

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-92038; File No. SR-OCC-2021-003)

May 27, 2021

Self-Regulatory Organizations; The Options Clearing Corporation; Order Approving Proposed Rule Change to Establish OCC's Persistent Minimum Skin-In-The-Game

I. INTRODUCTION

On February 10, 2021, the Options Clearing Corporation (“OCC”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change SR-OCC-2021-003, (“Proposed Rule Change”) pursuant to Section 19(b) of the Securities Exchange Act of 1934 (“Exchange Act”)¹ and Rule 19b-4² thereunder to establish a persistent minimum level of skin-in-the-game that OCC would contribute to cover default losses or liquidity shortfalls.³ The Proposed Rule Change was published for public comment in the Federal Register on March 2,

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Notice of Filing infra note 4, 86 Fed. Reg. at 12237.

2021.⁴ The Commission has received comments regarding the proposal described in the Proposed Rule Change.⁵ This Order approves the Proposed Rule Change.

II. BACKGROUND⁶

“Skin-in-the-game,” as a component of financial risk management, entails a covered clearing agency choosing, upon the occurrence of a default or series of defaults and application of all available assets of the defaulting participant(s), to apply its own capital contribution to the relevant clearing or guaranty fund in full to satisfy any remaining losses prior to the application of any (a) contributions by non-defaulting members to the clearing or guaranty fund, or (b) assessments that the covered clearing agency require non-defaulting participants to contribute

⁴ Securities Exchange Act Release No. 91199 (Feb. 24, 2021), 86 Fed. Reg. 12237 (Mar. 2, 2021) (File No. SR-OCC-2021-003) (“Notice of Filing”). OCC also filed a related advance notice (SR-OCC-2021-801) (“Advance Notice”) with the Commission pursuant to Section 806(e)(1) of Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, entitled the Payment, Clearing, and Settlement Supervision Act of 2010 and Rule 19b-4(n)(1)(i) under the Exchange Act. 12 U.S.C. 5465(e)(1). 15 U.S.C. 78s(b)(1) and 17 CFR 240.19b-4, respectively. The Advance Notice was published in the Federal Register on March 1, 2021. Securities Exchange Act Release No. 91184 (Feb. 23, 2021), 86 Fed. Reg. 12057 (Mar. 1, 2021) (File No. SR-OCC-2021-801). A Notice of No Objection to the Advance Notice was published in the Federal Register on April 12, 2021. See Securities Exchange Act Release No. 91491 (Apr. 7, 2021), 86 Fed. Reg. 19061 (Apr. 12, 2021) (File No. SR-OCC-2021-801).

⁵ Comments on the Proposed Rule Change are available at <https://www.sec.gov/comments/sr-occ-2021-003/srocc2021003.htm>.

Since the proposal contained in the Proposed Rule Change was also filed as an advance notice, all public comments received on the proposal are considered regardless of whether the comments are submitted on the Proposed Rule Change or the Advance Notice. Comments on the Advance Notice are available at <https://www.sec.gov/comments/sr-occ-2021-801/occ2021801.htm>.

⁶ Capitalized terms used but not defined herein have the meanings specified in OCC’s Rules and By-Laws, available at <https://www.theocc.com/about/publications/bylaws.jsp>.

following the exhaustion of such participant's funded contributions to the relevant clearing or guaranty fund.⁷

OCC's skin-in-the-game component of its financial risk management regime is described in its current rules, which provide for the use of OCC's own capital to mitigate losses arising out of a Clearing Member default.⁸ Specifically, OCC's rules provide for the offsetting of default losses remaining after the application of a defaulted Clearing Member's margin deposits and Clearing Fund contributions with OCC's capital in excess of 110 percent of the Target Capital Requirement at the time of the default.⁹ OCC's rules also provide for charging losses remaining after the application of OCC's excess capital to OCC senior management's deferred compensation¹⁰ as well as non-defaulting Clearing Members.¹¹

⁷ See Securities Exchange Act Release No. 78961 (Sep. 28, 2016), 81 Fed. Reg. 70786, 70806 (Oct. 13, 2016) (S7-03-14) ("Covered Clearing Agency Standards").

⁸ See Securities Exchange Release No. 88029 (Jan. 24, 2020), 85 Fed. Reg. 5500, 5502 (Jan. 30, 2020) (File No. SR-OCC-2019-007) ("CMP Approval Order").

⁹ See OCC Rule 1006(e), available at https://www.theocc.com/getmedia/9d3854cd-b782-450f-bcf7-33169b0576ce/occ_rules.pdf (last visited Mar. 16, 2021). See also CMP Approval Order at 5502.

