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September 4, 2018

**VIA EMAIL**

Brent J. Fields, Secretary
U.S. Securities and Exchange Commission
100 F. Street, N.E.
Washington, D.C. 20549-1090

Re: Re-Approval of the OCC Capital Plan (File No. SR-OCC-2015-02)

Dear Mr. Fields,

In connection with the above-referenced proceeding, and further to our discussions with Staff, the Options Clearing Corporation ("OCC") respectfully submits the attached presentation summarizing OCC's prior submissions and the evidence in the record sufficient for supporting the approval of the Capital Plan under the requirements of the Exchange Act.

As discussed in this presentation, the Capital Plan is consistent with the requirements of the Exchange Act and should be re-approved. When the D.C. Circuit remanded this matter to the Commission, it did so due to inadequacies in the Commission's explanation of its decision to approve the Capital Plan, rather than in the Plan itself or in the administrative record. This presentation lays out the breadth and detail of analysis and evidence in the administrative record based on which the Commission can and should provide a thorough, and reasoned, explanation of its decision to approve the Capital Plan. The D.C. Circuit has provided the Commission an opportunity to explain more fully why the administrative record supports its conclusion that OCC's Capital Plan complies with the requirements of the Exchange Act. The Commission should embrace that opportunity and reject Petitioners' request to reverse its prior decisions.

While the original administrative record would allow the Commission to address the concerns raised by the D.C. Circuit, the record has now been made even more robust with the disclosure of additional materials, including presentations from Oliver Wyman and Barclays (in addition to materials from these advisors provided during the Commission's initial review of the Capital Plan), an additional

Declaration from OCC's Executive Chairman, and the expert report of AlixPartners. Because a review of the administrative record supports—indeed, necessitates—the conclusion that the Capital Plan complies with the requirements of the Exchange Act, OCC respectfully requests that the Commission re-approve the Capital Plan.

Please note that OCC has requested confidential treatment of the annexed, unredacted presentation. OCC also intends to submit a public version that contains limited redactions on slides 54 through 56 (the "Confidential Matters"). These Confidential Matters contain confidential and proprietary information of a self-regulatory organization which are provided to the Commission's staff in connection with the Commission's role as OCC's supervisory regulator. The Confidential Matters contain detailed and proprietary financial information and financial projections developed by OCC Management. Because the Confidential Matters contain highly sensitive information about OCC's financial profile, OCC requests confidential treatment for the Confidential Matters pursuant to 5 U.S.C. § 552(b)(4) ("Exemption 4") and 17 C.F.R. § 200.83 to protect OCC from highly detrimental consequences that could impact OCC's essential business function if released to the public.

Sincerely,

Jeffrey B. Korn

Encl.

WILLKIE FARR & GALLAGHER LLP

NEW YORK WASHINGTON HOUSTON PARIS LONDON FRANKFURT BRUSSELS MILAN ROME

# The Path Forward for the Commission's Re-Approval of the OCC Capital Plan

Jeffrey B. Korn, Priya R. Aiyar

# The Commission Can and Should Re-Approve the Capital Plan

- The Commission's decision whether to re-approve the Capital Plan will be reviewed for "arbitrariness, caprice, and abuse of discretion." *Bradford v*. *SEC*, 590 F.2d 1085, 1093 (D.C. Cir. 1978).
- It is not arbitrary and capricious to conclude that the Capital Plan complies with the requirements of the Exchange Act.
- A close review of the development of the Capital Plan, as set forth in the administrative record, and the four requirements of the Exchange Act reveals that the Commission is more than able to re-approve the Capital Plan, and must do so to best protect investors and the public interest.

# The Commission Can and Should Re-Approve the Capital Plan (cont'd)

- As the Commission's recent approval of OCC's Recovery and Wind-Down Plan makes clear, OCC must have sufficient resources to respond to exigencies while complying with all applicable regulatory requirements.
- If the Capital Plan were disapproved, OCC would:
  - Have insufficient liquid net assets funded by equity to cover six months of operating expenses;
  - Have no plan for raising replenishment capital;
  - Have insufficient capital to withstand operational, business, and pension risks.

# Objectives (and Limitations) of the Capital Plan

- The Capital Plan is designed to ensure that OCC is always able to fulfill its critical role and function notwithstanding significant disruptions and dislocations.
- The Capital Plan was developed specifically to comply with the Commission's requirements that OCC have sufficient capital <u>funded by equity</u> to withstand operational, business, and pension risks, as well as a replenishment plan.
- The Capital Plan also had to be consistent with its stockholders' rights.
  - Rule 17Ad-22(e)(15) requires that OCC can obtain capital only from equity.
  - Attracting equity investment is challenging, as such capital would be trapped on OCC's balance sheet and not deployed to grow the business.
  - OCC's stockholders have governance rights including anti-dilution and veto rights, which were approved by the SEC at OCC's inception and are protected under Delaware law. OCC therefore did not have the option to raise equity from other sources.

# The Commission Does Not Have to "Trust the Process"

- OCC provided the Commission with an administrative record that supported the original approval of the Capital Plan, including:
  - Analysis from Barclays on the following topics:
    - Financial projections of OCC's expenses and revenue in various scenarios.
    - Analyses of various capital raise strategies in light of applicable regulations and limitations, including Barclays' recommended methodology.
    - Analyses of dividend and refund tax implications of the two alternatives presented.
  - Materials from the November 7, 2014, December 18, 2014, and February 11, 2015 Board Meetings such as:
    - Presentations on OCC's internal risk capital calculations, including projection models of expenses at 20% and 30% margins and resulting effects on fees and refunds.
    - Meeting minutes showing the OCC Board's internal deliberations and analysis regarding the Capital Plan.
    - Presentations, memos, and minutes of the December 2014 Board meeting in which the Capital Plan was approved.
  - A Declaration from OCC's Executive Chairman regarding the Board's consideration of the two alternatives developed by Barclays.

