increase its stockholder equity.

B. OCC's Projected Capital Requirement

According to OCC, using the methods described in detail below, OCC will annually determine a target capital requirement consisting of (i) a baseline capital requirement equal to the greatest of (x) six months operating expenses for the following year, (y) the maximum cost of the recovery scenario from OCC's recovery and wind-down plan, and (z) the cost to OCC of winding down operations as set forth in the recovery and wind-down plan ("Baseline Capital Requirement"), plus (ii) a target capital buffer linked to plausible loss scenarios from operational risk, business risk and pension risk ("Target Capital Buffer") (collectively, "Target Capital Requirement"). OCC determined that the appropriate Target Capital Requirement is \$247 million, reflecting a Baseline Capital Requirement of \$117 million, which is equal to six months of projected operating expenses, plus a Target Capital Buffer of \$130 million. This Target Capital Buffer would provide a significant capital cushion to offset potential business losses.

According to OCC, it had total shareholders' equity of approximately \$25 million as of December 31, 2013,⁹ meaning that OCC proposes to add additional capital of \$222 million to meet its 2015 Target Capital Requirement. OCC determined that a viable plan for Replenishment Capital should provide for a replenishment capital amount which

⁹ See OCC 2013 Annual Report, Financial Statements, Statements of Financial Condition, available on OCC's website, http://optionsclearing.com/components/docs/about/annual-reports/occ_2013_annual_report.pdf.

would give OCC access to additional capital as needed up to a maximum of the Baseline Capital Requirement (“Replenishment Capital Amount”).¹⁰ Therefore, OCC’s Capital Plan will include the following in order to provide OCC in 2015 with ready access to approximately \$364 million in equity capital:

Baseline Capital Requirement	\$117,000,000
Target Capital Buffer	<u>\$130,000,000</u>
Target Capital Requirement	\$247,000,000
Replenishment Capital Amount	<u>\$117,000,000</u>
Total OCC Capital Resources	\$364,000,000

C. Procedures Followed in Order to Determine Capital Requirement

According to OCC, various measures were used in determining the appropriate level of capital. An outside consultant conducted a “bottom-up” analysis of OCC’s risks and quantified the appropriate amount of capital to be held against each risk. The analysis was comprehensive across risk types, including credit, market, pension, operation, and business risk. Based on internal operational risk scenarios and loss modeling at or above the 99% confidence level, OCC’s operational risk was quantified at \$226 million and pension risk at \$21 million, resulting in the total Target Capital Requirement of \$247 million. Business risk was addressed by taking into consideration that OCC has the ability to fully offset potential revenue volatility and manage business risk to zero by adjusting the levels at which fees and refunds are set and by adopting a Business Risk Buffer of 25% when setting fees. Other risks, such as counterparty risk and on-balance sheet credit and market risk, were considered to be immaterial for

¹⁰ The obligation to provide Replenishment Capital will be capped at \$200 million, which OCC projects will account for increases in its capital requirements for the foreseeable future.

purposes of requiring additional capital based on means available to OCC to address those risks that did not require use of OCC's capital. As discussed in more detail below in the context of OCC's Fee Policy, the Business Risk Buffer of 25% is achieved by setting OCC's fees at a level intended to achieve target annual revenue that will result in a 25% buffer for the year after paying all operating expenses.

Additionally, OCC determined that its maximum recovery costs would be \$100 million and projected wind-down costs would be \$73 million. OCC projected its expenses for 2015 will be \$234 million, so that six months projected expenses are $\$234 \text{ million} / 2 = \117 million . The greater of recovery or wind-down costs and six months of operating expenses is therefore \$117 million, and OCC's Baseline Capital Requirement (minimum regulatory requirement) is therefore \$117 million. According to OCC, it then computed the appropriate amount of a Target Capital Buffer from operational risk, business risk, and pension risk, resulting in a determination that the current Target Capital Buffer should be \$130 million. Thus, the Target Capital Requirement is $\$117 \text{ million} + \$130 \text{ million} = \$247 \text{ million}$.

