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Executive Vice President
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May 27, 2014

VIA ELECTRONIC MAIL

Kevin O'Neill, Deputy Secretary
Securities and Exchange Commission
100 F Street N.E.
Washington, DC 20549-1090

Re: File No. S7-03-14: Proposed Standards for Covered Clearing Agencies

Dear Mr. O'Neill:

The Options Clearing Corporation ("OCC") appreciates this opportunity to comment on the Commission's proposed Standards for Covered Clearing Agencies (the "Proposal").[1] We support the flexible approach taken by the Commission and the implicit recognition by the Commission that a one-size-fits-all approach to regulating a covered clearing agency ("CCA") would be impractical and inappropriate. There are several aspects of the Proposal, particularly with respect to the "funded by equity" requirement in proposed Rule 17Ad-22(e)(15), the use of contingent capital in meeting the capital requirements under that proposed rule, and the acceptance of equity securities as collateral under proposed Rule 17Ad-22(e)(5), on which we believe the Proposal could be improved through minor modifications or the issuance of interpretive guidance by the Commission in the final rules release, and we look forward to discussing those aspects of the Proposal with Commission Staff in the near future.

ABOUT OCC

Founded in 1973, OCC is the world's largest equity derivatives clearing organization. OCC clears security options, security futures and other securities contracts subject to the jurisdiction of the Commission, and commodity futures and commodity options subject to the jurisdiction of the Commodity Futures Trading Commission ("CFTC"). OCC also began clearing over-the-counter options on the S&P 500 securities index in April, 2014. OCC is registered with the Commission as a clearing agency pursuant to Section 17A of the Securities

[1] Release No. 34-71699 (March 12, 2014), 79 Fed. Reg. 16866 (March 26, 2014), republished in 79 Fed. Reg. 29508 (May 22, 2014). Citations herein reference the Proposal as republished in the Federal Register.

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Exchange Act of 1934 (the "Exchange Act")[2] and is registered with the CFTC as a derivatives clearing organization ("DCO") pursuant to Section 5b of the Commodity Exchange Act.[3] OCC clears all standardized options listed on the twelve U.S. national securities exchanges that trade options and, in its capacity as a DCO, clears CFTC-regulated futures products for four U.S. futures exchanges.

BACKGROUND

Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"),[4] also known as the Payment, Clearing, and Settlement Supervision Act of 2010 ("Title VIII"), provides for enhanced regulation of financial market utilities ("FMUs"). This enhanced regulation applies only to FMUs that the Financial Stability Oversight Council ("FSOC") has designated as systemically important, or likely to become systemically important, in accordance with Section 804 of Title VIII. OCC was designated by FSOC as a systemically important FMU pursuant to Title VIII on July 18, 2012.[5] The Commission is OCC's Supervising Agency for purposes of Title VIII.

On April 16, 2012, the Committee on Payment and Settlement Systems of the Bank for International Settlements and the Technical Committee of the International Organization of Securities Commissions ("CPSS-IOSCO"), published its final Principles for Financial Market Infrastructures (the "PFMI Report").[6] The PFMI Report adopted standards (the "PFMIs") designed to harmonize and, where appropriate, strengthen the existing international standards for, among others, central counterparties ("CCPs").[7] The PFMIs, with few exceptions, "do not prescribe a specific tool or arrangement to achieve their requirements and allow for different

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[2] 15 USC § 78q-1.

[3] 7 USC § 7a-1.

[4] Public Law 111–203, 124 Stat. 1376 (July 21, 2010).

[5] *See* U.S. Treasury Department, Financial Stability Oversight Council Makes First Designations in Effort to Protect Against Future Financial Crises (July 18, 2012), *available at* http://www.treasury.gov/press-center/press-releases/Pages/tg1645.aspx.

[6] CPSS-IOSCO, Principles for Financial Market Infrastructures (April 16, 2012), *available at* http://www.bis.org/publ/cpss101a.pdf.