# This Administrative Record Allowed the Commission to Engage in "Reasoned Decision-making"

- Even had OCC not supplemented this administrative record with additional materials following the remand, this record was more than sufficient to allow the Commission to engage in the type of analysis later required by the D.C. Circuit.
- As discussed in this presentation, the existing administrative record contains sufficient evidence to support the Commission's prior conclusions that the Capital Plan satisfies all the requirements of the Exchange Act.
- The defects identified by the D.C. Circuit were in the Commission's explanation of its prior decision – they were not gaps in the record itself.

# OCC Has Provided the Commission with A Robust Administrative Record

- Following the D.C. Circuit's decision, OCC bolstered the already robust record with the following materials:
  - Presentations from Oliver Wyman on:
    - Analyses of OCC’s operational, business, and pension risks under various scenarios.
    - Methods of identifying the Target Capital Requirement in light of those risk scenarios.
  - Additional presentations from Barclays on:
    - The preliminary analysis of OCC’s risks and capital requirements under applicable regulations.
    - A detailed comparison of the two capital raise alternatives (exchange capitalization and organic growth).
  - A Declaration from OCC’s Executive Chairman regarding the Capital Plan’s compliance with OCC By-laws.
  - The Expert Report of Marc J. Brown, Global Valuation Services Practice Coordinator at AlixPartners, analyzing the reasonableness of the rate of return to the Stockholder Exchanges under the Capital Plan.

# OCC’s Capital Plan Was Approved Three Times

- Three times, the Commission determined that the Capital Plan complied with the four requirements of the Exchange Act.
  - February 26, 2015: Commission Notice of No Objection to the Capital Plan.
  - March 6, 2015: Staff approval pursuant to delegated authority.
  - February 11, 2016: Commission approval pursuant to de novo review.
- This was the correct determination, and the Commission is not precluded from making the same determination again after conducting the additional review directed by the D.C. Circuit.
- While the D.C. Circuit found that the Commission’s original Order “reflects little or no evidence of the basis for the OCC’s own determinations – and few indications that the SEC even knew what that evidence was,” that evidence was before the Commission originally and is before it even more amply now.

# Four Requirements of the Exchange Act

- *First*, a clearing agency's rules must be "designed . . . in general, to protect investors and the public interest." 15 U.S.C. § 78q-1(b)(3)(F).

- *Second*, a clearing agency's rules must "not impose any burden on competition not necessary or appropriate in furtherance of the purposes of" the Exchange Act. 15 U.S.C. § 78q-1(b)(3)(I).

- *Third*, a clearing agency's rules cannot be "designed to permit unfair discrimination . . . among participants in the use of the clearing agency." 15 U.S.C. § 78q-1(b)(3)(F).

- *Fourth*, a clearing agency must "comply with . . . its own rules." 15 U.S.C. § 78s(g)(1).

# The Capital Plan Is Designed to Protect Investors and the Public Interest

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# OCC Was Designated as a SIFMU

- OCC "performs critical functions in the clearing and settlement process" and its services "increase the efficiency and speed of options trading and settlement as well as reduce members' operational expenses and counterparty credit risk." 2016 Approval Order, 81 Fed. Reg. 8294, at 8294 (Feb. 18, 2016).
- As a result, OCC has been designated as a SIFMU by the Financial Stability Oversight Council and is required to satisfy Rule 17Ad-22(e)(15) as follows:
  - (i) 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," which must account for "operational risk," and
  - (ii) have a viable plan "for raising additional equity should its equity fall close to or below" this amount.
- OCC is also required to satisfy domestic and international standards and regulatory requirements to ensure that it can continue to perform its central role in the options markets in the face of shocks to the financial markets and other business risks.

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# OCC Budget and Operating Expenses

- For decades, OCC refunded all fees collected in excess of expenses, leaving virtually no resources for necessary capital improvement.
- While this meant that OCC operated as a low-cost clearing services provider, it also meant that money that should have been retained and invested in improving and maintaining operational and technological infrastructure was instead rebated to clearing members.
- As a result, when OCC was designated as a SIFMU, it had approximately $25 million in capital and was starting from a much worse position than other CCPs.  Indeed, as the Commission has observed, OCC was the *only* clearing agency that needed to source new funding to satisfy SIFMU requirements.

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# Development of the Capital Plan

- The Capital Plan was developed by OCC in 2014 in response to the SIFMU requirements, while Rule 17Ad-22(e)(15) was under consideration by the Commission.
  - As an interim matter, while the Capital Plan was under development, OCC raised approximately $72 million from fees and fee increases.
- In March 2014, OCC's Board of Directors formed the Advisory Group to consider modifications to OCC's capital structure in order to satisfy PFMI Principle No. 15 and Proposed Rule 17Ad-22(e)(15).
  - Only two Stockholder Exchange directors were on the nine-member Advisory Group. The rest of the Advisory Group was comprised of public directors and clearing member directors.
- The Advisory Group retained:
  - Oliver Wyman to assist OCC in quantifying its operational and business risks;
  - Barclays to conduct a capital analysis exercise to determine how much additional capital OCC needed to raise and to advise on its capital-raising options.