¹⁰ Such deferred compensation is in trust with respect to OCC's Executive Deferred Compensation Plan ("EDCP"). See OCC Rule 101(e)(1), available at https://www.theocc.com/getmedia/9d3854cd-b782-450f-bcf7-33169b0576ce/occ_rules.pdf (last visited Mar. 16, 2021). The specific EDCP funds that comprise a portion of OCC's skin-in-the-game are referred to in OCC's rules as the "EDCP Unvested Balance." See *id.*

¹¹ See OCC Rule 1006(b), available at https://www.theocc.com/getmedia/9d3854cd-b782-450f-bcf7-33169b0576ce/occ_rules.pdf (last visited Mar. 16, 2021). See also CMP Approval Order at 5502. The application the EDCP Unvested Balance in parallel with non-defaulting Clearing Members' Clearing Fund contributions would necessarily occur before assessments related to the exhaustion of OCC's Clearing Fund.

OCC reviewed feedback received in connection with the initial filing of its current rules, relevant papers from industry participants and stakeholders concerning skin-in-the-game, and regulatory regimes in jurisdictions outside the United States.¹² OCC's current rules do not, however, dedicate OCC's excess capital for use solely as skin-in-the-game, or guaranty that OCC maintain a minimum amount of skin-in-the-game.¹³

Establishing the Minimum Corporate Contribution. OCC proposes to establish a persistent minimum level of skin-in-the-game that OCC would contribute to cover default losses or liquidity shortfalls. Such skin-in-the-game would consist of a minimum amount of OCC's own pre-funded resources that OCC would contribute prior to charging a loss to the Clearing Fund (the "Minimum Corporate Contribution") and the EDCP Unvested Balance.¹⁴ As proposed, funds comprising the Minimum Corporate Contribution would be excluded from OCC's liquid net assets funded by equity ("LNAFBE") for purposes of meeting OCC's Target Capital Requirement to ensure that OCC may maintain the Minimum Corporate Contribution exclusively for default management.¹⁵

¹² See Notice of Filing, 86 Fed. Reg. at 12238-39. For example, OCC is cognizant of the European Market Infrastructure Regulation's expectation that skin-in-the-game be a minimum of 25 percent of the central counterparty's regulatory capital requirement. See Notice of Filing, 86 Fed. Reg. at 12239.

¹³ See Notice of Filing, 86 Fed. Reg. at 12239.

¹⁴ OCC does not propose altering its rules regarding the use or sizing of the EDCP Unvested Balance.

¹⁵ In addition to the Minimum Corporate Contribution, OCC would continue to commit its LNAFBE greater than 110 percent of its Target Capital Requirement prior to charging a loss to the Clearing Fund. As proposed, OCC would apply the Minimum Corporate Contribution to address default losses before applying its excess LNAFBE.

OCC proposes to define the Minimum Corporate Contribution to mean the minimum level of OCC's own funds maintained exclusively to cover credit losses or liquidity shortfalls, the level of which OCC's Board of Directors (the "Board") shall determine from time to time. To facilitate implementation of OCC's proposal, the Board approved an initial Minimum Corporate Contribution at such a level that OCC's total skin-in-the-game (i.e., the sum of the Minimum Corporate Contribution and OCC's current EDCP Unvested Balance) would equal 25 percent of OCC's Target Capital Requirement. OCC stated that, in setting the initial Minimum Corporate Contribution, the Board considered factors including, but not limited to, the regulatory requirements in each jurisdiction in which OCC is registered or in which OCC is actively seeking recognition, the amount similarly situated central counterparties commit of their own resources to address participant defaults, the EDCP Unvested Balance, OCC's LNAFBE greater than 110 percent of its Target Capital Requirement, projected revenue and expenses, and other projected capital needs.¹⁶

Replenishing the Minimum Corporate Contribution. OCC proposes that, in the event it were to apply a portion of the Minimum Corporate Contribution to address losses or shortfalls arising out of a Clearing Member default, the size of the Minimum Corporate Contribution would be temporarily reduced, for a period of 270 days, to the amount remaining after its application.¹⁷ Each application of the Minimum Corporate Contribution would trigger a new

¹⁶ See Notice of Filing, 86 Fed. Reg. at 12239-40.

¹⁷ For example, if the Minimum Corporate Contribution were \$100 million and OCC applied \$25 million to address default losses, then the Minimum Corporate Contribution would be temporarily set at \$75 million.

