BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

In the Matter of The Options Clearing Corporation **For an Order Granting the Approval of** Proposed Rule Change 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 (File No. SR-OCC-2015-02)	File No. SR-OCC-2015-02

Petitioners' Submission on Remand from the United States Court of Appeals for the District of Columbia Circuit in Opposition to Proposed Rule Change 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

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Pursuant to the September 14, 2017 Corrected Order Scheduling Filing of Statements of Review issued by the Securities and Exchange Commission (the "Commission") and the November 13, 2017 Order Granting Motion to Substitute Parties and Motion for Extension of Time, Petitioners Susquehanna International Group, LLP, BOX Options Exchange LLC, Miami International Securities Exchange, LLC, Virtu Financial Inc., and Virtu Americas LLC (collectively, "Petitioners"), hereby submit this statement urging the Commission to disapprove the capital plan (the "Plan") proposed by the Options Clearing Corporation ("OCC").

INTRODUCTION

In its most recent submission, OCC appears to invite the Commission to repeat the errors that resulted in the D.C. Circuit unanimously striking down its prior approval of the Plan. OCC, for example, defends the rate of return the Plan pays to the shareholder exchanges—an absolutely critical issue in this proceeding—largely by appealing to the process used to develop and approve that rate of return.[1] But the D.C. Circuit expressly rejected such "trust the process" reasoning,[2] and defending the rate of return is impossible given that OCC set a rate of return that fluctuates in correlation to OCC's ever-growing operating expenses rather than a dividend set at a predetermined rate. Moreover, as Petitioners demonstrate, OCC's process was deeply flawed, both because OCC cut the nonshareholder exchanges out of the deliberative process in violation of its own bylaws and also because the shareholder exchanges appear to have used their veto power to extract unreasonable and anticompetitive concessions from OCC. In addition, in responding to the charge that the Plan harms investors and the public interest by slashing the refunds provided to clearing members, OCC once again offers the unsupported assertion that

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[1] *See* OCC's Post-Remand Submission to the Comm'n in Supp. of the Re-Approval of the Capital Plan at 18, 21 (Oct. 16, 2017) ("OCC Submission").
[2] *Susquehanna Int'l Grp., LLP v. SEC*, 866 F.3d 442, 447 (D.C. Cir. 2017).

"possibly a significant portion" of clearing-member refunds are not passed through to end-user customers in an attempt to convince the Commission to take the economically illiterate approach of considering upfront fees rather than net fees when evaluating the Plan.[3] But the D.C. Circuit flatly rejected this gambit the last time OCC tried it.[4]

Indeed, the overriding theme of OCC's submission is that we have been here before—that "the Capital Plan has been approved three times by the Commission"[5] so it should be approved again. Yet those three prior approvals provide no basis for approving the Plan once more, because they were ultimately rejected by the D.C. Circuit for failing to "represent the kind of reasoned decisionmaking required by either the Exchange Act or the Administrative Procedure Act."[6]

In fact, the Court made pointed critiques of the Commission's prior approval order, and OCC's subsequent submission does not remediate these concerns. Among them, the Court asked: (1) how the Commission knows that OCC's consultants were independent; (2) what analysis OCC's Board performed; (3) how OCC measured the "level" of the dividends; (4) how OCC measured the "costs and risks" to the shareholder exchanges; and (5) how OCC determined that the dividend level was reasonable for the associated costs and risks.[7] OCC's submission leaves these questions effectively unanswered.[8]

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[3] OCC Submission at 17.
[4] *Susquehanna Int'l Grp.*, 866 F.3d at 450.
[5] OCC Submission at 1.
[6] *Susquehanna Int'l Grp.*, 866 F.3d at 443.
[7] *Susquehanna Int'l Grp.*, 866 F.3d at 446.
[8] With respect to the first question, for example, OCC emphasizes that Barclays assisted it in developing the Plan's $247 million capital target. But if Barclays loaned the shareholder exchanges proceeds for making their $150 million contribution toward the capital target, it had an interest in the outcome of its analysis. The record does not speak to that question.

The Court similarly noted that the Commission's approval order "does not analyze whether—or explain why—it is reasonable to allocate roughly half of unused fees to dividends, as opposed to using a different percentage or a formula other than a fixed proportion of unused fees."[9] OCC's submission likewise provides no basis for the reasonability of this arrangement. Instead, it merely points out that this was negotiated, despite the Court's finding that "it is hardly accurate to describe the negotiations between Board members as 'arm's length,' " a finding that OCC's submission does nothing to undercut.[10]

To the extent OCC's submission provides anything new, it is the Board materials included in OCC's confidential appendix. (OCC apparently provided some of these materials before, but the Commission did not purport to rely on them in its earlier decisionmaking, and this is the first time Petitioners have seen them.) These materials, however, simply underscore the deep flaws in OCC's Plan and its underlying capital need claims. To take just a few significant examples, the materials indicate (1) that OCC's advisors significantly underestimated the rate of return the Plan pays to the shareholder exchanges because of an error in the advisors' model; (2) that OCC knew that even this underestimated rate of return was double the rate in precedent deals; (3) that OCC understood that the Plan would transform OCC from a "zero-profit" market utility into a profit-making enterprise; (4) that OCC's advisors projected that OCC would meet its "regulatory capital requirement" by the end of 2014 without collecting a single dollar from the shareholder exchanges; and (5) that OCC settled on a target capital amount much higher than the regulatory requirement through a rushed and admittedly flawed modelling process that

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[9] *Id.* at 447.
[10] *Id.*

sought to quantify risks with an implausible and vanishingly small likelihood of ever coming to pass.

Experience has likewise confirmed the deeply flawed and unfair nature of OCC's Plan. Under that Plan, the shareholder exchanges invested in OCC, a public utility with a Standard & Poor's AA+/Stable credit rating.[11] During the Plan's first two years, the shareholder exchanges received dividends of 13.3% and 17.1% for their investment in the AA+/Stable rated OCC.[12] By comparison, the United States of America sovereign debt has the exact same AA+/Stable rating from Standard & Poor's.[13] The yield on AA+/Stable rated United States debt is commonly referred to as "the risk free rate," and the recent yield on Ten Year United States Treasuries was approximately 2.37%.[14] Thus, the concession by OCC's financial advisors that the Plan would alter OCC's historic "zero profit" operating model was a significant understatement. In fact, the Plan has destroyed OCC's historic role as a public utility by creating a for-profit monopoly with exorbitant returns and perverse incentives that increase the dividends paid to the shareholder exchanges as OCC's operating expenses rise. Predictably, OCC's expenses have skyrocketed since the Plan's adoption such that OCC's 2016 actual expenses exceeded OCC's projected 2018 expenses by more than Redacted

The Court noted that the question of whether the OCC plan pays dividends to shareholder exchanges at a reasonable rate is a central issue, noting that windfall dividends could cause the Plan to "run afoul of the Exchange Act's prohibitions by unnecessarily or inappropriately burdening competition, harming the interests of investors and the public, or unfairly

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[11] OCC, 2016 ANNUAL REPORT at 6, https://goo.gl/Zrdv1S ("2016 ANNUAL REPORT").
[12] *See id.* at 26.
[13] *See Sovereign Ratings List*, S&P GLOBAL RATINGS (Aug. 3, 2017), https://goo.gl/wcWN3m.
[14] *See* Daily Treasury Yield Curve Rates, goo.gl/1FgSfz (yield for Nov. 29, 2017).

discriminating against nonshareholders and clearing members."[15] History proves that the Plan's usurious returns and perverse structure unquestionably add costs into the options marketplace which do exactly that. As a result, OCC once again fails to justify the Plan because such an improperly structured plan that so distorts the options marketplace cannot be justified.