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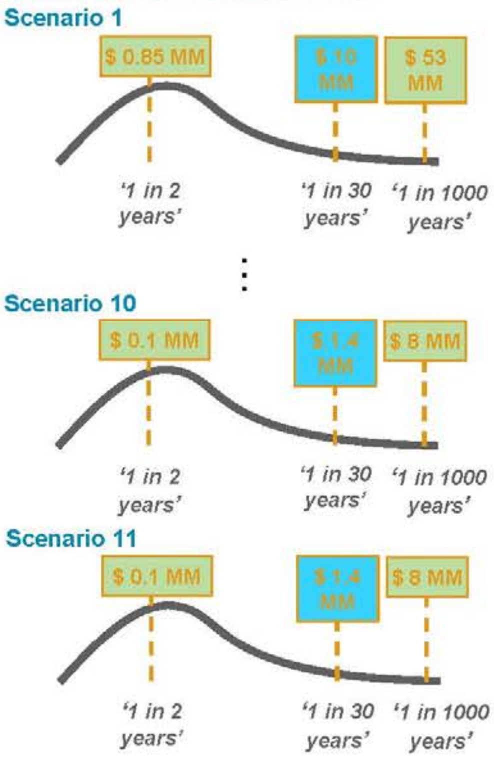
# Oliver Wyman's "Bottom-Up" Analyses

- Oliver Wyman conducted a "bottom-up" analysis of OCC's risks to quantify the appropriate amount of capital to be held against each risk, including consideration of credit, market, pension, operational, and business risks.
- Oliver Wyman gathered information about all aspects of OCC's business by conducting interviews and hosting multiple workshops with OCC personnel to understand and assess OCC's operational and business risks; identified 92 risk events potentially faced by OCC; and augmented this list based on peer and regulatory guidance.
- Oliver Wyman identified and analyzed 23 different scenarios in which these risks might materialize. Those scenarios were studied by Oliver Wyman and OCC in a series of workshops.
  - Oliver Wyman then conducted loss modeling at or above the 99.9% confidence level to determine the amount of capital required to address OCC's operational risks.

Operational risk

# Based on the list of scenarios and losses quantified by OCC experts during workshops, the operational risk model calculates a diversified tail loss figure

## Aggregation of losses across individual scenarios…




Input from workshop

Input from model

## …based on a correlation matrix between risk events…

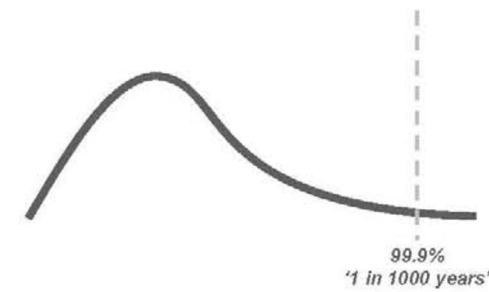
Illustrative

| | 1.1 | 1.2 | 2.1 | 3.1 | 3.2 | 4.1 | 4.2 | 5.1 | 6.1 | 6.2 | 7.1 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1.1 | | 0.4 | 0.1 | 0.1 | 0.1 | 0.4 | 0.4 | 0.1 | 0.1 | 0.1 | 0.1 |
| 1.2 | 0.4 | | 0.1 | 0.1 | 0.1 | 0.4 | 0.4 | 0.1 | 0.1 | 0.1 | 0.1 |
| 2.1 | 0.1 | 0.1 | | 0.1 | 0.1 | 0.4 | 0.4 | 0.1 | 0.1 | 0.1 | 0.2 |
| 3.1 | 0.1 | 0.1 | 0.1 | | 0.4 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 |
| 3.2 | 0.4 | 0.1 | 0.1 | 0.4 | | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 |
| 4.1 | 0.4 | 0.4 | 0.4 | 0.1 | 0.1 | | 0.4 | 0.1 | 0.1 | 0.1 | 0.2 |
| 4.2 | 0.4 | 0.4 | 0.4 | 0.1 | 0.1 | 0.4 | | 0.1 | 0.1 | 0.1 | 0.2 |
| 5.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | | 0.1 | 0.1 | 0.1 |
| 6.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | | 0.4 | 0.1 |
| 6.2 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.4 | | 0.1 |
| 7.1 | 0.1 | 0.1 | 0.2 | 0.1 | 0.1 | 0.2 | 0.2 | 0.1 | 0.1 | 0.1 | |

- Correlation matrix based on a public paper based on operational risk losses database (ORX) with an overlay of expert assessment

## …resulting in a capital figure

Operational Risk Losses Distribution




- Capital figure calculated using a simulation model which outputs an operational loss distribution based on internal and external inputs/assumptions

1. 1-in-2 year losses are estimated based on Oliver Wyman internal benchmark data on detailed risk appetite statements of financial institutions. leveraging 1-in-30 year losses obtained from OCC workshops

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# Oliver Wyman's "Bottom-Up" Analyses (cont'd)

- Based on this extensive modeling process, Oliver Wyman concluded that OCC required $226 million to address its operational risks.
  - When added to pension risks of $21 million, this established a target capital requirement ("Target Capital Requirement") of $247 million.
- OCC validated the reasonableness of the $247 million Target Capital Requirement by adding six months' worth of OCC's operating expenses ("Baseline Capital Requirement") to a Target Capital Buffer computed from operational risks, business risks, and pension risks after taking into account the baseline capital requirement.
  - $117M (six months' expenses) + $130M (operational and pension risks) = $247M = Target Capital Requirement