D. Overview of, and Basis for, OCC's Proposal to Acquire Additional Equity Capital

According to OCC, in order to meet its Target Capital Requirement, and after consideration of alternatives, OCC's Board of Directors approved a proposal from OCC's Stockholder Exchanges pursuant to which OCC would meet its Target Capital Requirement of \$247 million in early 2015 as follows:

Shareholders' Equity as of 1/1/2014	\$ 25,000,000
Shareholders Equity Accumulated Through Retained Earnings ¹¹	\$ 72,000,000
Additional Contribution from Stockholder Exchanges	<u>\$150,000,000</u>
Target Capital Requirement	\$247,000,000
Replenishment Capital Amount	<u>\$117,000,000</u>
 Total OCC Capital Resources	 \$364,000,000

The additional contribution of the Stockholder Exchanges will be made in respect of their Class B Common Stock on a *pro rata* basis. The Stockholder Exchanges will also commit to provide additional equity capital up to the Replenishment Capital Amount, which is currently \$117 million, in the event Replenishment Capital is needed. While the Replenishment Capital Amount will increase as the Baseline Capital Requirement increases, under OCC's proposal, it would be capped at a total of \$200 million, which could be outstanding at any point in time. OCC estimates that the Baseline Capital Requirement will not exceed this amount before 2022. When the limit is being approached, OCC will revise the Capital Plan as needed to address future needs. In consideration for their capital contributions and replenishment commitments, the Stockholder Exchanges will receive dividends as described in the Dividend Policy discussed below for so long as they remain stockholders, and maintain their contributed capital and commitment to replenish capital up to the Replenishment Capital Amount, subject to the \$200 million cap.

¹¹ According to OCC, "the \$72 million is after giving effect to the approximately \$40 million refund" expected to be made for 2014. Securities Exchange Act Release No. 74202 (February 4, 2015), 80 FR 7056, 7058 at note 15 (February 9, 2015) (SR-OCC-2014-813).

E. Fee, Refund, and Dividend Policies

Upon reaching the Target Capital Requirement, the Capital Plan requires OCC to set its fees at a level that utilizes a Business Risk Buffer of 25%. The purpose of this Business Risk Buffer is to ensure that OCC accumulates sufficient capital to cover unexpected fluctuations in operating expenses, business capital needs, and regulatory capital requirements. Furthermore, the Capital Plan requires OCC to maintain Fee, Refund, and Dividend Policies, described in more detail below, which are designed to ensure that OCC's shareholders' equity remains well above the Baseline Capital Requirement.

The required Business Risk Buffer of 25% is below OCC's 10-year historical pre-refund average buffer of 31%. The target will remain 25% so long as OCC's shareholders' equity remains above the Target Capital Requirement amount. The reduction in buffer margin from OCC's 10-year average of 31% to 25% reflects OCC's commitment to operating as an industry utility and ensuring that market participants benefit as much as possible from OCC's operational efficiencies in the future. This reduction will permit OCC to charge lower fees to market participants rather than maximize refunds to clearing members and dividend distributions to Stockholder Exchanges. OCC will review its fee schedule on a quarterly basis to manage revenue as closely to this target as possible.¹² For example, if the Business Risk Buffer is materially above 25% after the first quarter of a particular year, OCC may decrease fees for the

¹² If OCC's fee schedule needs to be changed in order to achieve the 25% Business Risk Buffer, OCC would file a proposed rule change seeking approval of the revised fee schedule.

remainder of the year, and conversely if the Business Risk Buffer is materially below 25% at this time, OCC may increase fees for the remainder of the year.