[7] *Id.* at 5 (Section 1.2).

means to satisfy a particular principle."[8] The PFMIs were "designed to be applied holistically because of the significant interaction between principles[.]"[9]

On March 12, 2014, the Commission issued the Proposal, which would adopt a new regulatory framework for CCAs, consistent with Title VIII and the PFMIs. Regulatory authorities around the world, including the CFTC and the Board of Governors of the Federal Reserve System (the "Board"), are in various stages of updating their regulatory regimes to adopt requirements that are consistent with the PFMIs.[10]

COMMENTS ON THE PROPOSAL

OCC supports the Commission's ongoing efforts to "strengthen the substantive regulation of registered clearing agencies, promote the safe and reliable operation of registered clearing agencies, and improve efficiency, transparency, and access to registered clearing agencies by establishing minimum requirements with due consideration given to observed practices and international standards."[11] OCC agrees with the Commission's preliminary belief, stated in the Proposal, that CCAs should be allowed "flexibility to use their market experience and understanding of their institutions to shape the rules, policies, and procedures implementing proposed Rule 17Ad-22(e)."[12] We also agree that the PFMIs and regulations implementing the PFMIs should be applied holistically.

OCC has operated safely and effectively for more than 40 years—including through the market crises of 1987 and 2008—mitigating systemic risk associated with derivatives trading, and OCC has a deep understanding of the markets for which it acts as a CCP. The ability to

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[8] *Id.* at 12 (Section 1.19).

[9] *Id.*

[10] In November 2013, the CFTC adopted new rules that apply heightened standards to systemically important DCOs for which the CFTC is the Supervisory Agency pursuant to Title VIII or which elect to become subject to the CFTC's PFMI regulations. Commodity Futures Trading Commission, Derivatives Clearing Organizations and International Standards; Final Rule; 78 Fed. Reg. 72476 (December 2, 2013); *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-12-02/pdf/2013-27849.pdf. In January 2014, the Board proposed rules implementing the PFMIs for financial market utilities for which the Board is the Supervisory Agency for purposes of Title VIII. Federal Reserve System; Financial Market Utilities; Proposed Rule; 79 Fed. Reg. 3666 (January 22, 2014); *available at* http://www.gpo.gov/fdsys/pkg/FR-2014-01-22/pdf/2014-00682.pdf. On March 31, 2014, OCC submitted a comment letter on the Proposed Board PFMI Rules. Letter from Craig S. Donohue, Executive Chairman, OCC, to Robert deV. Frierson, Secretary, Board (March 31, 2014), http://www.federalreserve.gov/SECRS/2014/April/20140429/R-1477/R-1477_033114_112201_564063302897_1.pdf.

[11] Proposal at 29513.

[12] Proposal at 29517.

continue to manage risk in a flexible and holistic manner will contribute to OCC's ability to continue this long track record of success in risk management. Indeed, we expect that in some instances, OCC's risk management efforts could result in policies and procedures that go beyond what is called for by Rule 17Ad-22(e). Adopting a flexible and holistic approach will allow OCC to make risk management decisions from a perspective of overall risk management, rather than from a purely "check the box," compliance-driven approach to risk management. We also expect that OCC's compliance process with respect to the final CCA standards will be iterative and will involve ongoing dialogue with each of our regulators and periodic reevaluation of whether existing policies and procedures are proving to be effective in promoting the overall results the Commission intends to achieve in implementing Rule 17Ad-22(e). We support the flexible approach taken by the Commission and believe that moving toward a more prescriptive "black letter" approach would be counterproductive.

We are pleased to provide the following comments on the Proposal, and look forward to working with the Commission and Commission Staff to implement appropriate policies and procedures in response to the Commission's final rules.

I. Governance

Proposed Rule 17Ad-22(e)(2)(iii) would require a CCA to "establish, implement, maintain and enforce written policies and procedures reasonably designed to . . . [p]rovide for governance arrangements that: [s]upport the public interest requirements in Section 17A of the Exchange Act . . . and the *objectives of owners and participants*[.]"[13] By comparison, CFTC Rule 39.32(a)(1)(iv) requires each systemically important DCO to "have governance arrangements that . . . [e]xplicitly support the stability of the broader financial system and other relevant public interest considerations of clearing members, *customers of clearing members*, and other relevant stakeholders"[14] and Proposed Board PFMI Rule 234.3(a)(2)(iii) would require each designated financial market utility ("DFMU") to have "governance arrangements that—(iii) [s]upport the stability of the broader financial system, other relevant public interest considerations such as fostering fair and efficient markets, and the legitimate interests *of relevant stakeholders*, including the designated financial market utility's owners, participants, and *participants' customers*[.]"[15] The Commission requested comment on whether it should require a CCA's policies and procedures for governance to support the objectives of participants' customers, securities issuers and holders, and other stakeholders.[16]

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[13] Proposal at 29520 (emphasis added).

[14] 17 C.F.R. § 39.32(a)(1)(iv) (emphasis added).