For these reasons and those discussed further below, the information before the Commission conclusively demonstrates that the Plan violates several requirements of the Exchange Act. The Commission must therefore disapprove it.[16]

ARGUMENT

I. The Plan Must Be Rejected Because OCC Violated Its Own Bylaws in Adopting It.

A. The Exchange Act authorizes the Commission to approve proposed changes to OCC's rules only if it finds that the proposed changes are consistent with the Act's requirements,[17] which include the requirement that OCC "comply with . . . *its own* rules."[18] That

[15] *Susquehanna Int'l Grp.*, 866 F. 3d at 446.
[16] Petitioners hereby incorporate by reference each of their prior submissions before the Commission and in their petition for review before the D.C. Circuit. *See, e.g.*, Letter from Tony McCormick, Chief Executive Officer, BOX Options Exchange (Feb. 19, 2015); Letter from Howard L. Kramer on behalf of Belvedere Trading, CTC Trading Group, IMC Financial Markets, Integral Derivatives, Susquehanna Investment Group & Wolverine Trading (Feb. 20, 2015); Letter from Barbara J. Comly, Executive Vice President, General Counsel & Corporate Secretary, Miami International Securities Exchange, LLC (Feb. 24, 2015); Letter from John A. McCarthy, General Counsel, KCG Holdings, Inc. (Feb. 26, 2015); Letter from John A. McCarthy, General Counsel, KCG Holdings, Inc. (Feb. 27, 2015); Letter from Richard J. McDonald, Chief Regulatory Counsel, Susquehanna International Group, LLP (Feb. 27, 2015); Letter from Barbara J. Comly, Executive Vice President, General Counsel & Corporate Secretary, Miami International Securities Exchange, LLC (Mar. 1, 2015); Letter from Tony McCormick, Chief Executive Officer, BOX Options Exchange (Mar. 3, 2015); and Letter from Brian Sopinsky, General Counsel, Susquehanna International Group, LLP (Mar. 4, 2015); Letter from SIG (Aug. 25, 2017); *see also* Final Opening Brief of Petitioners, *Susquehanna Int'l Grp.*, No. 16-1061 (D.C. Cir. Oct. 14, 2016), ECF No. 1641118; Final Reply Brief of Petitioners, *Susquehanna Int'l Grp.*, No. 16-1061 (D.C. Cir. Oct. 14, 2016), ECF No. 1641119.
[17] 15 U.S.C. § 78s(b)(2)(C)(i).
[18] *Id.* § 78s(g)(1) (emphasis added).

requirement is not met here because OCC violated its own bylaws when developing and adopting the Plan.

OCC's bylaws require that nonshareholder exchanges "be promptly provided with information that the Executive Chairman considers to be of competitive significance" to them.[19] Those bylaws also require that the nonshareholder exchanges "be afforded the opportunity to make presentations to the Board of Directors or an appropriate Committee of the Board of Directors" regarding matters that affect their interests.[20]

OCC violated these requirements during its development of the Plan. Despite the obvious competitive significance of the information under consideration, at no point during the process did the Board provide the nonshareholder exchanges with notice. Nor were the nonshareholder exchanges ever afforded the requisite opportunity to make presentations to the Board of Directors or to the Committees that participated in the process by which the Plan was devised and approved.

OCC's disregard for Sections 1.01 and 1.02 of Article VIIB resulted in precisely the type of anticompetitive harm that the Commission intended those bylaws to prevent. Both bylaws were adopted by OCC in 2002 when it was seeking SEC approval of its decision to bar new options exchanges from becoming shareholders. In approving this decision despite the obvious potential anticompetitive implications of shutting out emerging exchanges from ownership, the Commission emphasized the importance of these bylaws:

> [The fact that] OCC's management will provide non-equity exchanges with the opportunity to make presentations to the OCC board and will promptly pass on to non-equity exchanges any information disclosed at or in connection with OCC board meetings that management considers to be of competitive significance should

[19] OCC Bylaws, Art. VIIB § 1.01 (2002), https://goo.gl/PNrE79
[20] *Id.* at Art. VIIB § 1.02.

> help to ensure that no burden on competition that is not necessary or appropriate in furtherance of the Act will occur.[21]

Because OCC violated these bylaws, the Plan must be rejected.

B. OCC counters that its Executive Chairman's discretion is unreviewable, because the bylaw in question predicates the notice requirement on the Executive Chairman's "determin[ation]" that information is of competitive significance.[22] But the bylaw's language cannot bear the weight OCC would place upon it.

To begin, at a bare minimum the requirement that nonshareholder exchanges "be promptly provided with information that the Executive Chairman considers to be of competitive significance" implies a requirement that the Executive Chairman actually determine whether particular information bears such competitive significance. There is no evidence that the Executive Chairman made any such determination here. His declaration simply says that "in the exercise of my business judgment, I never considered the Capital Plan to be of competitive significance to the Non-Equity Exchanges."[23] But this does not establish that he actually made a determination that the Plan was not competitively significant; and it is just as consistent with his never having made a determination one way or the other as it is with his affirmatively determining that the Plan was not competitively significant.

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[21] Order Granting Approval of a Proposed Rule Change Relating to Providing Clearing Servs. to Options Exch. That Are Not Stockholders, Release No. 34-46469 (Sept. 6, 2002), 67 Fed. Reg. 58093, 58095 (Sept. 13, 2002).

[22] OCC also points to a bylaw authorizing its Board to "make such interpretations of the By-Laws . . . as it may deem proper," OCC Submission at 25, but this is a red herring—there is no evidence that the Board ever made the interpretation of the bylaw pressed by OCC here, and even if it had, such an interpretation would be reviewable by the Commission for substantive and procedural reasonableness.

[23] Declaration of Craig S. Donohue ¶ 22 (Oct. 16, 2017) ("Donohue Decl.") (attached to OCC Submission).

Furthermore, the requirement that the Executive Chairman determine whether information is competitively significant does not grant the Chairman an unconditional license to engage in arbitrary and capricious decisionmaking; rather, any such determination must be procedurally and substantively reasonable. Nor does this requirement relieve the Commission of its duty to review the Executive Chairman's determination and ensure its procedural and substantive reasonableness. To the contrary, just as matters that the Exchange Act charges the Commission with determining in the first instance are subject to judicial review under,[24] so too this matter that OCC's bylaws charge the Executive Chairman with determining in the first instance is subject to review by the Commission under the Exchange Act. The D.C. Circuit has made clear, moreover, that when engaging in such review the Commission cannot blindly defer to a regulated entity's "business judgment."[25]

Here, OCC failed to inform the nonshareholder exchanges that it was considering increasing capital by accepting capital contributions from the shareholder exchanges in exchange for significant dividend payments. OCC provides no evidence that the Executive Chairman made any determination that this information lacked competitive significance or, if he made such a determination, what factors he considered in making that determination. Even if the Chairman actually made such a determination, it would have been plainly unreasonable, for the competitive significance of the information is obvious. Indeed, it is difficult to think of information *more* competitively significant to the nonshareholder exchanges than the fact that OCC was considering for the first time making regular equity distributions to the shareholder exchanges

[24] *See, e.g.*, 15 U.S.C. §§ 78s(b)(2)(C)(i), 78y(a)(i).
[25] *See Bradford Nat'l Clearing Corp. v. SEC*, 590 F.2d 1085, 1113 (D.C. Cir. 1978).

and abandoning what OCC itself called its "zero profit" model.[26] To the extent those distributions were unreasonably large (as turned out to be the case), they had the prospect of putting the nonshareholder exchanges at a competitive disadvantage.

OCC argues that the Plan was not of competitive significance because it only calls for shareholder exchanges, and not nonshareholder exchanges, to make capital contributions. But this is a principal reason *why* the development of the Plan was of competitive significance. The exclusive opportunity of the shareholder exchanges to commit capital—and receive the corresponding compensation for that capital—is what provides the Plan with the potential to tilt the playing field in the shareholder exchanges' favor.