The Capital Plan will allow OCC to refund approximately \$40 million from 2014 fees to clearing members in 2015 and to reduce fees in an amount to be determined by OCC's Board of Directors, effective in the second quarter of 2015. OCC will announce new fee levels early in 2015 and will make such fees effective following notification to clearing members, making any necessary filings, and receiving any necessary approvals from the Commission. OCC will endeavor to provide clearing members with no less than 60-day notice in advance of the effectiveness of changes to fee levels, particularly those that result in increases to fee levels. No dividends will be declared until December 2015 and no dividends will be paid until 2016.

Changes to the Fee, Refund or Dividend Policies will require the affirmative vote of two-thirds of the directors then in office and approval of the shareholders of all of OCC's outstanding Class B Common Stock. The formulas for determining the amount of refunds and dividends under the Refund and Dividend Policies, respectively, which are described in more detail below, are based on, among other things, the current tax treatment of refunds as a deductible expense. The Refund and Dividend Policies will provide that in the event that refunds payable under the Refund Policy are not tax deductible, the policies would be amended to restore the relative economic benefits between the recipients of the refunds and the Stockholder Exchanges.

1. Fee Policy

Under the Fee Policy, in setting fees each year, OCC will calculate an annual revenue target based on a forward twelve months expense forecast divided by the

difference between one and the Business Risk Buffer of 25% (*i.e.*, OCC will divide the expense forecast by .75). Establishing a Business Risk Buffer at 25% will allow OCC to manage the risk that fees may generate less revenue than expected due to lower-than-expected trading volume or other factors, or that expenses may be higher than projected. The Fee Policy also will include provisions from existing Article IX, Section 9, of OCC's By-Laws to effectively state that the fee schedule also may include additional amounts necessary to (i) maintain such reserves as are deemed reasonably necessary by OCC's Board of Directors to provide facilities for the conduct of OCC's business and to conduct development and capital planning activities in connection with OCC's services to the options exchanges, clearing members and the general public, and (ii) accumulate such additional surplus as the Board of Directors may deem advisable to permit OCC to meet its obligations to clearing members and the general public. However, OCC states that these provisions will be used only in extraordinary circumstances and to the extent that the Board of Directors has determined that the required amount of such additional reserves or additional surplus will exceed the full amount that will be accumulated through the Business Risk Buffer (prior to payment of refunds or dividends) so OCC's fees will ordinarily be based on its projected operating expenses and the Business Risk Buffer of 25%.

Under the advance notice proposal, OCC will use the following formula to calculate its annual revenue target as follows:

$$\text{Annual Revenue Target} = \text{Forward 12 Months Expense Forecast} / (1 - .25).$$

Because OCC's clearing fee schedules typically reflect different rates for different categories of transactions, fee projections will include projections as to relative volume in

each such category. The clearing fee schedule will therefore be set to achieve a blended or average rate per contract sufficient, when multiplied by total projected contract volume, to achieve the Annual Revenue Target. Under extraordinary circumstances, OCC will add any amount determined to be necessary for additional reserves or surplus and divide the resulting number by the projected contract volume to determine the applicable average fee per cleared contract needed to achieve the additional amounts required. Consistent with past practice, OCC will notify its clearing members of the fees OCC determines it will apply for any particular period by describing the change in an information memorandum distributed to all clearing members. Consistent with past practice, OCC also will notify regulators of the fees it determines would apply for any particular period by filing an amendment to its schedule of fees as a proposed rule change for immediate effectiveness under Section 19(b)(3)(A) of the Act and Rule 19b-4(f)(2) thereunder.

2. *Refund Policy*

Under the Refund Policy, except at a time when Replenishment Capital is outstanding as described below, OCC will declare a refund to clearing members in December of each year, beginning in 2015, in an amount equal to 50% of the excess, if any, of (i) the pre-tax income for the year prior to the refund over (ii) the sum of (x) the amount of pre-tax income after the refund necessary to produce after-tax income sufficient to maintain shareholders' equity at the Target Capital Requirement for the following year plus (y) the amount of pre-tax income after the refund necessary to fund any additional reserves or additional surplus not already included in the Target Capital Requirement. Such refund will be paid in the year following the declaration after the