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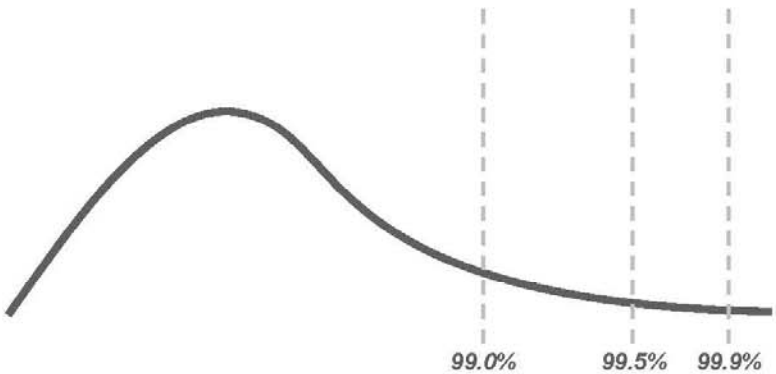
Operational risk

# Operational risk losses aggregated via the modelling process suggested $226MM loss at the 99.9th percentile

**Quantification of capital figures**
Based on different confidence intervals




| Confidence interval | Capital Figure |
|---|---|
| **99.0% (1 in 100 years)** | $105 MM |
| **99.5% (1 in 200 years)** | $136 MM |
| **99.9% (1 in 1000 years)** | $226 MM |

$226MM

*86% of total estimated capital*

Operational Risk Capital

# Quantification of Risk Capital

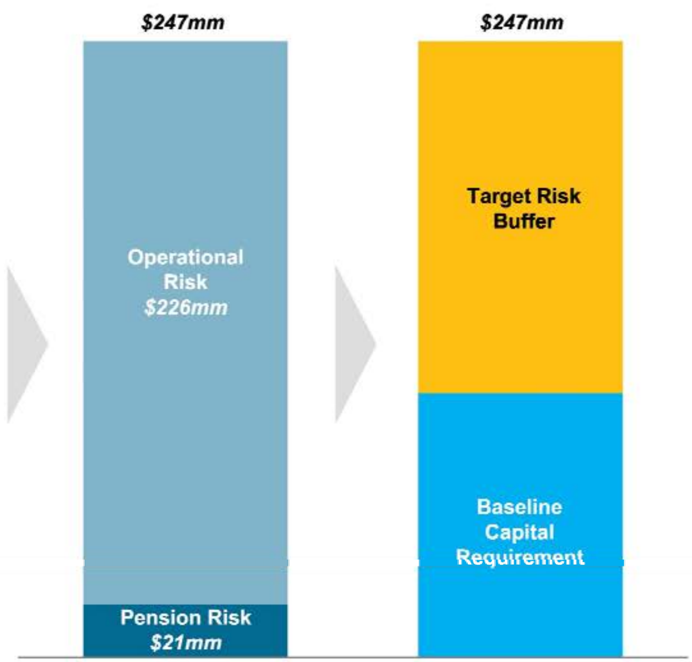
**Oliver Wyman undertook a risk quantification analysis, determining a need for $247mm of risk capital, reflecting a market and regulatory standard 99.9% confidence interval**

## Capital Figures

| | | |
|---|---|---|
| Operational Risk | $226mm | • Based on internal operational risk scenarios and loss model at 99.9th percentile |
| Business Risk | $0mm | • Potential revenue volatility fully offset by size of refunds and fee discounts previously extended to members |
| Pension Risk [(1)] | $21mm | • Pension/AOCI risk is the material capital component outside of operational risk<br>• Potential loss in pensions calculated by Towers Watson |
| Other Risks | ~$0mm | • Includes counterparty risk and on-balance sheet credit and market risk<br>• Deemed immaterial by OCC with respect to own capital needs |

## Risk Capital

*Bottom-up quantification approach and comparison to regulatory view*




1. *Pension risk loss scenarios based on a 99% confidence interval, modeled by Towers Watson, and reflects changes OCC will take against certain plans.*

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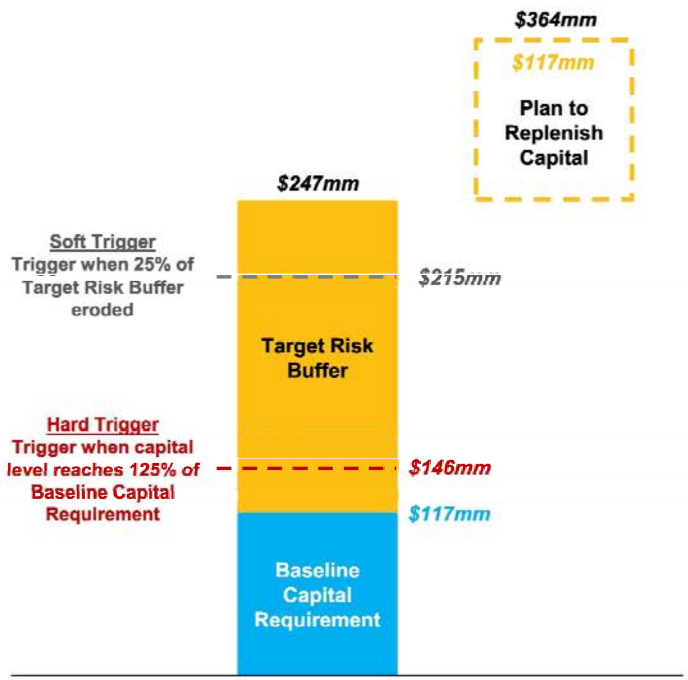
# Replenishment Capital

- With the assistance of Oliver Wyman and Barclays, OCC estimated that it would need replenishment capital of $117 million, which could be increased to as much as $200 million if the Baseline Capital Requirement increases.
- In total, OCC needed to raise, as <u>equity</u>, capital of a total of **<u>$364 million</u>** between liquid net assets and replenishment capital.