C. OCC also attempts to excuse its violation of its bylaws by arguing that the nonshareholder exchanges were not prejudiced because, even though they had no opportunity to participate in the development of the Plan before OCC, they nonetheless have an opportunity to participate in the review process before the Commission. But participation in the review process is no substitute for the right to participate in the deliberative process. The bylaws mandate that the nonshareholder exchanges must have an opportunity to participate in and potentially help shape and influence matters of competitive significance *before* they are decided upon. The ability to participate in an administrative review process—where the outcome is a binary thumbs up or thumbs down—is not an adequate substitute.

D. OCC finally argues that these bylaws are procedural and that this somehow shields OCC from any consequences for violating them. But the bylaws are not merely procedural; they provide substantive protection to the nonshareholder exchanges. Regardless, as

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[26] BARCLAYS CAPITAL INC., PROJECT OPTIMAL: ANALYSIS OF CAPITAL RAISE ALTERNATIVES 2 (Dec. 8, 2014).

explained above, the Commission can only affirm the Plan if it determines that it is consistent with the Exchange Act, including the Exchange Act's requirement that OCC follow its own rules. That requirement was violated here, and the Plan therefore must be rejected.

II. The Plan Must Be Rejected Because It Imposes an Undue Burden on Competition and Was Not Designed To Promote Competition.

The Commission must reject the Plan unless it determines, for itself, that the Plan does "not impose any burden on competition not necessary or appropriate in furtherance of the purposes of" the Exchange Act.[27] Furthermore, in deciding whether to approve the Plan, the Commission must move beyond the question of burdens to competition to consider whether the Plan affirmatively "will *promote* . . . competition."[28] The Plan cannot satisfy these requirements. To the contrary, the Plan imposes a significant and unwarranted burden on competition by generally requiring that half of excess clearing fees resulting from options trades executed on *any* of OCC's member exchanges will be used to pay dividends to the shareholder exchanges—but not to OCC's nonshareholder exchanges. Indeed, the more options trades the *nonshareholder exchanges* generate, the larger the dividend that will be paid to the *shareholder exchanges*. The new profit maximizing monopoly model thus burdens (and certainly does not promote) competition because it gives the shareholder exchanges an unfair advantage not available to nonshareholder exchanges in the concededly "fierce" and "intense" competition for order flow.[29] Indeed, consolidation in the exchange marketplace has already taken place while the Plan has been in effect, as former Petitioner Bats Global Markets has been acquired by CBOE Holdings,

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[27] 15 U.S.C. § 78q-1(b)(3)(I).
[28] *Id*. § 78c(f) (emphasis added).
[29] OCC Submission at 19.

the owner of one of the shareholder exchanges.[30] OCC's attempts to defend the Plan's dividends lack merit.

A. OCC's Submission Confirms that the Dividend Rate Is Unreasonable.

1. The D.C. Circuit made abundantly clear that the Commission cannot simply "trust the process" undertaken by OCC when evaluating the propriety of the Plan's dividend provisions.[31] The D.C. Circuit gave several reasons for this holding, including that OCC sat on both sides of the table and the nonshareholder exchanges sat on neither.[32] "More fundamentally," however, the D.C. Circuit reasoned that the Exchange Act requires the Commission itself to undertake an "examination of the substance of the Plan," not just the process by which it was adopted.[33] OCC, incredibly, responds by arguing . . . trust the process. Its most recent submission says nothing about the substantive reasonableness of the rate of return provided by the Plan's dividend provisions, which it confirms is substantial; indeed, the shareholder exchanges received

[30] *See* Press Release, CBOE Holdings Agrees to Acquire Bats Global Markets to Strengthen CBOE Holdings' Global Position in Innovative Tradable Products, and Services, and Achieve Meaningful Cost and Operational Efficiencies (Sept. 26, 2016), https://goo.gl/VAf7DW. OCC has challenged any connection between this acquisition and the Plan, but this is belied by the fact that a joint proxy statement/prospectus prepared by Bats and CBOE Holdings encouraging the companies' shareholders to approve the transaction includes the following statement in a section entitled "Risks Relating to Bats":

> [A] rule change recently adopted by the . . . OCC . . . and affirmed on review by the SEC in February 2016, concerns a capital plan that could effectively allow the OCC's stockholder exchanges, which include CBOE, ISE, NASDAQ and NYSE, to monetize for their benefit the OCC's monopoly over options clearing. Bats believes that the capital plan has the potential to result in a wealth transfer from options investors to the OCC's stockholder exchanges, stifling future competition in the options market and increasing the costs of trading listed options.

Joint Proxy Statement/Prospectus at 54–55 (Dec. 9, 2016), goo.gl/iY27jP.

[31] *Susquehanna Int'l Grp.*, 866 F.3d at 447.

[32] *See id.* at 448.

[33] *Id.*

$25.6 million in 2017,[34] or a 17.1% rate of return on their capital contribution of $150 million into the AA+/Stable rated OCC.[35] Instead, OCC doubles down on its discredited process-based arguments: "That compensation, in the form of after-tax dividends, was negotiated by an Advisory Group made up predominantly of OCC Board members who were not representatives of Stockholder Exchange[s]."[36] And again: "OCC's Board reviewed the risks to the Stockholder Exchanges' capital contribution and the Replenishment Capital Commitment with the assistance of Barclays and Oliver Wyman, and concluded that the dividends to be paid were reasonable compensation for those risks."[37] These arguments provide no basis for *the Commission* to determine that the Plan's dividends are reasonable, and for that reason alone the Plan should be rejected.[38]

The materials included in OCC's appendix further undermine the Plan's dividend provisions. For example, a Barclays presentation dated December 5, 2014 includes projections of the expected internal rate of return to the shareholder exchanges for their contribution of capital. In the base case, Barclays estimated that rate to be 11.7% or 13.7%, depending on the method by

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[34] 2016 ANNUAL REPORT at 28.
[35] OCC Submission at 21. OCC also asserts that the shareholder exchanges received approximately $17 million in 2016, *id*., but the actual amount was $19.7 million, *see* 2016 ANNUAL REPORT at 29.
[36] OCC Submission at 18.
[37] *Id*. at 21.
[38] OCC's conclusory arguments do not even provide the bases for its own conclusion that the dividends were reasonable. It does not identify the risks of the capital contribution, let alone assign valuations to those risks or provide a valuation methodology. Nor does it provide the criteria, data inputs, and methodology for determining that the dividends were reasonable compensation for those risks. Significantly, OCC does not claim that Barclays and/or Oliver Wyman opined that the dividends were reasonable, merely that the OCC Board concluded it (i.e., "trust the process"). Moreover, it must be kept in mind that the OCC Board did not approve any level of dividends at all; it approved a process to arrive at indeterminate dividends, and OCC provided no basis for concluding that the process is reasonable.

which it was calculated.[39] But the Barclays analysis was fundamentally flawed in two ways: first, it based its projections on the assumption that the shareholder exchanges would contribute *$222 million*, not the $150 million that they actually contributed.[40] The mismatch between the Barclays analysis and the actual terms of the Plan further undermines OCC's "trust the process" arguments, as the "process" relied on an estimated rate of return that was based on a faulty understanding of how much capital the shareholder exchanges would contribute. In addition, the Barclays internal-rate-of-return analysis further underestimates the dividend rate because in calculating the value of the dividends to the shareholder exchanges, Barclays subtracted the amount of taxes the shareholder exchanges were expected to pay on those dividends after receiving them.