issuance of OCC's audited financial statements, provided that (i) the payment does not result in total shareholders' equity falling below the Target Capital Requirement, and (ii) such payment is otherwise permitted by applicable Delaware law and applicable federal laws and regulations. OCC will not be able to pay a refund on a particular date unless dividends were paid on the same date. If Replenishment Capital has been contributed and remains outstanding, OCC will not pay refunds until such time as the Target Capital Requirement is restored through the accumulation of retained earnings. Refunds in accordance with the Refund Policy will resume once the Target Capital Requirement is restored and all Replenishment Capital is repaid in full, provided that the restoration of the Target Capital Requirement and the repayment of Replenishment Capital occurred within 24 months of the issuance date of the Replenishment Capital. If within 24 months of the issuance date of any Replenishment Capital, such Replenishment Capital has not been repaid in full or shareholders' equity has not been restored to the Target Capital Requirement, OCC will no longer pay refunds to clearing members, even if the Target Capital Requirement is restored and all Replenishment Capital is repaid at a later date.

3. *Dividend Policy*

The Dividend Policy provides that, except at a time when Replenishment Capital is outstanding, OCC will declare a dividend on its Class B Common Stock in December of each year in an aggregate amount equal to the excess, if any, of (i) after-tax income for the year, after application of the Refund Policy (unless the Refund Policy has been eliminated, in which case the refunds shall be deemed to be \$0) over (ii) the sum of (A) the amount required to be retained in order to maintain total shareholders' equity at the Target Capital Requirement for the following year, plus (B) the amount of any additional

reserves or additional surplus not already included in the Target Capital Requirement. Such dividend will be paid in the year following the declaration after the issuance of OCC's audited financial statements, provided that (i) the payment does not result in total shareholders' equity falling below the Target Capital Requirement, and (ii) such payment is otherwise permitted by applicable Delaware law and applicable federal laws and regulations. If Replenishment Capital has been contributed and remains outstanding, OCC would not pay dividends until such time as the Target Capital Requirement is restored.

F. OCC's Status as an Industry Utility

According to OCC, OCC has always been operated on an "industry utility" model. The Stockholder Exchanges have contributed only minimal capital to OCC.¹³ OCC's By-Laws currently require that OCC set its clearing fees at a level that is designed to cover operating expenses and to maintain such reserves and accumulate such additional capital as are deemed reasonably necessary for OCC to meet its obligations to its clearing members and the public. Clearing fees that are collected in excess of these amounts are refunded annually on a *pro rata* basis to the clearing members that paid them. Under this model, OCC has never paid dividends to the Stockholder Exchanges, but has paid significant refunds to clearing members each year. OCC is aware that some portion of those refunds may not be passed through by the clearing members to their end user customers. Accordingly, OCC believes that by adopting an approach that pays

¹³ According to OCC, its common stock and paid in capital total \$2,659,999. See OCC 2013 Annual Report, Financial Statements, Statements of Financial Condition, available on OCC's website, http://optionsclearing.com/components/docs/about/annual-reports/occ_2013_annual_report.pdf.

dividends to the Stockholder Exchanges, which have invested a significant amount of additional capital (\$150 million), but that reduces the historical pre-refund average buffer of 31% by adopting a Business Risk Buffer of 25%, the approach outlined in its Capital Plan maintains, and perhaps better aligns with, an industry utility model.

According to OCC, given the very large increase in capital that OCC has determined to be appropriate and to meet the increased responsibilities imposed upon it as a systemically important financial market utility, OCC has decided that the best alternative available to it is to obtain a substantial further capital contribution from the Stockholder Exchanges. OCC believes that this cannot be accomplished without modification of the past practice of not providing dividends to stockholders.