[15] *See supra* note 10, Financial Market Utilities, 79 Fed. Reg. 3666, 3689 (January 22, 2014) (emphasis added).

[16] Proposal at 29521.

We support proposed Rule 17Ad-22(e)(2)(iii) as it is currently drafted. The Commission's approach is consistent with PFMI Principle 2, which refers to governance arrangements supporting "the objectives of relevant stakeholders"[17] and with Key Consideration 7 of PFMI Principle 2, which refers to "direct and indirect participants and other relevant stakeholders."[18] While we agree with the Commission and other regulators that we must consider interests that extend beyond those of our owners and direct clearing members to include the interests of indirect participants, such as customers of clearing members, we believe mandatory representation of customers and other stakeholders on a CCA's board of directors is unnecessary. The interests of such stakeholders are adequately addressed through participation of a sufficient number of independent directors on the board of directors or through other means, such as participation in industry forums, in which the customers of OCC's clearing members also participate.

In addition, proposed Rule 17Ad-22(e)(2)(iv) would require each CCA to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide for governance arrangements that establish that the board of directors and senior management have appropriate experience and skills to discharge their duties and responsibilities.[19] The Commission indicated that it "believes that covered clearing agencies are well positioned to determine which individuals would have the appropriate experience, skills, incentives and integrity to discharge their duties and responsibilities that reflect the particular characteristics of each covered clearing agency."[20] We agree with this statement.

Finally, in response to the Commission's request for comment on whether the Commission should require CCAs to have policies and procedures that provide for governance arrangements that ensure major decisions are disclosed to the public, we do not believe such a requirement is necessary. We believe the interests of public stakeholders in having visibility into major decisions of a CCA are adequately served through participation of a sufficient number of independent directors on the CCA's board of directors, the other means described above (including participation in industry forums) and the rule filing process to which CCAs are subject, including in the case of a systemically important FMU, the requirement to file advance notices of any changes to its rules, procedures or operations that could materially affect the nature or level of risks presented by the FMU. Furthermore, OCC and other CCAs currently make voluntary disclosures on their public websites regarding their governance arrangements, including posting Board and Board Committee charters. In the case of OCC, later this year these voluntary disclosures will also include a public disclosure document that will follow the

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[17] PFMI Report, supra note 6, at 26.

[18] *Id.*

[19] Proposal at 29521.

[20] *Id.*

Disclosure Framework for Financial Market Infrastructures developed by CPSS-IOSCO, which document will be updated as necessary to reflect any material changes to OCC's governance arrangements, systems or environment.

II. Audit Committee Independence

Proposed Rule 17Ad-22(e)(3)(v) would require a CCA to "[m]aintain a sound risk management framework for comprehensively managing legal, credit, liquidity, operational, general business, investment, custody, and other risks that arise in or are borne by the covered clearing agency which: . . . (v) [p]rovides for an independent audit committee."[21] The Commission states that, in order to satisfy this requirement, a CCA "could use such independence criteria as are established by its board of directors."[22] We believe that the Commission has struck the appropriate balance by requiring an independent audit committee, while deferring to the reasonable judgment of a CCA's board of directors in determining how to define "independence." We believe that "independence" must be judged in the context of a particular CCA. For example, OCC's Board of Directors is currently comprised of nine member directors, five exchange directors, three public directors and two management directors.[23] Each Member Director is required to be an OCC clearing member or a representative of an OCC clearing member organization. Each Exchange Director is nominated as such by the respective OCC Equity Exchange. OCC would not expect to treat such Member Directors or Exchange Directors as being *per se* non-independent for purposes of serving on OCC's audit committee, but instead would intend to address the independence of such directors on a case-by-case basis and with a view toward the materiality of any possible conflicts of interest such directors may have. The association of those directors with OCC's clearing members or OCC's equity exchanges (which own OCC), would likely be included in the mix of factors to be evaluated by our Board of Directors in determining whether such persons are appropriate candidates to serve on OCC's audit committee. OCC believes there is value in having persons with extensive industry knowledge and experience serving on its audit committee, and we do not believe that our Board of Directors would want to preclude from service on such committee those persons most likely to have the relevant experience.

III. "Cover One" Versus "Cover Two"

Proposed Rule 17Ad-22(e)(4) would adopt a "cover one" standard for credit risk and proposed Rule 17Ad-22(e)(7) would adopt a "cover one" standard for liquidity risk. Proposed Rule 17Ad-22(e)(4) would adopt a "cover two" standard for credit risk for those CCAs that are

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[21] Proposal at 29523.