These issues can be addressed by using Barclays' own projections of the dividends OCC would pay and the $150 million actually contributed by the shareholder exchanges to estimate an annual dividend rate. As the chart below shows, that rate is considerably higher than the internal rate of return shown in the Barclays presentation, and it is more in line with what the shareholder exchanges actually received in 2017—and it is expected to grow moving forward:

Year	**Dividend Paid to Exchanges (millions)[41]**	**Rate (dividend/$150 million)**
2015	$25.50	17.00%
2016	$25.00	16.67%
2017	$25.60	17.07%
2018	$25.40	16.93%
2019	$25.50	17.00%
2020	$26.30	17.53%
2021	$27.20	18.13%

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[39] BARCLAYS, PROJECT OPTIMAL ALTERNATIVE CAPITAL RAISE: PROPOSAL ANALYSIS 4 (Dec. 5, 2014).
[40] *Id.*
[41] *Id.*

2022	$28.10	18.73%
2023	$29.00	19.33%
2024	$29.90	19.93%

The Barclays presentation also demonstrates that these rates of return are unreasonably high. Another slide, titled "Contingent Capital – Precedent Deals," lists a number of other transactions with much lower payment rates—an average rate of 5.98%.[42] OCC apparently thought it was giving the shareholder exchanges a return of approximately two times this rate, which is bad enough, but the chart above shows that in actuality it was three times. Either way, this information demonstrates that the rate of return given to the shareholder exchanges was unreasonable.[43]

Of course, OCC had—and knew that it had—less expensive options for raising capital. OCC could have issued a new class of common stock or preferred securities and sold them to clearing members, to the exchanges, or even to the general public. In 2014, OCC itself informed the Commission that it was in the process of evaluating the use of appropriately structured preferred stock as a part of its capital plan and that "non-cumulative preferred stock that is redeemable at OCC's discretion after five years . . . would be a highly efficient and effective mechanism for OCC to comply with the rule."[44] One of the presentations made to the Board by Barclays confirms that preferred stock could also be used to provide "bridge" financing, at least for replenishment capital.[45] One of the shareholder exchanges offered to provide OCC with a

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[42] *Id*. at 14.
[43] As explained below, the shareholder exchanges' commitment to provide replenishment capital in extremely remote circumstances does not alter this conclusion.
[44] Letter from OCC to Kevin O'Neill, Deputy Secretary, SEC, 14 (May 27, 2014).
[45] BARCLAYS, ANALYSIS OF CAPITAL RAISE ALTERNATIVES at 6.

capital infusion at an 8% to 9% annual rate of return over a certain fixed period of time, an alternative far more favorable—and that imposes a far smaller burden on competition—than the Plan, which provides for a substantially higher, and ever increasing, rate of return to be paid in perpetuity.[46] Yet another alternative would have been to set the dividend at a predefined rate; Susquehanna itself has offered to contribute $150 million to OCC at LIBOR + 3%.[47] Because OCC instead set the dividend such that it increases with fees rather than as a predetermined rate applied to the funds contributed by the shareholder exchanges, it is impossible to conclude that the dividend rate is reasonable because no one knows for sure just how high that rate will reach.[48]

OCC also could have met its capital target simply by retaining excess fees.[49] Indeed, in December 2015, shortly after accepting the shareholder exchanges' $150 million capital contribution, OCC announced not only that it would be reducing fees but also that it would be

[46] *See* Affidavit of Joel Greenberg ¶¶ 9–10 (Oct. 7, 2015), *Susquehanna Int'l Grp.*, No. 16-1061 (Sept. 29, 2016), ECF No. 1638347 (submitted by Susquehanna Int'l Grp. before the SEC on Sept. 29, 2016).
[47] *See* Letter from David M. Pollard, Head of Strategic Planning and Special Counsel, Susquehanna Int'l Grp. to OCC Board of Directors at 1 (Aug. 25, 2017) (attached as Exhibit B to Aug. 25, 2017 SEC submission).
[48] Susquehanna's prior filings, for example, have shown based on OCC's own projections in its prior submissions that the return on investment percentage rates will rise into the 20s and 30s in the near future. *See* Susquehanna Int'l Grp., LLP Petition for Review of Order Made Pursuant to Delegated Authority Approving Proposed Rule Change By Options Clearing Corporation at 11 (Mar. 20, 2015). In addition, without the disclosure of the shareholder exchanges' cost of capital, analysis of the shareholder exchanges' rate of return would be frustrated even if it were set at a defined rate.
[49] Letter from Howard Kramer, on behalf of Belvedere Trading, CTC Trading Group, IMC Financial Markets, Integral Derivatives, Susquehanna Investment Group, and Wolverine Trading, to Brent J. Fields, Secretary, SEC, 6–7 (Feb. 20, 2015); Letter from Ellen Greene, Managing Director, Financial Services Operations, SIFMA, to Brent J. Fields, Secretary, SEC, 4 (Feb. 20, 2015).

paying out $161 million in refunds and dividends.[50] The announcement of such a large capital distribution so soon after accepting the shareholder exchanges' contribution belies any suggestion that OCC could not have raised capital fast enough by simply retaining fees. In all events, any suggestion that time was of the essence is difficult to take seriously, for nothing in the record suggests that OCC faced, for the first time in its history, a need to tap into its pre-existing and rapidly increasing capital reserves to meet operating expenses—let alone an imminent need to do so.

Given the ready availability of these alternatives, it would be reasonable to conclude that OCC adopted the Plan because the shareholder exchanges saw an opportunity to obtain an unreasonable rate of return, payable exclusively to themselves, and threatened to veto any alternative that gave them anything less than everything they wanted. Indeed, OCC's Executive Chairman confirms that (a) "*all* Stockholder Exchanges were required to vote for [the Plan] in order for it to be passed," (b) the "Stockholder Exchanges represented to OCC that they *required* payment of the dividend described above as an incentive to participate in the Plan," and (c) that the "Stockholder Exchanges *have no obligation* to admit additional stockholders to OCC under its governing documents."[51] Each and every shareholder exchange had absolute veto power over the terms of the Plan, as well as the power to prohibit anyone else from participating in it or even contributing equity to OCC. They wielded that power to extract an unreasonably favorable deal

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[50] Press Release, OCC, OCC Declares Clearing Member Refund and Dividend for 2015 and Reduction of Fees under Approved Capital Plan (Dec. 17, 2015), goo.gl/68sisq.
[51] Donohue Decl. ¶¶ 11, 18, 20 (emphases added). The fact that the shareholder exchanges' chose to exclude other investors undercuts the assertion that their investment in OCC is a risky one. If it were, presumably the shareholder exchanges would be eager to share that risk with others.

for themselves. The result is a Plan that places an unnecessary and inappropriate burden on competition and must therefore be rejected under the Exchange Act.[52]

2. Despite acknowledging that the competition between the shareholder and nonshareholder exchanges is “fierce” and “intense,” OCC insists that the Plan does not burden competition at all, even though it uses fees that are generated by clearing trades executed on both the shareholder and nonshareholder exchanges to provide the shareholder exchanges alone with a subsidy.[53] This argument simply makes no sense. A company in a fiercely competitive field that is given a subsidy that it can use to lower prices, increase services, or build a war chest to use as it sees fit plainly obtains an unfair advantage over its competitors. Remarkably, OCC goes so far as to suggest that the Plan is competition *enhancing* because it may allow the shareholder exchanges to decrease their prices. But that is precisely the point—the shareholder exchanges will be able to use the monopoly profits of OCC to obtain an advantage over the nonshareholder exchanges in the fiercely competitive exchange marketplace.[54]

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[52] OCC takes exception to the argument that its investment is “risk free.” But, of course, what the OCC ultimately needs to show is that the return on the shareholder exchanges’ investment is a reasonable one, not simply that there was some theoretical risk to their capital, no matter how small. And for all the reasons we have given, OCC has failed to justify the outsized dividends it is paying the shareholder exchanges. Furthermore, the principal “risk” that OCC claims for the capital contribution is the assertion that it is illiquid. But this assertion does not negate the risk-free nature of the investment, and it ignores (1) OCC’s admission that it “has all the tools” to ensure that any replenishment capital is repaid timely, OCC Submission at 23, which tools are equally applicable to its target capital; and (2) the reality that the only reason the investment is illiquid is because OCC sought to exclude anyone other than the shareholder exchanges from participating in the sweetheart deal.

[53] OCC Submission at 19.