Accordingly, OCC is establishing a new Fee Policy, Refund Policy, and Dividend Policy. Because of the Business Risk Buffer being set at 25%, the combination of the Fee, Refund and Dividend Policies will effectively cap the dividends to be paid to the Stockholder Exchanges at a level that OCC's Board of Directors (with the advice of outside financial experts) has determined results in a reasonable rate of return on contributed capital, particularly in comparison to the implied cost of capital to the clearing members and their customers of an alternative approach considered by the Board of Directors that would require the accumulation of retained earnings through higher fees and no refunds for several years. OCC will continue to refund a percentage of excess clearing fees to clearing members, thereby benefiting both clearing members and their customers.

OCC believes that the Capital Plan therefore effectively preserves OCC's industry utility model of providing its services in an efficient manner, while also enhancing the

benefits to the end user customers by charging lower initial fees due to the decrease in the buffer margin from OCC's 10-year average of 31% to 25%. OCC states that it believes clearing members and customers will benefit from the proposed Capital Plan because the plan will allow OCC to continue to provide clearing services at low cost, including through a significant refund of 2014 fees, a reduction of fees beginning in 2015 and projected continuing refunds and lower fees for the foreseeable future.

According to OCC, it believes that Stockholder Exchanges will benefit from the dividend they receive and, perhaps more importantly, they will be assured that OCC is in a position to provide clearing services for their markets on an on-going basis within the same basic structure that has served these markets well since their inception and without the need to radically change the structure to address potential demands of outside equity investors. Non-Stockholder Exchanges also will benefit by continuing to receive OCC's clearing services for their products on the same basis as they presently do.¹⁴

OCC also believes that the Capital Plan will better align the interests of Stockholder Exchanges and clearing members with respect to expenses, because changes to the level of operating expenses directly affect the Target Capital Requirement. In short, OCC believes that the present proposal represents a fair and reasonable balancing of the interests of the Stockholder Exchanges, the other exchanges for which OCC provides clearing services, clearing members, customers, and the general public while providing an immediate infusion of capital and a structure within which OCC can meet its obligations to the public as a systemically important financial market utility.

¹⁴ According to OCC, Non-Stockholder Exchanges contribute capital by purchasing a promissory note in the principal amount of \$1,000,000. *See* Section 2 of Article VIIB of OCC's By-Laws. The required Capital Contribution of Non-Stockholder exchanges will not change under the Capital Plan.

G. Replenishment Capital Plan

OCC is establishing a Replenishment Capital Plan whereby OCC's Stockholder Exchanges are obligated to provide on a *pro rata* basis a committed amount of Replenishment Capital should OCC's total shareholders' equity fall below the hard trigger, as described below.¹⁵ The aggregate committed amount for all five Stockholder Exchanges in the form of Replenishment Capital that could be outstanding at any time will be capped at the excess of (i) the lesser of (A) the Baseline Capital Requirement, which is currently \$117 million, at the time of the relevant funding, or (B) \$200 million, over (ii) amounts of outstanding Replenishment Capital ("Cap Formula"). The \$200 million figure in the Cap Formula takes into account projected growth in the Baseline Capital Requirement for the foreseeable future. The commitment to provide Replenishment Capital will not be limited by time, but rather only by the Cap Formula. Replenishment Capital will be called in whole or in part after the occurrence of a "hard trigger" event described below. If the Baseline Capital Requirement approaches or exceeds \$200 million, OCC's Board of Directors may consider, as part of its annual review of the Replenishment Capital Plan, alternative arrangements to obtain replenishment capital in excess of the \$200 million committed under the Replenishment Capital Plan. In addition, the Refund Policy and the Dividend Policy will provide that, in the absence of obtaining any such alternative arrangements, the amount of the difference will be subtracted from amounts that would otherwise be available for the payment of refunds and dividends.

¹⁵ The Replenishment Capital Plan is a component of the Capital Plan.

Replenishment Capital contributed to OCC under the Replenishment Capital Plan will take the form of a new class of common stock (“Class C Common Stock”) of OCC to be issued to the Stockholder Exchanges solely in exchange for Replenishment Capital contributions.