[22] Proposal at 29524.

[23] *See* OCC By-Laws, Article III, Sections 1 and 6.

"involved in activities with a more complex risk profile,"[24] and proposed Rule 17Ad-22(e)(7) would require a CCA to evaluate annually the feasibility of maintaining sufficient liquid resources to meet a "cover two" standard for liquidity risk if the CCA is involved in activities with a more complex risk profile. We support these rules because we believe they reflect an appropriate balance between robust risk management and the efficient use of capital, subject to our comments below.

Under the Proposal, the determination of whether a CCA is "involved in activities with a more complex risk profile" would be made pursuant to proposed Rule 17Ab2-2.[25] Proposed Rule 17Ab2-2(c) would allow the SEC to determine whether any of the activities of a CCA providing central counterparty services have a more complex risk profile, warranting subjecting the CCA to heightened standards under Rules 17Ad-22(e)(4) and (7). In making this determination, the Commission could consider "(i) characteristics such as the clearing of financial instruments that are characterized by discrete jump-to-default price changes or that are highly correlated with potential participant defaults; and (ii) such other characteristics as it deems appropriate in the circumstances."[26]

The substantial majority of derivatives cleared by OCC are standardized options listed on the twelve U.S. national securities exchanges that trade options. OCC also clears futures listed on four U.S. futures exchanges. OCC also currently clears (a) a small volume of credit default options, (b) stock loan transactions, and, (c) effective April, 2014, over-the-counter options ("OTC Options") on the S&P 500 Index. OCC may in the future clear other OTC Options on other indices or on single securities, subject to obtaining necessary regulatory approvals.

Without challenging the principle that CCAs that face greater risk of simultaneous defaults because of the overall risk profile of the products they clear may reasonably be required to meet a "cover two" standard, we believe that it is necessary to take a number of factors into consideration in making a determination as to whether a CCA's clearing activity should trigger this requirement. These factors should include the *proportion* of the CCA's clearing activities involving higher risk products as well as the manner in which the CCA manages those risks. A CCA may have other ways of addressing the added risk incurred in riskier instruments (for example, through enhanced margin systems) that would make moving to a "cover two" standard unnecessary for that CCA.

The vast majority of OCC's clearing activities relates to plain vanilla put and call options on stocks, indices and other underlying interests of a type that OCC has been clearing for many years subject to SEC oversight. However, OCC clears one product—credit default options—for

[24] Proposal at 29525.

[25] Proposal at 29515.

[26] Proposal at 29612.

which OCC's payment obligations may be triggered suddenly and automatically upon the occurrence of a credit event on the reference obligation of the relevant reference entity. We do not believe clearing *any amount* of such options should trigger a "cover two" standard. OCC's cleared volume in credit default options is currently trivial in comparison to OCC's clearing of listed options on single securities and securities indices. (As of May 22, 2014, OCC has total open interest in credit default options of 16 contracts.) Requiring a CCA to move from "cover one" to "cover two" on the basis of such trivial volumes strikes us as the wrong approach. We suggest that the Commission clarify that it is not the intention to interpret the rules in a manner that, in our view, would yield such an unreasonable result.

A cover two standard is, inherently and by design, a blunt regulatory instrument. A CCA may have ways of gradually increasing its financial resources as the risks posed to the CCA increase, in lieu of moving directly to a cover two credit or liquidity standard. OCC intends to consider the risks posed by each new instrument proposed to be cleared to evaluate whether the proposed clearing activity could justify moving to a cover two standard for either credit or liquidity purposes or taking other risk mitigating actions. At this time, we do not believe that any of OCC's existing clearing activities, including OCC's clearance of OTC Options, should be sufficient to justify a finding by the Commission that OCC presents a "more complex risk profile." We understand that whether a CCA is subject to a "cover one" or "cover two" standard may change over time and that a CCA, such as OCC, that is initially subject to the lower credit and liquidity standards should continue to evaluate its risk profile as new products are proposed and the relative volumes of clearing activity shifts among products.