[54] Contrary to OCC’s contention, *see* OCC Submission at 20 n.42, there is nothing inconsistent between this argument and the argument that the Plan will increase net fees. As discussed below, by tying dividends to fees the Plan creates a systemic incentive for OCC to increase fees to benefit its owners with increased dividends. These increases would be felt across the board by customers of all exchanges, shareholder and nonshareholder alike. The shareholder exchanges,

B. OCC's Submission Confirms that the Capital Required by the Plan Is Unreasonable.

Because the dividends the Plan pays to the shareholder exchanges are unreasonable, the Commission must reject the Plan on account of the undue burden it places on competition. But there is another problem with the Plan's dividend provisions. OCC's basis for requiring the dividends in the first place—the shareholder exchanges' capital commitments—is itself faulty.

1. OCC argues that "OCC's Board determined based on [an Oliver Wyman] analysis that OCC needed an additional $222 million of capital immediately on hand" on top of its preexisting $25 million capital reserve, and that it "is therefore required by Rule 17Ad-22(e)(15) to maintain this level of capital funded by equity."[55] This argument is incorrect.

OCC is wrong when it insists that Rule 17Ad-22(e)(15) immediately required it to hold a total of $247 million of capital. For one thing, the Rule was only a proposal at the time, did not become effective until December 12, 2016, and required compliance only by April 11, 2017.[56] More important, the Rule simply requires "cover[ed] clearing agencies to maintain sufficient capital funded by equity 'equal to the greater of either six months of [its] current operating expenses or 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.' "[57] A September 2014 Barclays' presentation makes clear that for OCC this amount was not $247 million. Instead, this amount—which Barclays called the "Regulatory Capital Requirement"—

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however, could offset these increases to a certain extent by using the outsized dividends they are receiving to fund decreases to their own prices or to invest in improvements to their services.

[55] OCC Submission at 14.

[56] *See* Standards for Covered Clearing Agencies, Release No. 34-78961, 81 Fed. Reg. 70786-01, 70786 (Oct. 13, 2016).

[57] OCC Submission at 14 n.26 (quoting 17 C.F.R. § 240.17Ad-22(e)(15)).

was $106 million.[58] What is more, Barclays "estimated that OCC [would] be in compliance with the Regulatory Capital Requirement . . . by the end of 2014 through retention of earnings."[59] This presentation demonstrates that OCC's reliance on the anticipated promulgation of the Commission's capital rules lacks merit, as OCC could easily have met (and, in fact, did meet) the "Regulatory Capital Requirement" in a timely manner without having to raise a dime from the shareholder exchanges.

Instead of calculating its capital needs based on the requirements of Rule 17Ad-22(e)(15), OCC asked Oliver Wyman to perform "a bottom-up analysis of risks at OCC" and to "quantif[y] the appropriate amount of capital to be held against each risk."[60] This is not the analysis required by the Commission's rules. Yet even this analysis suffered from a number of apparent flaws.

First, it appears that Oliver Wyman's analysis was marked by several shortcomings possibly attributable to the haste with which it was conducted. In a September 15, 2014 presentation, Oliver Wyman explained that "some of the assumptions" it had made were "simplifications to industry standard given the expedited timeframe for this initial modeling effort," and it emphasized that it would be "important" to "consider potential enhancements to the methodology going forward."[61] Examples of these shortcomings include that Oliver Wyman's procedures for "loss modelling" fell short of the "industry standard," which resulted in

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[58] BARCLAYS CAPITAL INC., PROJECT OPTIMAL THIRD UPDATE: AD HOC STRATEGIC ADVISORY GROUP DISCUSSION 13 (Sept. 30, 2014) ("PROJECT OPTIMAL THIRD UPDATE").
[59] *Id*. at 2.
[60] *Id*.
[61] OLIVER WYMAN, OPERATIONAL / BUSINESS RISK CAPITAL PLANNING SUPPORT: FINAL HANDOFF ADDENDUM 48 (Sept. 15, 2014).

"potentially conservative" results.[62] Using the industry standard approach to loss modelling, by contrast, would have had the "potential to decrease required capital."[63] Oliver Wyman also recognized a degree of "subjectivity in the final capital number" due in part to a "lack of internal data" used in its modelling.[64] Despite these shortcomings—and despite the fact that Oliver Wyman's presentation indicates that it was providing only "an initial capital estimate"—it does not appear that any "final capital estimate" was ever provided, or that any enhancements were made to the process moving forward, as the capital target ultimately included in the Plan simply accepts the preliminary loss estimates provided in this initial presentation.[65] OCC's submission does not even acknowledge—much less offer an explanation for—OCC's requirement that Oliver Wyman perform its analysis in such a hasty manner, nor OCC's apparent decision to ignore Oliver Wyman's recommendation that a more thorough analysis be conducted.

Second, the Oliver Wyman materials demonstrate that OCC chose to raise its capital to a level sufficient to protect itself against the threat of vanishingly remote risks. In its submission to the Commission, OCC states that "Oliver Wyman . . . conducted loss modeling at or above the 99% confidence level to determine the amount of capital required to address OCC's operational risks."[66] The appendix materials demonstrate that the phrase "or above" carries extraordinary weight in that statement, for "at" the 99% (1-in-100-year loss) confidence level, Oliver Wyman

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[62] *Id*. at 41.
[63] *Id*.
[64] *Id*.
[65] *Id*. at 4. Curiously, the $226 million loss estimate provided by Oliver Wyman in its September 12, 2014 report that was based on ninety-three different potential loss scenarios was just $2 million off the total capital initially recommended three months earlier in a June 2014 "placeholder" exercise by Barclays. *See* BARCLAYS CAPITAL INC., PROJECT OPTIMAL MONTH 1 UPDATE: AD HOC STRATEGY GROUP DISCUSSION 18 (June 17, 2014).
[66] OCC Submission at 6.

projected that OCC's operational loss risk was $105 million—a number almost exactly matching the regulatory capital requirement identified by Barclays, and a number that would not have required the shareholder exchanges to contribute any capital.[67] At the 99.5% (1-in-200 year loss) confidence interval, that figure increased modestly to $136 million.[68] It was only when the confidence interval was increased to 99.9% (1-in-1000-year loss) that the operational loss risk reached the $226 million figure that OCC eventually adopted.[69] (The target capital requirement combined this $226 million amount with $21 million in purported pension risk.[70])[71]

In short, OCC determined its preferred capital target by means different than the means used in the Commission's regulations, relied on an analysis that was conducted in haste and subject to significant express reservations and acknowledged shortcomings, and selected the most extreme risk scenario to arrive at a capital target more than double the regulatory capital requirement. Significantly, OCC in its submission to the Commission offers no argument in support of its determination to adopt a capital target based on loss scenarios with a 1 in 1,000 year chance of occurring—indeed, OCC does not even acknowledge that feature of the Plan, which is only reflected in the confidential appendix. Once again, OCC effectively invites the Commission to simply "trust the process."