270-day period.¹⁸ Under the proposal, OCC would be obligated to notify Clearing Members of any such reduction of the Minimum Corporate Contribution. OCC believes that 270 calendar days, or approximately nine months, is sufficient time for OCC to accumulate the funds necessary to reestablish the Minimum Corporate Contribution.¹⁹

OCC proposes change to its Rules, Capital Management Policy, Default Management Policy, Clearing Fund Methodology Policy, and Recovery and Orderly Wind-Down Plan to effectuate the changes described above.

III. DISCUSSION AND COMMISSION FINDINGS

Section 19(b)(2)(C) of the Exchange Act directs the Commission to approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to such organization.²⁰ After carefully considering the Proposed Rule Change, the Commission finds that the proposal is consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to OCC. More specifically, the Commission

¹⁸ For example, if OCC were to contribute a portion of the Minimum Corporate Contribution on day 1 and another portion 100 days later, the Minimum Corporate Contribution would remain temporarily reduced until day 370.

¹⁹ See Notice of Filing, 86 Fed. Reg. at 12240. OCC stated that the analysis on which its belief is based is the same analysis on which OCC relied to set various thresholds related to OCC's plan for replenishing its regulatory capital. See id.

²⁰ 15 U.S.C. 78s(b)(2)(C).

finds that the proposal is consistent with Section 17A(b)(3)(F) of the Exchange Act²¹ and Rule17Ad-22(e)(2) thereunder.²²

Before addressing the relevant portions of the Exchange Act and rules and regulations thereunder, however, we address a part of the comment submitted by Susquehanna International Group (“SIG”) not related to Section 17A(b)(3)(F) of the Exchange Act or Rule17Ad-22(e)(2) thereunder.²³ SIG argued, as one of its concerns, that OCC’s fees, dues, and other charges would be per se unreasonable, and therefore inconsistent with Section 17A(b)(3)(D) of the Exchange Act, because funding the proposal with clearing fees would facilitate a shareholder windfall.²⁴ We do not address these issues in this order because OCC has not proposed to change any fees, dues, or other charges in the Proposed Rule Change.²⁵ The reasonability of OCC’s existing fees,

²¹ 15 U.S.C. 78q-1(b)(3)(F).

²² 17 CFR 240.17Ad-22(e)(2).

²³ See letter from Richard J. McDonald, SIG, dated March 30, 2021, to Vanessa Countryman, Secretary, Commission (“SIG Letter”), available at <https://www.sec.gov/comments/sr-occ-2021-003/srocc2021003.htm>. In its comment letter, SIG argues that the Proposed Rule Change is inconsistent with Sections 17A(b)(3)(D) and (F) of the Exchange Act. The Commission’s consideration of SIG’s concerns pertaining to Section 17A(b)(3)(F) is addressed in section III.A. below.

²⁴ SIG Letter at 3-4.

SIG also (i) expresses concern regarding OCC’s current retention of \$325 million in capital; (ii) indicates that OCC should focus on reducing clearing fee rates; and (iii) suggests that the current organization of OCC’s shareholders as for profit entities creates a misalignment of interests. SIG Letter at 2. Because these issues do not bear on the grounds for approval or disapproval applicable to the Proposed Rule Change, the Commission does not address them in this order.

²⁵ Another commenter read SIG’s comment to imply that the inclusion of fees as part of the proposed skin-in-the-game would incentivize OCC members to increase their charges for providing clearing services as a method of mitigating the risk of their actual skin-in-the-game. See comment submitted by CJ Chou (April 8, 2021), available at <https://www.sec.gov/comments/sr-occ-2021-003/srocc2021003.htm>. As the Commission

dues, or other charges pursuant to Section 17A(b)(3)(D) of the Exchange Act is therefore beyond the scope of this Proposed Rule Change.

A. Consistency with Section 17A(b)(3)(F) of the Exchange Act

Section 17A(b)(3)(F) of the Exchange Act requires, among other things, that the rules of a clearing agency be designed to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible and, in general, to protect investors and the public interest.²⁶ Based on its review of the record, the Commission finds the proposal is consistent with Section 17A(b)(3)(F) of the Exchange Act.

The Commission continues to regard skin-in-the-game as a potential tool to align the various incentives of a covered clearing agency's stakeholders, including management and clearing members.²⁷ OCC's current rules provide for the application of excess capital as skin-in-the-game. The Commission believes that OCC's proposal to set aside capital to maintain a minimum amount of skin-in-the-game strengthens OCC's existing skin-in-the-game rules.

understands it, SIG's argument pertains to the size and use of OCC's fees, not changes in fees imposed on clients by the Clearing Members absent a fee increase by OCC.