IV. Stress Tests

Proposed Rule 17Ad-22(e)(4)(vi) would require a CCA to have policies and procedures to test the sufficiency of its total financial resources available to meet the minimum financial resource requirements by conducting (a) a stress test of its total financial resources at least once *each day* using standard predetermined parameters and assumptions; (b) a comprehensive analysis on at least a *monthly basis* of the existing stress testing scenarios, models and underlying parameters and assumptions, and considering modifications to ensure they are appropriate for determining the CCA's required level of default protection in light of current and evolving market conditions; and (c) a comprehensive analysis of stress testing scenarios, models, and underlying parameters and assumptions *more frequently than monthly* when the products cleared or markets served display high volatility or become less liquid, and when the size or concentration of positions held by the CCA's participants increases significantly.[27] A CCA would also be required to report the results of these analyses to appropriate decision makers at the CCA and use these results to evaluate the adequacy of and adjust its margin methodology,

[27] Proposal at 29526-27.

model parameters, models used to generate clearing or guaranty fund requirements, and any other relevant aspects of its credit risk management framework.[28]

A CCA would also be required to perform at least annually a "conforming model validation" for its credit risk models.[29] Robust and comprehensive stress tests are a central component of CCA risk management, and OCC supports these rules as drafted and endorses the foregoing approach.

V. Collateral Risk Management

Proposed Rule 17Ad-22(e)(5) would require a CCA to have policies and procedures (a) reasonably designed to limit the assets it accepts as collateral to those with low credit, liquidity, and market risks, and (b) that establish and enforce appropriately conservative haircuts and concentration limits.[30] The sufficiency of collateral haircuts and concentration limits would need to be reviewed not less frequently than annually.[31] OCC supports this aspect of the Proposal as it is currently drafted, and encourages the Commission to adopt a flexible and holistic approach to applying these requirements, particularly with respect to the acceptance of equity securities as collateral.

OCC believes that accepting equity securities as collateral is appropriate, particularly in a true "portfolio margin" system, such as OCC's System for Theoretical Analysis and Numerical Simulations ("STANS"), in which collateral assets and the positions supported by these assets are considered collectively in determining margin requirements. OCC accepts equity deposits from clearing members in the form of (a) specific deposits (*i.e.*, deposits in lieu of margin) and (b) valued securities. Specific deposits are deposits by clearing members of customer securities that exactly underlie a short stock option, resulting in a covered short option position. Valued securities are deposits of equity securities that are "covered securities" within the meaning of Section 18(b)(1) of the Securities Act of 1933. If such a security does not underlie a listed option contract, it must have a market value of at least $3 per share for OCC to accept it as a valued security. OCC may determine to not accept a security that meets these requirements, at its discretion, upon a determination that other factors, including trading volume, the number of shareholders, the number of outstanding shares, and the current bid/ask spreads warrant such a waiver. A security that is suspended from trading by, or subject to special margin requirements under the rules of, the market that listed or qualified the security for trading because of volatility, lack of liquidity or similar characteristics, may not be deposited as margin with OCC.

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[28] Proposed Rule 17Ad-22(e)(4)(vi)(D).

[29] Proposed Rule 17Ad-22(e)(4)(vii).

[30] Proposal at 29528.

[31] *Id.*

From a credit perspective, equities are cleared and transferred through the facilities of the National Securities Clearing Corporation and the Depository Trust Company, respectively, which largely mitigates the counterparty credit risks associated with transacting in equities. OCC manages the market risk related to accepting equity securities as collateral in a sophisticated manner consistent with STANS via its "Collateral in Margins" system, which allows OCC to set margin coverage and apply appropriate haircuts on a security-by-security basis. Collateral in Margins also measures exposures of cleared contracts and collateral on a combined basis. By recognizing scenarios in which an equity security serves as a hedge to a clearing member's position in cleared contracts, OCC provides an incentive for clearing members to pledge securities that reduce their overall risk to OCC.

From a liquidity perspective, OCC's Board of Directors has approved, and OCC will be implementing in the near future, subject to regulatory approval, enhancements to STANS intended to address concerns related to (a) concentration of equity collateral and (b) the acceptance of equity collateral from a clearing member that presents wrong-way risk. Once approved and implemented, OCC will limit the amount of equity security collateral a clearing member may pledge to OCC as margin in a particular equity. Such limit will equal the two-day average of the equity security's daily trade volume. If the pledged equity security is a security that is issued by the clearing member, the foregoing limit will be reduced to zero days. These policies will allow a clearing member to pledge securities that directly hedge its position in cleared contracts, but limit the amount of exposure OCC will accept in a particular asset class beyond the hedge.