2. These significant flaws in OCC's target capital requirement also undermine the relevance of the up to $200 million of replenishment capital that the shareholder exchanges have

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[67] PROJECT OPTIMAL THIRD UPDATE at 51.
[68] *Id.*
[69] *Id.*
[70] *Id.* at 12.
[71] As this explanation of the Oliver Wyman analysis should make clear, that analysis appears to have been focused simply on answering the question of what losses could occur in various scenarios, not on analyzing what amount of capital would need to be held to protect against those losses.

agreed to provide.[72] The Commission's regulations require OCC to maintain "a viable plan . . . for raising additional equity should its equity fall close to or below the amount required" to be held by the regulations.[73] As just discussed, Barclays determined that OCC's "Regulatory Capital Requirement" was $106 million. Thus, every dollar held above that amount—currently $141 million—essentially *is* replenishment capital. Furthermore, Oliver Wyman's analysis makes clear that it is extremely unlikely that the shareholder exchanges will ever be required to contribute additional replenishment capital—for that to happen OCC would have to suffer losses more extreme than those projected to occur in a 1-in-1000-year loss scenario. And even in the unlikely event that the shareholder exchanges were ever required to contribute replenishment capital, there is a substantial risk that they would not be able to provide that capital because, as Barclays recognized, "OCC and exchanges would likely face similar market challenges" and, thus, "in times of stress, as OCC's capital level is depleted, exchanges may be unwilling or unable to provide incremental capital as per the Plan."[74] Finally, given that OCC itself insists that it "has all the tools to ensure the Replenishment Capital is repaid [in a timely manner] by retaining earnings . . . and increasing fees to the extent necessary,"[75] it is unclear why OCC did not include these tools in a suite of options in addition to or in lieu of the existing, unreliable replenishment capital commitment. Indeed, the Commission recently approved a more flexible

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[72] OCC's submission provides no substantive argument or analysis in support of the amount it claims to need for replenishment capital, nor for any probability that the replenishment capital would be called upon or any metric to value the shareholder exchanges' replenishment capital commitment for purposes of determining reasonable compensation to the exchanges.
[73] 17 C.F.R. § 240.17Ad-22(e)(15)(iii).
[74] PROJECT OPTIMAL THIRD UPDATE at 21.
[75] OCC Submission at 23.

replenishment plan proposed by the DTC, NSCC, and FICC including these types of options (and others).[76]

For all of these reasons, the shareholder exchanges' replenishment capital commitment cannot be used to justify the massive dividend payments they are receiving.[77]

III. The Plan Must Be Rejected Because It Discriminates Against Nonshareholder Exchanges and Clearing Members and Treats Clearing Members Inequitably.

The Exchange Act also requires that OCC's rules "provide for the equitable allocation of reasonable dues, fees, and other charges among its participants,"[78] and it prohibits OCC from adopting rules "designed to permit unfair discrimination . . . among participants in the use of the clearing agency."[79] The Plan violates these requirements in several ways.

A. As an initial matter, the Plan unfairly discriminates between the shareholder exchanges and nonshareholder exchanges (and other participants such as clearing members, for that matter) by providing the shareholder exchanges with a lucrative investment opportunity that it denies to the nonshareholder exchanges and all other participants.

OCC attempts to justify this discriminatory treatment on the grounds that the shareholder and nonshareholder exchanges are "differently situated," because "the former have provided $150 million in capital and have committed to provide an additional $200 million under the

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[76] Order Approving Proposed Rule Changes, as Modified by Amendments No. 1, to Adopt the Clearing Agency Policy on Capital Requirements and the Clearing Agency Capital Replenishment Plan at 8–9, Release No. 34-81105 (July 7, 2017), https://goo.gl/uBJzg3.

[77] As explained below, if replenishment capital were ever to remain outstanding for over two years, the shareholder exchanges' divided rate would *double* because refunds would be permanently eliminated. This doubled rate of return—potentially as much as 40% annually—obviously is even less defensible than the already inflated dividend rate.

[78] 15 U.S.C. § 78q-1(b)(3)(D).

[79] *Id.* § 78q-1(b)(3)(F).

Capital Plan."[80] But that is precisely the point. The Plan provides an attractive and lucrative investment opportunity, but it provides it solely to the shareholder exchanges.

There also is no merit to OCC's argument that this inequitable treatment does not amount to discrimination in the "use" of OCC.[81] Use of OCC's services is essential to the business of both the shareholder and nonshareholder exchanges. While exchanges do not use OCC's services directly, their survival depends upon the use of those services because the clearing members that operate on the exchanges must be able to access them. And the Plan unfairly favors the shareholder exchanges, and the clearing members that operate on them, because it results in OCC paying unreasonably large dividends to the shareholder exchanges that the exchanges can in turn use to improve their services or decrease their prices (or both). The unfairness is exacerbated by the manner in which the dividends are funded. The money used to pay the dividends is obtained from the excess clearing fees collected from clearing members operating on all exchanges, shareholder and nonshareholder alike, but the dividend payments go exclusively to the shareholder exchanges. OCC effectively taxes the nonshareholder exchanges' customers to pay the shareholder exchanges. Indeed, the more business the nonshareholder exchanges generate, the higher the payments to the shareholder exchanges will be.

The fact that the shareholder exchanges had a right, under OCC's bylaws, "to decline to offer equity to any third party" is a likely factual explanation for *why* the Plan unfairly discriminates against nonshareholders,[82] but it cannot exempt the Plan from the Exchange Act's prohibition of such discrimination. Had the shareholder exchanges threatened to veto any capital plan if OCC did not agree, as part of that plan, to refuse to clear any trades carried out on one of

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[80] OCC Submission at 22.
[81] *Id.*
[82] *Id*.

the nonshareholder exchanges, the fact that the shareholder exchanges' consent could be won only by agreeing to such a discriminatory and anticompetitive condition obviously could not insulate that Plan from invalidation under the Exchange Act. The same holds true here, where the shareholder exchanges have used their veto power to provide themselves with an exclusive investment opportunity offering an exorbitant rate of return on their money.

Similarly, regardless of whether Barclays advised OCC that it would be more difficult and complex to raise capital in a way that did not privilege the existing shareholders over the nonshareholder exchanges,[83] that does not change the fact that the Exchange Act prohibits a capital plan that discriminates in this fashion. That complying with the law may, at times, be more difficult than breaking the law does not relieve one of the obligation to obey the law. (Additionally, OCC does not assert that the difficulty was prohibitive, nor provide any cost-benefit analysis for dismissing the alternative(s).) Furthermore, OCC cannot plausibly assert the illiquidity of the shareholder exchanges' investment as a justification for outsized dividends when that illiquidity results solely from OCC's acquiescence in the shareholders' demand for an exclusive investment opportunity.

B. In addition, the Plan unfairly discriminates and inequitably allocates fees and other charges in the manner in which it treats the entities that contribute capital to OCC. It does so in several ways.

First, OCC raised the capital necessary to meet the Plan's target capital amount by (a) retaining $72 million in excess clearing fees that otherwise would have been refunded to clearing

[83] OCC Submission at 22.

members, and (b) receiving $150 million from the shareholder exchanges.[84] While the shareholder exchanges have been handsomely rewarded for their investment, the clearing members received nothing whatsoever in return for theirs. Instead, they will see their future refunds slashed by at least 50%.

Second, OCC will maintain its capital targets going forward primarily by drawing from its business risk buffer to retain fees that would otherwise be refunded to clearing members, drawing on the shareholders for the replenishment capital they have committed only if the targets cannot be maintained in this manner. While the Plan carefully provides for repayment of any replenishment capital that might be provided by the shareholder exchanges—even at the expense of temporarily suspending dividends and refunds—the clearing members will neither be repaid nor receive any compensation for their capital contributions.

Third, refunds to clearing members and dividends to the shareholder exchanges are treated differently if replenishment capital remains outstanding for more than 24 months—refunds are cut off forever, while dividends will resume at a doubled rate of 100% of excess fees once the replenishment capital has been repaid.

OCC's efforts to justify this provision are wholly ineffectual. OCC asserts that the Plan must create an incentive for OCC to repay the replenishment capital within 24 months. But OCC also insists that it "has all the tools to ensure the Replenishment Capital is repaid within this time period by retaining earnings . . . and increasing fees to the extent necessary."[85] OCC offers no explanation for why the complete suspension of refunds and dividends would not, standing

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[84] Notice of Filing of a Proposed Rule Change 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 at 10, Release No. 34-741136 (Jan. 26, 2015), https://goo.gl/wE4RJG.
[85] OCC Submission at 23.

alone, provide all the incentive required to use these tools in a timely manner. Indeed, the incentives created by the Plan are precisely the opposite for the shareholder exchanges, who now have every reason to seek to use their significant influence over OCC's decisions to *delay* the repayment of replenishment capital beyond 24 months in order to dramatically increase their dividend payments in perpetuity.