The commenter also expressed difficulty in obtaining quantitative data regarding clearing fee refunds and how much, proportionally, fees would contribute to the minimum skin-in-the-game under the Proposed Rule Change. *Id.* With regard to quantitative data describing clearing fee refunds, the audited financial statements that OCC posts annually include a line item for refundable clearing fees where applicable. *See e.g.*, OCC's 2020 Financials at page 5, available at <https://www.theocc.com/getattachment/9f5d22ff-d810-4690-948d-f9a207df083d/attachment.aspx>. With regard to how much, proportionally, fees would contribute to the minimum skin-in-the-game under the Proposed Rule Change, the Commission notes that OCC has publically stated that its revenues primarily consist of clearing fee revenues. *Id.* at 7.

²⁶ 15 U.S.C. 78q-1(b)(3)(F).

²⁷ Covered Clearing Agency Standards, 81 FR at 70805–06.

OCC's current rules align senior management's personal economic incentives with OCC's overall risk management incentives,²⁸ but do not guaranty that an amount of OCC capital would be set aside to ensure a pre-determined minimum level of skin-in-the-game.

The Commission believes that holding a defined Minimum Corporate Contribution, as opposed to an undefined amount of excess capital, would incentivize OCC further to maintain the appropriate amount of resources to manage a Clearing Member default because failure to do so would result in a direct cost to OCC. Incentivizing OCC to maintain an appropriate amount of resources, in turn, could reduce the potential losses charged to the Clearing Fund contributions of non-defaulting Clearing Members in the event of a Clearing Member default, which in turn would help assure the safeguarding of the Clearing Fund contributions of non-defaulting Clearing Members.

In its comment letter, SIG argues that the Proposed Rule Change contravenes the protection of investors and the public interest.²⁹ SIG states that OCC was established as a monopoly organization in order to serve as a market utility³⁰ and that it has always been recognized and accepted by concerned parties that monies held as excess OCC capital are excess fees not yet rebated, as opposed to retained earnings.³¹ In support of its argument that OCC

²⁸ See Securities Exchange Act Release No. 87257 (Oct. 8, 2019), 84 Fed. Reg. 55194, 55199 (Oct. 15, 2019) (File No. SR-OCC-2019-805).

²⁹ SIG Letter at 4.

³⁰ SIG Letter at 1.

³¹ SIG Letter at 2.

should not retain earnings generated through clearing fees, SIG states that OCC has not previously had to draw on such funds to address a shortfall.³²

The Commission is not persuaded by SIG's arguments with regard to Section 17A(b)(3)(F). As discussed above, the Commission believes that holding a defined Minimum Corporate Contribution would incentivize OCC further to maintain the appropriate amount of resources to manage a Clearing Member default. Aligning OCC's incentives with risk management considerations, such as default management, supports the public interest because it supports OCC's role as a utility for clearing and settling U.S. listed options. Further, OCC's rules do not require OCC to distribute retained earnings in excess of expenses.³³

In addition to providing those services customarily provided by clearing houses of national securities exchanges,³⁴ OCC is a Covered Clearing Agency registered with the Commission.³⁵ As a Covered Clearing Agency, OCC is obligated to comply with risk management standards that the Commission adopted under Section 805(a)(2) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010³⁶ and Section 17A of the Exchange

³² SIG Letter at 2.

³³ If OCC's capital exceeds 110 percent of its Target Capital Requirement, rules authorize, but does not require, OCC's Board to reduce the cost of clearing. See Securities Exchange Act Release No. 88029 (Jan. 24, 2020), 85 Fed. Reg. 5500, 5502 (Jan. 30, 2020) (File No. SR-OCC-2019-007). If the Board chooses to reduce the cost of clearing, it is authorized to do so by lowering fees or declaring a fee holiday as well as issuing refunds. See Id.

³⁴ See Fourth Amended and Restated Certificate of Incorporation of OCC, Section III, available at https://www.theocc.com/getmedia/9d7754f6-99ca-4d69-a934-a6fa996c9c16/OCC_Certificate_of_Incorporation.pdf.

³⁵ 17 CFR 240.17Ad-22(a)(15).

³⁶ 12 U.S.C. 5464(a)(2).