The Replenishment Capital Plan is a component of OCC’s overall Capital Plan. In implementing the Replenishment Capital Plan, OCC’s management would monitor OCC’s levels of shareholders’ equity to identify certain triggers, or reduced capital levels, that might require action. OCC has identified two key triggers – a soft trigger and a hard trigger – and proposes that OCC will take certain steps upon the occurrence of either. The “soft trigger” for re-evaluating OCC’s capital will occur if OCC’s shareholders’ equity falls below the sum of (i) the Baseline Capital Requirement and (ii) 75% of the Target Capital Buffer. The soft trigger will be a warning sign that OCC’s capital had fallen to a level that requires attention and responsive action to prevent it from falling to unacceptable levels. Upon a breach of the soft trigger, OCC’s senior management and OCC’s Board of Directors will review alternatives to increasing capital, and take appropriate action as necessary, including increasing fees or decreasing expenses, to restore shareholders’ equity to the Target Capital Requirement.

The “hard trigger” for making a mandatory Replenishment Capital call will occur if shareholders’ equity falls below 125% of the Baseline Capital Requirement (“Hard Trigger Threshold”). OCC considers that a breach of the Hard Trigger Threshold is a sign that significant corrective action, with a more immediate impact than increasing fees or decreasing expenses, should be taken to increase OCC’s capital, either as part of a recovery plan or a wind-down plan for OCC’s business. OCC’s shareholders’ equity will

have to fall more than \$100,000,000 below the fully funded capital amount described above in order to breach the Hard Trigger Threshold. As a result, OCC views the breach of the Hard Trigger Threshold as unlikely and occurring only as a result of a significant, unexpected event. In the event of such a breach, OCC's Board of Directors must determine whether to attempt a recovery, a wind-down of OCC's operations, or a sale or similar transaction, subject in each case to any necessary stockholder consent.¹⁶ If the Board of Directors decides to wind-down OCC's operations, OCC will access the Replenishment Capital in an amount sufficient to fund the wind-down, as determined by the Board and subject to the Cap Formula. If the Board of Directors decides to attempt a recovery of OCC's capital and business, OCC will access the Replenishment Capital in an amount sufficient to return shareholders' equity to an amount equal to \$20 million above the Hard Trigger Threshold, subject to the Cap Formula.

While Replenishment Capital is outstanding, no refunds or dividends will be paid and, if any Replenishment Capital remains outstanding for more than 24 months or the Target Capital Requirement is not restored during that period, changes to how OCC calculates refunds and dividends may be necessary (as described in more detail in OCC's Refund Policy and Dividend Policy). In addition, while Replenishment Capital is outstanding, OCC will first utilize the entire amount of available funds to repurchase, on a *pro rata* basis from each Stockholder Exchange, to the extent permitted by applicable Delaware and federal law and regulations, outstanding shares of Class C Common Stock as soon as practicable after completion of the financial statements following the end of

¹⁶ The requirement for stockholder consent would arise under OCC's Restated Certificate of Incorporation, which would provide that any decision to attempt a recovery would require separate approval by the stockholders, while a decision to wind-down would require separate approval by the stockholders.

each calendar quarter at a price equal to the original amount paid for such shares, plus an additional “gross up” amount to compensate the holders of the Class C Common Stock for taxes on dividend income (if any) that they may have to recognize as a result of such repurchase.¹⁷ For this purpose, “Available Funds” will equal, as of the end of any calendar quarter, the excess, if any, of (x) shareholders’ equity over (y) the Minimum Replenishment Level. The “Minimum Replenishment Level” will mean \$20 million above the Hard Trigger Threshold, so that OCC’s shareholders’ equity will remain at or above the Minimum Replenishment Level after giving effect to the repurchase.