OCC's additional argument that an increased rate of return is reasonable as compensation for the shareholder exchanges having not received any return on their investment for two years only highlights the discriminatory and inequitable nature of the Plan. As explained above, clearing members contributed $72 million toward OCC's initial capital target, and replenishment capital principally will be repaid by increasing and retaining (rather than refunding) clearing member fees. Further, while replenishment capital is outstanding, both refunds and dividends are suspended entirely. Yet as a "reward" for having their refunds suspended for two years, clearing members will receive not the double return granted to the shareholder exchanges but instead the permanent elimination of their right to receive any refunds at all. Moreover, OCC provides no explanation for why OCC needs an incentive to repay replenishment capital within 24 months when the subject creditors are on OCC's board; nor how avoiding harm to third parties like clearing firms provides any incentive to OCC itself.

IV. The Plan Must Be Rejected Because It Harms Investors and the Public Interest.

The Plan finally must be rejected because it is not "designed . . . to protect investors and the public interest."[86] To the contrary it systematically sacrifices the interests of the investing public to those of the shareholder exchanges. The features of the Plan discussed above—the undue burden that it imposes on competition, the indefensible dividend provisions and

[86] 15 U.S.C. § 78q-1(b)(3)(F).

unsupported capital targets, and the discriminatory and inequitable treatment of nonshareholder exchanges and clearing members—are all contrary to the interests of investors and the public. The Plan also harms the interests of the investing public in two additional ways. First, it transforms OCC from a zero-profit market utility into a profit-making monopoly. Second, it immediately increases net fees and creates systemic incentives to raise fees to even higher levels.

A. Before the Plan, OCC refunded to clearing members all of the fees that it collected in excess of its expenses. It thus operated on a zero-profit basis, and OCC's owners, the shareholder exchanges, did not receive dividends or any other equity distributions. After the Plan, fully half of excess fees are retained as profits for the purpose of distributing dividends to the shareholder exchanges.

That the Plan would transform OCC into a for-profit entity did not escape Barclays or OCC when they were evaluating the Plan. A December 8, 2014 presentation lists the pros and cons of Alternative A—having the shareholder exchanges contribute capital—and Alternative B—growing capital by retaining excess fees. A "con" of Alternative A was "OCC's 'zero profit' operating model adjusted to provide reasonable IRR on contributed capital . . . ."[87] (As explained above, the shareholder exchanges' return was miscalculated and not, in fact, reasonable.) A "pro" of Alternative B, in contrast, was that the "current 'zero profit' operating model remains unchanged."[88] OCC thus knowingly and intentionally transformed itself into a profit-making entity.

B. The manner in which the Plan transforms OCC into a profit-making entity makes the effects of that transformation particularly harmful to investors and the public interest. As

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[87] BARCLAYS, ANALYSIS OF CAPITAL RAISE ALTERNATIVES at 2.
[88] *Id.*

explained above, OCC could have structured the transaction differently by, for example, repaying the shareholder exchanges' capital contributions over time in order to make any change in OCC's non-profit status merely temporary or by setting the dividend at a predefined (and reasonable) rate. Instead, OCC chose to set aside fully half of its profits—i.e., excess fees—for payment of dividends. OCC has provided no basis whatsoever for tethering dividends to excess clearing fees; especially while retaining the ability to govern the level of excess fees through its budgeting power. Because of its structure, the Plan has the immediate effect of increasing net fees. Before the Plan, 100% of excess fees were returned to clearing members; under the Plan, only 50% are refunded. Furthermore, this method of calculating OCC's dividends creates systemic incentives for OCC to increase its fees and, by so doing, to increase the dividends payable to the shareholder exchanges. These incentives are made worse by the fact that OCC is a monopoly—it need not worry about maintaining competitive prices. OCC therefore has tremendous power to increase fees for the benefit of its shareholder-exchange owners. OCC's attempts to defend these aspects of its Plan lack merit.

First, OCC claims that the Plan decreases its business risk buffer to 25% from the historical buffer of 31%. But the new buffer actually is 33% because it is calculated by dividing projected expenses by 0.75.[89] Thus, if OCC had expenses of $100, it would set fees to collect $133.33 (100/.75 = 133.33)—a buffer of 33.33%. It is not clear whether OCC calculated its historical buffer in the same idiosyncratic way. One of the presentations in OCC's appendix includes a chart showing historical pre-refund profit margins from 2004 to 2013, but the values

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[89] *See* Letter from James E. Brown, General Counsel, OCC, in response to Comments from Howard L. Kramer on behalf of six market maker firms at 3 n.9 (Feb. 23, 2015), https://goo.gl/GKnHdh.

are expressed in percentages rather than in the underlying figures so the method of calculation cannot be confirmed.[90]

At any rate, regardless of whether up-front fees are higher or lower under the Plan than they have been historically, it is indisputable that *net* fees are now higher. Under the prior regime, fees net of refunds equaled OCC's operating costs. Now, they equal OCC's operating costs plus 16.67% (half of the 33.33% capital buffer). Remarkably, OCC's only response is its wholly unsupported "understanding" that "a portion, possibly a significant portion, of those refunds are *not* passed through by the clearing members to their end-user customers."[91] The reason this is remarkable is that the D.C. Circuit has already held that the Commission acted arbitrary and capriciously by relying on essentially the exact same statement by OCC.[92] Furthermore, even if some clearing members do not pass refunds through to customer end users, it does not follow that those refunds do not benefit those end users. For example, the clearing members could use the refunds to improve their services, or they could offer lower upfront costs themselves through lower fees in anticipation of receiving a refund at the end of the year. Indeed, in the intensely competitive market for option investors, it is doubtful that a clearing member that *did not* use refunds to win and retain customers could long survive.

Second, OCC argues that net fees would have increased even more had it opted for Option B—building capital exclusively through retained earnings. But at most this increase would have been temporary, versus the permanent increase caused by the Plan. This is demonstrated by OCC's own evidence. A November 24, 2014 slide presentation prepared by

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[90] *See* OCC, OCC CAPITAL PLANNING: BUSINESS RISK IMPACT TO FEE & REFUND POLICY 6 (Nov. 24, 2011) ("BUSINESS RISK").
[91] OCC Submission at 17.
[92] *Susquehanna Int'l Grp.*, 866 F.3d at 450.

OCC includes a "management recommendation" to "maintain current fee structure (estimated Redacted profit margin) and the suspension of refunds until target capital is reached. Once target capital is reached"—estimated to occur during 2016—"target a Redacted profit margin . . . ."[93]

Third, OCC insists that the Plan does not create incentives for OCC to increase fees, despite the fact that when fees increase, the shareholder exchanges' dividends increase. That is so, OCC says, because "increasing operating expenses and corresponding clearing fees would lead to an increase in the Target Capital Requirement, which would require OCC to retain more earnings by reducing refunds and dividends."[94] But as with many of OCC's other arguments, this argument ignores many facets of the issue at hand, not least of which is the fact that any increase in the Target Capital Requirement results in a dollar for dollar increase in OCC's equity which is 100% allocable to the shareholder exchanges. Essentially, the shareholder exchanges always benefit from higher OCC expenses, either through the requirement to increase retained earnings or by paying out ever increasing dividends. This can be demonstrated by an example. Suppose OCC's projected expenses in year 1 are $100. Under the Plan, OCC would set fees to collect $133.33 and, assuming its projections were accurate, would set aside $16.67 at the end of the year for payment of dividends.[95] Now, assume OCC increases its projected expenses in year 2 to $110. OCC would set fees to collect $146.67 ($110/.75), leaving it with $36.67 in excess fees at the end of the year. Rather than setting this entire amount aside for refunds and dividends, OCC would need to retain $5 under Rule 17Ad-22(e)(15) (representing the increase in OCC's six-month operating expenses). The $5 retained at OCC would increase retained earnings by $5,

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[93] BUSINESS RISK at 7, 9.
[94] OCC Submission at 15.
[95] Of course, OCC would have to pay taxes on this amount before paying out dividends, but that does not affect the argument developed here.

thereby increasing the value of the shareholder exchanges' interest in OCC by a like amount. That would leave an excess of $31.67, with $15.84 set aside for dividends. This is a moderate decrease in dividends from year 1, but in year 3 and every year thereafter so long as expenses stayed constant, the amount set aside for dividends would increase to $18.34. Of course, given this prospect for long-term dividend increases it is doubtful that expenses would stay constant for very long. Under the Plan, the shareholder exchanges always win.