# Replenishment Capital

**In the event of operational losses, OCC will need to have a plan to replenish lost capital**

## Replenishment Capital Structure




## Overview

Plan to Replenish

- Creating a Plan to Replenish Capital (the "Plan") is an integral part of a broader capital plan
  - Provides OCC with ability to replenish capital in the event of a loss

Trigger Mechanism

- Early warning "trigger" mechanisms will need to be included as part of the Plan to Replenish Capital
  - The Soft Trigger is used to initiate internal discussions at OCC of the Board of Directors and Senior Management
  - The Hard Trigger is used to indicate when capital levels have fallen and the Plan has to be enacted to bolster the capital base

Mechanics

- When the "Hard Trigger" is breached, OCC will access the Plan in an amount sufficient to get to $20mm in excess of the Hard Trigger threshold ($166mm based on the current Hard Trigger of $146mm, so if shareholders' equity falls to $125mm, $41mm will be drawn)
- Can be accessed multiple times until the Plan size is exhausted
- Once equity levels again equal the Target Capital Requirement ($247mm currently), the Plan will be refilled using excess after-tax income

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# Barclays Develops Two Alternatives

- There are always costs to raising additional equity capital.
  - There is no requirement under the Exchange Act that the capital funded by equity be raised from the lowest-cost provider.

- Barclays and the Advisory Group identified two methods of raising the necessary capital from equity plus replenishment capital.
  - Alternative B would have been funded by increasing customer fees and retaining after-tax earnings, which would have been highly tax-inefficient.
    - These fees would then transform into equity, which would accrue to the exclusive benefit of the Stockholder Exchanges.
  - Alternative A was funded by a significant capital infusion by OCC's stockholders, and large additional replenishment commitments.
    - The Advisory Group recognized that those stockholders would need to be compensated for putting $150 million of equity at risk in an illiquid investment plus their commitment to capital replenishment, resulting in $150 million (and potentially **$350 million**) being tied up indefinitely on OCC's balance sheet.

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# Capital Raise Alternatives – Benefits & Considerations

**Under a range of scenarios, Alternative A represents the lower cost of funding OCC's capital plan while ensuring timely compliance with the final rules**

| | Alternative A – Exchange Capitalization | Alternative B – Organic Growth |
|---|---|---|
| Benefits | • Immediate capital injection and replenishment commitment ensure timely compliance with SEC requirements<br>• Refunds restored for 2014 and beyond<br>• Fees normalized beginning in 2015<br>• No need for incrementally higher fees or outside equity capital to bridge OCC's compliance prior to 2016/17<br>• Injection of exchange capital eliminates "wealth transfer" issues<br>• Exchange owners and clearing member users better aligned on expense discipline given sharing of excess operating income | • Current "zero profit" operating model remains unchanged<br>• Clearing members and end-users capture all operating efficiencies in the future<br>• Replenishment capital on the balance sheet may be viewed by the regulators as superior to exchange replenishment commitment |
| Considerations | • Short-term benefit of refunds and lower fees may not be viewed by end-users as a positive trade-off for long-term exchange dividend stream<br>• Exchange dividends subject to double taxation<br>• OCC's "zero profit" operating model adjusted to provide reasonable IRR on contributed capital, although returns are effectively capped | • Higher fees maintained and refunds suspended from 2014 to late 2017 (approximately 46 months)<br>• Absent further fee increases or unexpectedly high volumes, it is unlikely that OCC can meet expected compliance deadlines without further increasing fees or seeking outside bridge capital<br>  ▪ Increasing the blended fee schedule to $0.094 will allow OCC to reach the Target Capital Requirement of $364 million by September 2015<br>  ▪ Results in a change to the PV of cash flows<br>• Industry funding of Target Capital Requirement and Replenishment Plan Target exacerbates "wealth transfer" issues<br>• Overcapitalizing the balance sheet is an inefficient use of capital |

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# Negotiation of the Dividend

- The Stockholder Exchanges required compensation for their highly illiquid equity investment in a profit constrained company and for their mandatory replenishment obligation.
- Based on advice from Barclays, the Advisory Group—a majority of which were not Exchange Directors—reached an agreement on an after-tax dividend that it concluded was fair and reasonable consideration for the Stockholder Exchanges' capital outlays and commitments for additional capital outlays.
- The Advisory Group proposed an annual dividend calculated by first providing clearing members with a refund of 50% of OCC's earnings before tax and then issuing the after-tax amount of the remainder as a dividend to the Stockholder Exchanges.
- The result, which was submitted to and approved by OCC's Board, is the Capital Plan.