According to OCC, the capital base described above will permit OCC to hold at all times cash and other assets of high quality and sufficiently liquid to allow OCC to meet its current and projected operating expenses under a range of scenarios, including adverse market conditions. OCC expects it will hold at all times liquid net assets funded by equity sufficient to cover potential general business losses so that OCC can continue operations and services as a going concern if those losses materialize, which assets will always be greater than either (x) six months of the covered clearing agency’s current operating expenses, or (y) the amount determined by the Board of Directors to be sufficient to ensure a recovery or orderly wind-down of critical operations and services. These assets will be held in addition to resources held to cover participant defaults, among other risks.¹⁸

¹⁷ According to OCC, based on current federal tax rates, if the full amount of the payment is classified as a dividend and the recipient is entitled to a dividends received deduction, this gross up is estimated to be approximately 12% of the payment.

¹⁸ OCC stated that these assets will be held in addition to resources held to cover participant defaults or other risks covered under certain credit risk standards and

II. Summary of Comments Received

The Commission received five comment letters on OCC's proposal and three comment letters from OCC responding to the issues raised by the commenters.¹⁹ Three of the five commenters generally supported OCC's need to raise additional capital,²⁰ but all five commenters opposed how the Capital Plan raised the additional capital.²¹ After careful review of those comments, the Commission has determined that most of the issues raised by the commenters do not relate to the nature or level of risks presented by OCC.

One commenter, however, raised the issue that the Replenishment Capital Plan may create a misalignment of interests between the exchanges and clearing members, which could in turn create an imbalance in the management of certain risks.²² Specifically, this commenter stated that because no refunds are paid to clearing members while any portion of that Replenishment Capital remains outstanding and that refunds are discontinued permanently if the Replenishment Capital remains outstanding for two years, the plan effectively uses the fees to maximize and prioritize the dividends payable to the Stockholder Exchanges, which is at the expense of the clearing

liquidity risk standards set forth in proposed Commission rules. *See* Securities Exchange Act Release No. 74202 (February 4, 2015), 80 FR 7056 (February 9, 2015) (SR-OCC-2014-813).

¹⁹ The Commission received one comment letter on the proposed rule change and advance notice (*See* SIFMA Letter) and four comment letters on the proposed rule change only (*See* BOX Letter; BATS Letter; MM Letter; and MIAX Letter). *See supra* note 5.

²⁰ *See* BOX Letter; SIFMA Letter; and MM Letter.

²¹ *See* BOX Letter; SIFMA Letter; BATS Letter; MM Letter; and MIAX Letter.

²² *See* SIFMA Letter.

members.²³ Further, this commenter notes that the proposed amendments to OCC's By-Laws would allow the Stockholder Exchanges to manage the risk of their Replenishment Capital being required by determining whether retained earnings could be used to compensate for a loss or deficiency in the clearing fund, thereby also allowing the Stockholder Exchanges to determine to fund clearing fund deficiencies through additional retained earnings rather than risk having to fund their required Replenishment Capital commitment.²⁴ As a result, this commenter believes that the Replenishment Capital Plan may create a misalignment of interests between the Stockholder Exchanges and clearing members, which could in turn create an imbalance in the management of certain risks.²⁵

OCC asserts in its response that these concerns regarding Replenishment Capital are misplaced.²⁶ OCC contends that its By-Laws provide that in lieu of charging a loss or deficiency proportionately to the clearing fund computed contributions of non-defaulting clearing members, OCC may, in its discretion, and subject to the unanimous approval of the holders of Class A Common Stock and Class B Common Stock, elect to charge such loss or deficiency in whole or in part to OCC's current earning or retained earnings.²⁷ Accordingly, OCC considers the net effect of its Replenishment Capital Plan to be simply a timing effect, with Replenishment Capital treated as an advance against the refunds to

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.*

²⁶ *See* OCC Letter III.