The foregoing discussion, of course, relies on one big assumption—that increasing OCC's operating expenses will require OCC to retain additional capital. But as explained above, OCC *declined* to rely on Rule 17Ad-22(e)(15)'s requirement that it hold six months' expenses in capital ($106 million at the time the Plan was being developed) in favor of a target capital requirement of $247 million based not on OCC's expenses but rather on a risk-modelling exercise. OCC could thus increase its annual operating expenses by hundreds of millions of dollars, with corresponding increases in dividends, before the Commission's rules would require it to increase its capital by one dollar. Any "incentive" for OCC "to control operating expenses and keep clearing fees as low as possible" is therefore illusory.[96]

The evidence submitted by OCC further confirms that the Plan's dividend provisions create incentives to increase fees and expenses. Barclays, in the projections discussed above, estimated that in the "base case" OCC would pay the shareholder exchanges a total of $267.5 million from 2015 to 2024.[97] Barclays also presented a "downside case," which estimated that OCC would pay the shareholder exchanges a lesser total of $251.7 million over the same time

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[96] OCC Submission at 15.
[97] BARCLAYS, PROJECT OPTIMAL ALTERNATIVE CAPITAL RAISE: PROPOSAL ANALYSIS 4 (Dec. 5, 2014). (Total derived by summing annual "Dividend Paid to Exchanges" figures.)

frame.[98] What explains the difference between the base case and downside case estimates? In the former, operating revenue starts at Redacted in 2015 and increases to Redacted by 2024.[99] In the latter, operating revenue increases to Redacted in 2017 and then stays at that number through 2024.[100] Under the Plan, of course, OCC's *revenues* increase when *expenses* increase, with OCC setting fees to collect projected expenses plus the business risk buffer. (This is reflected in the Barclays figures, which show a consistent margin of 25%, representing the buffer.[101]) Thus, the Barclays base case—the case that is more profitable for the shareholder exchanges—represents a scenario with increasing expenses and fees, while the Barclays downside case—the case that is less profitable for the shareholder exchanges—represents a scenario in which fees and expenses stay more or less constant. These projections confirm that increasing expenses will in fact lead to increased returns for the shareholder exchanges under the Plan. And, by making clear that the *downside* scenario for the shareholder exchanges is one in which fees and expenses *do not* increase, these projections underscore the extent to which the Plan's dividend provisions create incentives that are contrary to the public interest.

Finally, OCC points to a March 2016 fee decrease to claim that the Plan has lowered fees in practice. But this is misleading. The March 2016 fee decrease followed a substantial increase in April 2014 that allowed OCC to begin accumulating capital through retained earnings.[102] When OCC instead decided to raise a portion of its capital through a contribution by the

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[98] *Id*. at 5. (Total derived by summing annual "Dividend Paid to Exchanges" figures.)
[99] *Id*. at 4.
[100] *Id*. at 5.
[101] *Id*. at 4–5.
[102] *See* Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Reflect the Elimination of a Discount to OCC's Clearing Fee Schedule at 3, Release No. 34-71769 (Mar. 21, 2014), https://goo.gl/z93SkL.

shareholder exchanges, it was able to reverse course to a certain extent and lower fees (which, as explained above, it would have been able to do soon thereafter had it opted to raise capital solely through retained earnings). But even after the March 2016 decrease, fees were still high as a historical matter. For example, before April 2014 a trade consisting of 2000 contracts would have cost $18.00.[103] Under the April 2014 fee schedule, the cost of that trade increased to $55.[104] The cost of such a trade did decrease under the March 2016 fee schedule, but only to $46—still 156% higher than pre-April 2014 levels.[105] What is more, OCC has now increased fees twice since March 2016, such that a 2000 contract trade once again costs $55.[106]

Under the Plan, the fees OCC charges are tied directly to OCC's expenses. And like fees, expenses have been increasing since the Plan was implemented. Indeed, they have been increasing at a faster rate than projected. In a June 2014 report, Barclays forecasted that OCC's 2018 operating expenses would be Redacted in the base case and Redacted in a stress case.[107] Under the Plan, however, OCC's expenses already reached $245.7 million in 2016.[108] Far from providing an incentive to guard against rising expenses, the Plan positively encourages them by linking rising expenses to rising shareholder dividends. The ongoing trend in OCC's

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[103] *OCC Schedule Fees/ January 2013*, OCC, https://goo.gl/ubLK9x.
[104] *See* Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Reflect the Elimination of a Discount to OCC's Clearing Fee Schedule, Release No. 34-71769 (Mar. 21, 2014), https://goo.gl/1GpqCZ.
[105] *See* Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Revise The Options Clearing Corporation's Schedule of Fees at 4, Release No. 34-77041 (Feb. 3, 2016), https://goo.gl/au8gZ2.
[106] *See* Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Simplify The Options Clearing Corporation's Schedule of Fees at 4, Release No. 34-77336 (Mar. 10, 2016), https://goo.gl/9mJDuY; Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Revise The Options Clearing Corporation's Schedule of Fees at 4, Release No. 34-79028 (Oct. 3, 2016), https://goo.gl/Bsab64.
[107] BARCLAYS CAPITAL INC., PROJECT OPTIMAL MONTH 1 UPDATE: AD HOC STRATEGY GROUP DISCUSSION 11–12 (June 17, 2014).
[108] 2016 ANNUAL REPORT at 27.

fees and expenses cuts decidedly against the Plan, and this practical experience confirms that the Plan is harmful to investors and the public interest.

CONCLUSION

For all of these reasons, the Commission should disapprove the Plan.

Dated: November 30, 2017

x________________________

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<u>**CERTIFICATE OF COMPLIANCE**</u>

I, David H. Thompson, Counsel for Petitioners, hereby certify that the foregoing Post-Remand Submission to the Commission in Opposition to the Re-Approval of the Capital Plan complies with the word limitation provided in 17 C.F.R. § 201.450(c). Exclusive of the exempted portions of the brief, as provided by 17 C.F.R. § 201.450(c), the Submission includes 10,745 words. The undersigned relied upon the word count function of Microsoft Word in preparing this certificate.

David H. Thompson
Counsel for Petitioners

Dated: November 30, 2017

CERTIFICATE OF SERVICE

I, Harold S. Reeves, counsel for Susquehanna International Group, LLP, Miami International Securities Exchange, LLC, BOX Options Exchange, Inc., Virtu Financial Inc., and Virtu Americas LLC, hereby certify that on November 30, 2017, I served copies of the attached *Petitioners' Submission on Remand from the United States Court of Appeals for the District of Columbia Circuit in Opposition to Proposed Rule Change 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 the OCC by Facsimile and Federal Express and filed the original with the Secretary by Facsimile and Federal Express at the following addresses:

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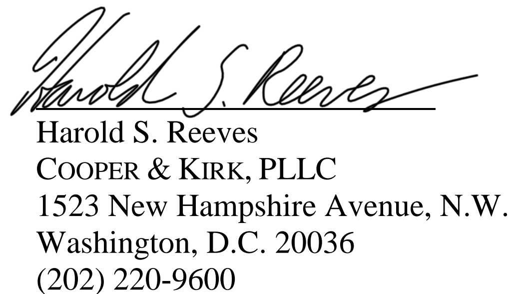

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