# Barclays' DCF Analysis Under Alternative A

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Excerpt from December 18, 2014 Barclays Presentation to the Board of Directors

## Exchange Contribution – Exchange View

| *($ in mm)* | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | TV |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Total Operating Revenue | $324.6 | $313.8 | $307.3 | $315.7 | $324.9 | $335.3 | $346.1 | $357.1 | $368.6 | $380.4 | $392.5 | |
| *Business Risk Buffer* | *44%* | *25%* | *25%* | *25%* | *25%* | *25%* | *25%* | *25%* | *25%* | *25%* | *25%* | |
| Earnings Before Tax ("EBT") | $142.3 | $78.5 | $76.8 | $78.9 | $81.2 | $83.8 | $86.5 | $89.3 | $92.1 | $95.1 | $98.1 | |
| Retained Capital (ptx) | 110.8 | | | | 3.2 | 5.3 | 5.5 | 5.6 | 5.8 | 5.9 | 6.1 | |
| Distributable EBT | $31.6 | $78.5 | $76.8 | $78.9 | $78.1 | $78.5 | $81.1 | $83.7 | $86.4 | $89.2 | $92.0 | |
| Implied Net Income | 20.5 | 51.0 | 49.9 | 51.3 | 50.7 | 51.0 | 52.7 | 54.4 | 56.1 | 58.0 | 59.8 | |
| Refund to Members (ptx) | $31.6 | $39.2 | $38.4 | $39.5 | $39.0 | $39.3 | $40.5 | $41.8 | $43.2 | $44.6 | $46.0 | |
| Dividend Paid to Exchanges (atx) | 0.0 | 25.5 | 25.0 | 25.6 | 25.4 | 25.5 | 26.3 | 27.2 | 28.1 | 29.0 | 29.9 | |
| Taxes Paid by Exchanges on Dividend | | 3.1 | 3.0 | 3.1 | 3.0 | 3.1 | 3.2 | 3.3 | 3.4 | 3.5 | 3.6 | |
| Dividend Recognized by Exchanges | | $22.4 | $22.0 | $22.6 | $22.3 | $22.5 | $23.2 | $23.9 | $24.7 | $25.5 | $26.3 | |
| Terminal Year Dividend Growth | | | | | | | | | | | | 2.5% |
| Terminal Multiple (dividend) | | | | | | | | | | | | 10.0x |
| Terminal Value | | | | | | | | | | | | $269.8 |
| Discount Factor | 1.000 | 0.909 | 0.826 | 0.751 | 0.683 | 0.621 | 0.564 | 0.513 | 0.467 | 0.424 | 0.386 | 0.386 |
| PV of Dividends to Exchanges | $0.0 | $20.4 | $18.2 | $17.0 | $15.2 | $13.9 | $13.1 | $12.3 | $11.5 | $10.8 | $10.1 | $104.0 |

### DCF Methods

**Exit Multiple Method**

| | |
|---|---|
| Sum: PV of Dividends | $142.6 |
| PV of Terminal Value | 104.0 |
| Total PV of Dividends | **$246.6** |
| Internal Rate of Return | 18.6% |

| | Exchange Capital Commitment | | | | | |
|---|---|---|---|---|---|---|
| | $130 | $150 | $175 | $200 | $222 | $247 |
| IRR | 21.5% | 18.6% | 15.7% | 13.4% | 11.7% | 10.0% |

**Terminal Growth Method**

| | |
|---|---|
| Sum: PV of Dividends | $142.6 |
| PV of Terminal Value | 138.7 |
| Total PV of Dividends | **$281.3** |
| Internal Rate of Return | 20.5% |

| | Exchange Capital Commitment | | | | | |
|---|---|---|---|---|---|---|
| | $130 | $150 | $175 | $200 | $222 | $247 |
| IRR | 23.3% | 20.5% | 17.7% | 15.4% | 13.7% | 12.0% |

### Assumptions

| | |
|---|---|
| % EBT to Exchanges | 50.0% |
| Business Risk Buffer | 25.0% |
| Rev. Growth ('19-'24) | 3.2% |
| Corporate OCC Tax Rate | 35.0% |
| Dividend Tax (post-DRD) | 12.0% |
| Discount Rate | 10.0% |
| Target Capital Requirement | $247.0 |
| Capital from Exchanges | $150.0 |
| Capital Retained at YE 2014 | $72.0 |
| Equity as of 12/31/14 | $25.0 |

BARCLAYS



OCC

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# Stockholder Dividend

- The capital investment from the Stockholder Exchanges is distinct from a traditional equity investment:
  - It is trapped capital, which sits on OCC's balance sheet for regulatory compliance purposes *only*, and does nothing to grow the business.
- There was no rational business reason for the Stockholder Exchanges to contribute this capital; the dividend provides the Stockholder Exchanges with the necessary financial incentive to make this highly illiquid capital contribution.

# Dividends Compared to Refunds

- The Stockholder Exchanges do not receive the same amount in dividends as clearing members receive as refunds.
- While clearing members, who have no equity investment, are refunded half of OCC's net operating income, the Stockholder Exchanges only receive the remainder of the remaining half of OCC's net income *after* sufficient funds are withheld to pay taxes.
- As a result, the size of OCC's stockholder dividends will always be significantly less than the size of OCC's refunds to clearing members.
- Indeed, dividends are measured in *tens* of millions, while refunds are measured in *hundreds* of millions.