Equity securities are currently the largest asset class used by OCC's clearing members to satisfy their requirements to post margin or securities in lieu of margin (*i.e.*, collateral). Currently, approximately 27% of clearing members' total collateral deposits are in the form of specific deposits of equity securities and 35% of clearing members' total collateral deposits are in the form of valued securities. OCC's ability to accept equity securities as collateral is critically important to OCC's efforts at systemic risk mitigation, and we believe that we should continue to accept equity securities as collateral within our existing framework.[32]

VI. <u>Liquidity Risk Management</u>

Proposed Rule 17Ad-22(e)(7) would require a CCA to have policies and procedures in place to "[hold] qualifying liquid resources sufficient to meet the minimum liquidity resource

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[32] In the Proposal, in discussing proposed Rule 17Ad-22(e)(6)(v) (which implements the margin PFMI), the Commission states that "a covered clearing agency may take into account certain netting procedures or offsets through which credit exposure may be reduced in measuring credit exposure, including the use of portfolio margining procedures across products where applicable." Proposal at 29529 (emphasis added). OCC strongly supports this statement and we believe this statement implicitly supports the conclusion that an appropriately designed portfolio margin system that permits the use of equity collateral should comply with the requirements of proposed Rule 17Ad-22(e)(5) with respect to quality of collateral.

requirement under [proposed Rule 17Ad-22(e)(7)(i)] in each relevant currency for which the covered clearing agency has payment obligations owed to clearing members."[33] Proposed Rule 17Ad-22(a)(15) would define "qualifying liquid resources" as (i) cash held either at the central bank of issue or at creditworthy commercial banks; (ii) assets that are readily available and convertible into cash through *prearranged funding arrangements* without material adverse change provisions; and (iii) other assets that are readily available and eligible for pledging to, or conducting other appropriate forms of transaction with, a relevant central bank, if the CCA has access to routine credit at such central bank that permits pledges or other transactions by the CCA.[34] Examples provided by the Commission of appropriate prearranged funding arrangements include (A) committed arrangements, including: (1) lines of credit, (2) foreign exchange swaps, and (3) repurchase agreements; or (B) other prearranged funding arrangements determined to be highly reliable even in extreme but plausible market conditions by the board of directors of the CCA following a review conducted for this purpose not less than annually.[35]

OCC supports the Commission's approach to these proposed rules, including the expansion of qualifying liquid resources beyond committed funding arrangements. We agree that limiting the funding arrangements included within the definition of "qualifying liquid resources" to committed funding arrangements is not necessary or appropriate in determining liquidity requirements for a CCA operating in the U.S. securities markets and that expanding the concept of "qualifying liquid resources" to include other highly reliable funding arrangements is necessary and appropriate to ensure the proper functioning of CCAs, as required by the Exchange Act.[36]

We agree that a committed liquidity facility would generally be preferable over a non-committed facility, all other things being equal. However, other terms of a facility, such as the size or cost of the facility, may tip the balance toward selection of the non-committed facility. For example, it may be necessary for a CCA to obtain a non-committed facility in order to obtain a sufficient amount of overall liquidity due to a lack of commercial availability of committed liquidity facilities that are sufficiently large. The liquidity needs of clearing organizations are unique and there are a limited number of liquidity providers in the market that are willing and able to participate in committed liquidity facilities for clearing organizations. The total capacity under all such committed facilities is therefore also limited, although the limit may change over time and is difficult to pinpoint with any precision. Furthermore, one clearing organization entering into a committed liquidity facility will necessarily decrease the available committed liquidity capacity that is available to all other clearing organizations. Potential liquidity

[33] Proposal at 29534.

[34] Proposal at 29531 (emphasis added).

[35] *Id.*

[36] *See* Proposal at 29532.

providers are under no regulatory obligation to provide committed liquidity facilities, and those financial institutions are subject to their own increasingly strict risk mitigating regulations, including under Basel III. In addition, as CCAs move eventually toward relying on central banks to hold their custody and settlement accounts, the commercial banks on which the CCAs have historically relied to hold their custody and settlement accounts may find that they have less of a commercial incentive to participate in CCA liquidity facilities. A bank may not want to devote a portion of its balance sheet to a CCA that is not otherwise a large customer of the bank. These commercial and regulatory realities could further constrain the availability to a CCA of committed liquidity.