²⁷ *Id.*

which Stockholder Exchanges otherwise would have been entitled.²⁸ OCC contends that it is neither the purpose nor the effect of the Replenishment Capital Plan to shift the potential loss from a clearing member default, which has always been mutualized, so long as OCC remains solvent.²⁹

III. Discussion and Commission Findings

Although the Payment, Clearing and Settlement Supervision Act does not specify a standard of review for an advance notice, its stated purpose is instructive.³⁰ The stated purpose is to mitigate systemic risk in the financial system and promote financial stability by, among other things, promoting uniform risk management standards for systemically-important financial market utilities and strengthening the liquidity of systemically important financial market utilities.³¹

Section 805(a)(2) of the Payment, Clearing and Settlement Supervision Act³² authorizes the Commission to prescribe risk management standards for the payment, clearing, and settlement activities of designated clearing entities and financial institutions engaged in designated activities for which it is the supervisory agency or the appropriate financial regulator. Section 805(b) of the Payment, Clearing and Settlement Supervision

²⁸ *Id.*

²⁹ *Id.*

³⁰ *See* 12 U.S.C. 5461(b).

³¹ *Id.*

³² 12 U.S.C. 5464(a)(2).

Act³³ states that the objectives and principles for the risk management standards prescribed under Section 805(a) shall be to:

- promote robust risk management;
- promote safety and soundness;
- reduce systemic risks; and
- support the stability of the broader financial system.

After carefully considering OCC's proposal, the comments received, and OCC's responses thereto, the Commission finds that OCC's Capital Plan is consistent with the objectives and principles described in Section 805(b) of the Payment, Clearing and Settlement Supervision Act.³⁴

While most of the issues raised by the commenters do not relate to the nature or level of risks presented by OCC, one commenter raised a specific concern with respect to OCC's Replenishment Capital Plan. The Commission, however, believes that OCC's Capital Plan, when considered in its totality, does not adversely change the nature or level of risks presented by OCC. Although this commenter alleged a potential misalignment of interests between the Stockholder Exchanges and clearing members when Replenishment Capital is outstanding, decisions made regarding the capitalization of OCC are made by the Board of Directors. OCC's By-Laws address the use of capital to cover clearing member defaults in lieu of using the clearing fund and address the power of the Board of Directors to make decisions in such circumstances. Further, the Board of Directors' obligations under corporate law will require the Board of Directors to revisit on a

³³ 12 U.S.C. 5464(b).

³⁴ *Id.*

periodic basis material provisions of the Capital Plan in the future, including those related to decisions regarding Replenishment Capital, and to review any credible new capital proposals that may be brought forward by management or members of the Board of Directors from time to time. The Commission believes such processes create a reasonable expectation that the potential concerns described by the commenter can be controlled by OCC, and therefore the Commission agrees with OCC that the commenter's contentions regarding the purpose and use of the Replenishment Capital are misplaced.

The Capital Plan will provide OCC with an immediate injection of capital and future committed capital to help ensure that it can continue to provide its clearing services if it suffers business losses as a result of a decline in revenues or otherwise. Given that OCC has been designated as a systemically important financial market utility, OCC's ability to provide its clearing services if it suffers business losses contributes to reducing systemic risks and supporting the stability of the broader financial system. In so doing, OCC's Capital Plan is consistent with the objectives of Section 805(b) of the Payment, Clearing and Settlement Supervision Act,³⁵ which are to promote robust risk management, promote safety and soundness, reduce systemic risks, and support the stability of the broader financial system.

³⁵ 12 U.S.C. 5464(b).

IV. Conclusion

IT IS THEREFORE NOTICED, pursuant to Section 806(e)(1)(I) of the Payment, Clearing and Settlement Supervision Act,³⁶ that the Commission DOES NOT OBJECT to advance notice proposal (File No. SR-OCC-2014-813) and that OCC is AUTHORIZED to implement the proposal as of the date of this notice or the date of an order by the Commission approving a proposed rule change that reflects rule changes that are consistent with this advance notice proposal (File No. SR-OCC-2015-02), whichever is later.

By the Commission.

Brent J. Fields
Secretary

³⁶ 12 U.S.C. 5465(e)(1)(I).