# Excerpt from December 8, 2014 Barclays Presentation to Advisory Group

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## Dividend & Refund Tax Considerations

**OCC is not taxed on the earnings refunded to clearing members, however, the income paid as dividends to the exchanges would need to be tax-affected prior to distribution.**

### Tax Implications

- The IRS currently allows for OCC to net the refund against revenue, which lessens OCC's earnings and income tax paid
- The new dividend and refund policies are not expected to change the tax treatment of clearing member refunds if documented consistently with past refund policy
- Refund policy would state that OCC will retain the amount of capital (post-tax) required for regulatory requirements. 50% of any remaining earnings before tax will be refunded to the clearing members
- Subsequent to the refund, OCC would calculate net income and any amount not required for regulatory needs would be paid as a dividend to exchanges

### Refund Policy Example (in millions)

**Shareholder's Equity = Capital Plan Target**

| | | |
|---|---|---|
| Jan 1 Shareholder's Equity | $247 | A |
| Earnings Before Tax and Refund | 81 | B |
| Capital Plan Target ("CPT") | 247 | C |
| Retained Capital Needed to Meet CPT (C-A) | - | D |
| Refund ((B-D)*50%) | **$41** | E |
| Earnings Before Taxes (B-E) | 41 | F |
| Net Income (Exchange Dividend) (F*(1-40%)) | **$24** | |

**Shareholder's Equity < Capital Plan Target**

| | | |
|---|---|---|
| Jan 1 Shareholder's Equity | $247 | A |
| Earnings Before Tax and Refund | $81 | B |
| Capital Plan Target ("CPT") | $249 | C |
| After-Tax Retained Capital Needed to Meet CPT (C-A) | $2 | D |
| Tax Affected Amount to Retain (D/(1-40%)) | $3 | E |
| Refund ((B-E)*50%) | **$39** | F |
| Earnings Before Taxes (B-F) | $42 | G |
| Net Income after Taxes (G*(1-40%)) | $25 | H |
| Net Income Retained to meet Capital Plan Target (D) | $2 | |
| Exchange Dividend (G-D) | **$23** | |

BARCLAYS

8

OCC

Protects Investors

# OCC Board Review

- OCC's Board of Directors is comprised of experienced financial professionals who are fully aware of and capable of complying with their fiduciary duties.
- On December 18, 2014, the Board met to discuss these materials prepared by Barclays and reviewed the two alternatives developed by Barclays.
- These materials were submitted to the Commission on December 19, 2014.

Protects Investors

# OCC Board Approval

- The Directors engaged in a thorough debate of the two alternatives and ultimately approved Alternative A.

pressure on fees going forward. In response to comments regarding the manner by which fees would be set in the future, Mr. Donohue explained the "business risk buffer" concept and noted that, by adopting a business risk buffer of 25%, which is less than the historical average of 31%, fees should be reduced beginning in the second quarter of 2015, which will benefit market participants, particularly customers that do not currently receive any portion of the refunds. In response to comments regarding the size of the dividend, certain of the Exchange Directors pointed out that it was not just a return on the $150 million capital contribution, but also compensated the stockholder exchanges for the risks associated with agreeing to provide replenishment capital. After discussion, upon motion made and seconded, the following resolutions were adopted upon the affirmative vote of two-thirds of the Directors currently in office, with Mr. Dehnert, Ms. Kula and Mr. Ruth voting against and Mr. Werts abstaining:

> **RESOLVED**, by the Board of Directors of THE OPTIONS CLEARING CORPORATION, that the Board hereby approves the capital plan referred to as "Alternative A" in the "Project Optimal Capital Plan Discussion Materials," dated December 18, 2014, presented to the Board, including amending Article IX, Section 9 of the By-Laws of the Corporation as necessary or appropriate to reflect the changes to the fee structure of the Corporation required to implement Alternative A;

WILLKIE FARR & GALLAGHER LLP

# The Capital Plan Is Designed to Protect Investors and the Public Interest

- Petitioners have asserted that OCC has not provided sufficient evidence for the SEC to conclude that OCC's Board and advisors conducted an analysis supporting the conclusion that "the dividend level was reasonable for the associated cost and risks."
- The preceding review of the analysis conducted by OCC's Board and advisors – analysis which has been submitted to the Staff as part of the administrative record – demonstrates otherwise.
- The Exchange Act does *not* prohibit OCC from compensating its stockholders for making equity contributions or capital commitments. Nor does it regulate equity returns.
- It does require OCC's rules to be "designed ... in general, to protect investors and the public interest."
- There can be no question that maintaining adequate capital protects investors and is in the public interest.

# The Capital Plan Does Not Place an Undue Burden on Competition

# The Capital Plan Does Not Impose Any Burden On Competition Not Necessary or Appropriate in Furtherance of the Purposes of the Act

- Because clearing members are all treated the same under the Capital Plan, the only conceivably affected competition here is between exchanges.
- As noted previously by the Commission, exchanges principally compete for order flow. That competition is fierce, with fifteen equity options exchanges competing for order flow.
- There are numerous substitutes available, market power is limited, prices are constrained, and competitive behavior is dictated by competitive forces that have nothing whatsoever to do with Capital Plan dividends.