Act (the “Clearing Agency Rules”).³⁷ The Clearing Agency Rules address having policies and procedures regarding, *inter alia*, the maintenance of assets to address losses attributable to Clearing Member defaults³⁸ as well as general business risk losses.³⁹

SIG argues further that OCC’s proposal puts only the public’s skin in the game. SIG states that market participants bear the risk imprudent decisions by the exchanges in their capacity as the OCC shareholders and of their designee board members because such participants would be denied a rebate of excess fees.⁴⁰

The Commission is not persuaded by this argument either. SIG’s argument assumes that OCC’s Clearing Members have a right to clearing fee revenues not applied to operating costs in a given year, but, as noted above in this section, OCC’s rules, as approved by the Commission, do not require OCC to distribute retained earnings in excess of expenses. SIG’s argument also assumes, without support, that OCC’s five Exchange Directors would not only be willing to make “imprudent decisions to the detriment of OCC’s Clearing Members,” but that the Exchange Directors would be able to enlist sufficient support among OCC’s nine Member Directors to force such “imprudent decisions” through the Board approval process.

³⁷ 17 CFR 240.17Ad-22. See Securities Exchange Act Release No. 68080 (Oct. 22, 2012), 77 Fed. Reg. 66220 (Nov. 2, 2012) (S7-08-11). See also Covered Clearing Agency Standards, 81 Fed. Reg. 70786. OCC is a “covered clearing agency” as defined in Rule 17Ad-22(a)(5).

³⁸ See 17 CFR 240.17Ad-22(e)(4).

³⁹ See 17 CFR 240.17Ad-22(e)(15).

⁴⁰ SIG Letter at 3.

Based on the foregoing, the Commission believes that the Proposed Rule Change is consistent with the requirements of Section 17A(b)(3)(F) of the Exchange Act.⁴¹

B. Consistency with Rule 17Ad-22(e)(2) under the Exchange Act

Rule 17Ad-22(e)(2) under the Exchange Act requires that a covered clearing agency establish, implement, maintain, and enforce written policies and procedures reasonably designed to provide for governance arrangements that, among other things, are clear and transparent; clearly prioritize the safety and efficiency of the covered clearing agency; and support the public interest requirements of the Exchange Act.⁴² In adopting Rule 17Ad-22(e)(2), the Commission discussed comments it received regarding the concept of skin-in-the-game as a potential tool to align the various incentives of a covered clearing agency's stakeholders, including management and clearing members.⁴³ And, while the Commission declined to include a specific skin-in-the-game requirement in the rule, it stated its belief that "the proper alignment of incentives is an important element of a covered clearing agency's risk management practices," and noted that skin-in-the-game "may play a role in those risk management practices in many instances."⁴⁴ OCC's current rules require the application management compensation and excess capital as skin-in-the-game, which in turn should help further align the interests of OCC's stakeholders, including OCC management and Clearing Members.⁴⁵

⁴¹ 15 U.S.C. 78q-1(b)(3)(F).

⁴² 17 CFR 240.17Ad-22(e)(2).

⁴³ Covered Clearing Agency Standards, 81 FR at 70805-06.

⁴⁴ Covered Clearing Agency Standards, 81 FR at 70806.

⁴⁵ See CMP Approval Order at 5507.

As described above, OCC's proposal would not reduce the resources OCC would apply to address default losses or remove the current skin-in-the-game component of OCC's rules. Rather, OCC proposes to set aside a defined amount of capital for the sole purpose of absorbing losses and shortfalls arising out of a Clearing Member default. OCC has clearly stated the factors that the Board would consider when determining the amount of resources to hold as skin-in-the-game, a portion of which would comprise the Minimum Corporate Contribution. OCC also proposes to establish a clear process for addressing reductions in the Minimum Corporate Contribution arising out of a Clearing Member's default. Accordingly, the Commission believes that the proposed changes to establish a persistent minimum level of skin-in-the-game are consistent with Rule 17Ad-22(e)(2) under the Exchange Act.⁴⁶

⁴⁶ 17 CFR 240.17Ad-22(e)(2).

IV. CONCLUSION

On the basis of the foregoing, the Commission finds that the Proposed Rule Change is consistent with the requirements of the Exchange Act, and in particular, the requirements of Section 17A of the Exchange Act⁴⁷ and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Exchange Act,⁴⁸ that the Proposed Rule Change (SR-OCC-2021-003) be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁴⁹

J. Matthew DeLesDernier
Assistant Secretary

⁴⁷ In approving this Proposed Rule Change, the Commission has considered the proposed rules' impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

⁴⁸ 15 U.S.C. 78s(b)(2).

⁴⁹ 17 CFR 200.30-3(a)(12).