VII. Customer Portability

Proposed Rule 17Ad-22(e)(14) would require a CCA to have policies and procedures to "[e]nable, when the covered clearing agency provides central counterparty services for security based swaps or engages in activities that the Commission has determined to have a more complex risk profile, the segregation and *portability* of positions of a participant's customers and the collateral provided to the covered clearing agency with respect to those positions and effectively protect such positions and related collateral from the default or insolvency of that participant."[37] OCC strongly supports efforts to improve the protection of customer positions and collateral and we look forward to working with the Commission and with other industry participants to implement customer portability to the fullest extent practicable. We note that there could be tension between the competing goals of customer portability and the need for a CCA to ensure its own safety and soundness and the safety and soundness of the markets as a whole. We urge the Commission to recognize the need for a CCA to balance these competing priorities and to avoid any interpretation of proposed Rule 17Ad-22(e)(14) that prohibit a CCA from liquidating positions, including customer positions, where, in the CCA's judgment, liquidation is reasonably necessary for the protection of the CCA.

VIII. Capital

Proposed Rule 17Ad-22(e)(15)(ii) would require a CCA to "[hold] liquid net assets *funded by equity* equal to the greater of 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 of the covered clearing agency[.]"[38] The resources used to satisfy this requirement would be in addition to the resources used to cover participant defaults or other risks pursuant to Rule 17Ad-22(b)(3) or (e)(4), as well as those used to satisfy the liquidity risk standards of Rule 17Ad-22(e)(7). The resources would need to be of "high quality and sufficiently liquid to allow the

[37] Proposal at 29546 (emphasis added).

[38] Proposal at 29548 (emphasis added).

covered clearing agency to meet its current and projected operating expenses under a range of scenarios, including in adverse market conditions."[39]

The Commission has indicated that a CCA *could* satisfy the "funded by equity" requirement by having policies and procedures that limit appropriate liquid net assets to cash or cash equivalents, because these types of assets would best facilitate continued operations if a clearing agency experienced general business losses.[40] The Commission also indicated that a CCA "could satisfy this requirement by having policies and procedures that fund liquid net assets by common stock, disclosed reserves, or other retained earnings in order to ensure that a covered clearing agency has a permanent source of capital from which to draw. . . ."[41] We endorse the Commission's proposal to require a CCA to maintain liquid net assets sufficient to allow the CCA to continue to operate for no less than six months, subject to our comments below with respect to the inclusion of projected revenues over that same period. It is appropriate to require a CCA to hold in reserve six months of operating expenses, given the central role played by CCAs in the capital markets and in the functioning of the broader economy. However, we urge the Commission to not take too narrow a view of what sources of funding would be considered "equity" funding under Rule 17Ad-22(e)(15).

The impact and significance of the liquid net assets requirement may be very different for different CCAs, depending upon the ownership and governance structure of the CCA. For example, OCC operates under a model whereby it is required by its By-Laws to set its fees at a level designed to cover its operating expenses and to maintain such reserves as are deemed reasonably necessary by OCC's Board of Directors to provide facilities for the conduct of OCC's business in connection with the services it provides to its exchanges, its clearing members and the general public.[42] Historically, fees received in excess of that amount have been refunded to clearing members based on the fees each clearing member paid during the relevant period. However, OCC recently adopted, effective April 1, 2014,[43] changes to its clearing fees to eliminate certain fee discounts to, in part, help OCC create a sufficient cushion of liquid net assets to allow OCC to comply with Rule 17Ad-22(e)(15) before the end of 2014. As we have indicated to Commission Staff in the past, raising equity capital through the issuance of common stock is difficult for an organization like OCC, given OCC's ownership and governance structure. We determined that increasing our retained earnings by eliminating clearing fee

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[39] Proposal at 29616.

[40] Proposal at 29548.

[41] Proposal at 29548-49.

[42] OCC By-Laws, Article IX, Section 9.

[43] Release No. 34-71769 (March 21, 2014), 79 FR 17214 (March 27, 2014) (SR-OCC-2014-05).

discounts was the most certain and pragmatic approach to generating adequate resources to generate a six-month cushion over the short term.

OCC is also in the process of evaluating the use of appropriately structured preferred stock as a part of our longer-term capital plan. We believe that, for example, non-cumulative preferred stock that is redeemable at OCC's discretion after five years should be considered an appropriate source of "equity" funding under the rule. This would be a highly efficient and effective mechanism for OCC to comply with the rule. If the Commission agrees, we request that the Commission affirmatively state its agreement in the final rules release. We look forward to ongoing discussions with the Commission and Commission Staff concerning our long-term capital plans.

It may also be appropriate, as an alternative to having capital on our balance sheet, for OCC to have a buffer, such as a contingent capital arrangement, that would require OCC's clearing members and/or its equity exchanges to infuse capital if OCC were to experience capital losses necessitating a call for such contributions. We believe that a committed contingent funding plan, in which exchanges, clearing members or other financially sound third parties agree to contribute additional funds, should be sufficient to satisfy the equity funding requirement. As with the issuance of preferred stock, the terms of any such contingent funding plan would be subject to approval by the Commission.

We are aware that contingent funding arrangements requiring clearing members to contribute additional capital during a period of market stress would be pro-cyclical, requiring contributions at the same time clearing members are likely to most stressed by having to make such contributions. We also intend to consider our equity funding in the overall context of our default waterfall. Any policies and procedures that we adopt in fulfilling our obligations under Rule 17Ad-22(e)(15) would be appropriately considered in the broader context of the safety and soundness of OCC and with a view toward not raising systemic risk concerns for the broader financial markets.

As we have previously indicated in comment letters to CPSS-IOSCO and to the Board, we believe that, in calculating its six-month liquid asset coverage, a CCP should be allowed to include revenues that are projected to be received by the CCP over the same six-month period, subject to an appropriate haircut. In either a wind-down or a recovery scenario, OCC would expect to continue to generate revenues through fees payable to OCC on transactions entered into for the purpose of closing open positions in cleared contracts. In a recovery scenario, OCC would expect to set its fees, and/or adjust its discount policy, at the level necessary to generate the revenue necessary to allow OCC to continue to operate. Given that OCC is the sole clearing organization for all securities options exchanges in the United States, OCC believes it would be in a position to make significant adjustments to its fees, if necessary to support a recovery plan.

IX. Tiered Participation Agreements

Proposed Rule 17Ad-22(e)(19) would require a covered clearing agency to have policies and procedures reasonably designed to identify, monitor and manage the material risks to the covered clearing agency arising from arrangements in which firms that are indirect participants rely on the services provided by direct participants to access the CCA's payment, clearing or settlement facilities.[44] On its face, this rule does not require a CCA to collect and monitor customer-by-customer information with respect to cleared transactions or to manage risks on a customer-by-customer basis. However, we are concerned that the Proposal could be interpreted as requiring a CCA to obtain information from its clearing members identifying with specificity each of the customers attached to each cleared transaction and to routinely monitor customer-level risks with respect to each such customer. While we agree that a CCA should have the ability to gather certain information from its direct participants, we do not believe it is appropriate for a CCA to routinely police the systemic risks created by each indirect participant in the CCA. We acknowledge that circumstances may make it necessary or appropriate for a CCA to monitor the systemic risk created by one or more significant indirect participants on a case-by-case basis. CCAs are not generally in the position to track, analyze and regulate the various interdependencies that arise under the current clearing framework for specific indirect participants. The direct participants are better positioned to monitor the risks posed by indirect participants, and it is those direct participants who should be required to routinely monitor customer-level risks, and not the CCA, which is a step removed and not well positioned to monitor all customers of clearing members. For CCAs to fulfill this role would be extremely costly to the CCAs. They lack the information or infrastructure to perform this function. Further, requiring CCAs to monitor customer-specific risks would be largely duplicative of activities already undertaken by the relevant regulators and self-regulatory organizations. The existing approach has worked well and we believe it to be the appropriate approach going forward.

X. Implementation Timing

We look forward to working with the Commission and Commission Staff to ensure OCC is in compliance with the final rules implemented as a result of the Proposal. We ask the Commission to provide sufficient time for CCAs to implement the requirements with respect to equity capital funding pursuant to proposed Rule 17Ad-22(e)(15). As the Commission estimates in Table 2 accompanying the Proposal, OCC may need to raise in excess of $60 million of equity capital if the Proposal is adopted in its current form. While OCC is already working on plans to raise equity capital, those plans will require a sufficient amount of lead time to implement. We currently believe that we would be in a position to comply with Rule 17Ad-22(e)(15) by no later than January 1, 2015 and we do not believe the Commission should adopt a more aggressive implementation deadline for that rule.

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[44] Proposal at 29553.

OCC appreciates the opportunity to comment on the Proposal. We would be pleased to provide the Commission with any additional information or analysis that might be useful to the Commission in adopting final rules and we look forward to working with the Commission and Commission Staff in implementing the rules.

Very truly yours,

James E. Brown

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