No Undue Burden on Competition

# Dividends Cannot Possibly Affect Competition

- The Capital Plan does not unduly burden competition because the amounts paid to the Stockholder Exchanges are *de minimis* and cannot possibly affect competition for order flow in this intensely competitive environment.
  - Dividends are measured in the low tens of *millions*, whereas exchange revenues for execution services are measured in the *billions*.
- Even if the Stockholder Exchanges were to use the dividend exclusively to subsidize their equity option products, it would be two cents or less per contract.
  - Assuming a $30M dividend, the dividend rate per contract side for equity options based on 2017 volume data for each of the Stockholder Exchanges would be:
    - NASDAQ OMX PHLX = 0.00939
    - CBOE = 0.00939
    - ISE = 0.0179
    - NYSE ARCA = 0.0198
    - NYSE AMEX = 0.0204
- Unsurprisingly, there is **<u>no</u>** evidence of reduced fees or other incentives from the Stockholder Exchanges since the Capital Plan.
  - In fact, since the Capital Plan went into effect, the Stockholder Exchanges have <u>lost</u> market share.

# The Exchange Act Does Not Require An "Open Competitive Process"

No Undue Burden on Competition

- Contrary to some Petitioners' assertions, the Exchange Act does *not* require that a Capital Plan be set by an "open competitive process" or "transparent pricing data to support fairness of the proposal."
- Rule 17Ad-22(e)(15) requires sufficient capital "funded by equity" and imposes no such "competitive process" requirement.
- Nor was an "open competitive process" even possible. OCC's stockholders have a right not to be diluted and not to accept additional stockholders. These rights were approved by the Commission at the inception of OCC, are afforded protection under Delaware law, and OCC does not have any authority to override them.
- The Exchange Act does not authorize clearing members to substitute their own business judgment for the judgment of the OCC Board of Directors.

# The Capital Plan Was Not Designed to Permit Unfair Discrimination Among Participants in the Use of The Clearing Agency

# The Exchange Act Does Not Require Equal Treatment of Differently Situated Participants

- OCC has no obligation to treat Stockholder Exchanges with respect to the Capital Plan the same as non-Equity Exchanges because they are differently situated.
  - The former have provided $150 million in capital and have committed to provide an additional $200 million under the Capital Plan. The non-Equity Exchanges have not made any such contribution and have no such commitment.
  - The Stockholder Exchanges, as stockholders, have certain rights under OCC By-laws, including anti-dilution rights.
- There is nothing in the Exchange Act that requires OCC to treat unequal participants in an equal manner.

# Compliance with OCC By-Laws

# The Capital Plan Complies with All OCC By-Laws

- Petitioners assert that OCC did not comply with its By-Laws because the record contains no evidence that the Executive Chairman made a determination that the Capital Plan was not of competitive significance and did not need to be disclosed to Non-Stockholder Exchanges.
- The By-Laws require only information that the "Executive Chairman considers to be of competitive significance" be shared with Non-Stockholder Exchanges.
  - This language requires an affirmative, subjective determination by the Executive Chairman before the obligation to disclose a matter to Non-Stockholder Exchanges arises.
  - If no such affirmative, subjective determination was made, there is no obligation.
- Moreover, pursuant to the By-Laws themselves, deference must be given to the OCC Board's interpretation of its own By-Laws.
  - Art. III, Sec. 8 ("In the exercise of its powers, the Board of Directors may . . . make such interpretations of the By-Laws and Rules . . . as it may deem proper.")

Complies with Its Rules

# Declaration of OCC's Executive Chairman

- On October 13, 2017, OCC submitted to the Commission a Declaration from the Executive Chairman stating:

> "In the exercise of my business judgment, I never considered the Capital Plan to be of competitive significance to the Non-Equity Exchanges."

- This confirms that the Executive Chairman did not consider the Capital Plan to be of competitive significance – at any time. As discussed above, this view is well-founded because the Capital Plan is not competitively significant.

- The By-Laws are clear that the duty to provide notice to non-Stockholder Exchanges is triggered *only* when the Executive Chairman has made an affirmative and subjective determination that the information is "of competitive significance." That did not happen.

# The Opinion of the D.C. Circuit Does Not Preclude Re-Approval of the Capital Plan

# Standard of Review

- The Commission shall approve a proposed rule change of a self-regulatory organization "if it finds that such proposed rule change is consistent with" the provisions of the Exchange Act. 15 U.S.C. § 78s(b)(2)(C)(i).
- The Commission's decision whether to re-approve the Capital Plan will be reviewed for "arbitrariness, caprice, and abuse of discretion." *Bradford v. SEC*, 590 F.2d 1085, 1093 (D.C. Cir. 1978).
- It is not arbitrary and capricious to conclude that the Capital Plan complies with the four requirements of the Exchange Act.
  - The administrative record demonstrates the robust financial analyses which the OCC Board relied upon to determine the Target Capital Requirement and identify the best method of raising that capital.
  - The Commission is more than able to engage in the "reasoned decision-making" required by the D.C. Circuit and conclude that the Capital Plan can be approved.

# Opinion of the D.C. Circuit Court of Appeals

- The Court held that the Approval Order did not demonstrate that the Commission had engaged in the reasoned decision-making, supported by substantial evidence, that is required by the Exchange Act and the APA.
- The Court highlighted five specific ways in which the Order failed to satisfy this standard:
  - Reasonableness of the dividend rate
  - Reasonableness of the capital target
  - Likelihood of increase in net customer fees
  - Possible elimination of refunds in the Replenishment Capital scenario
  - Compliance with OCC's By-laws
- The Court held that the Order was "arbitrary and capricious, unsupported by substantial evidence, and otherwise not in accordance with law" and remanded the matter to the SEC to make further findings and to conduct a proper analysis.

# The Commission Can Address These Concerns while Re-approving the Capital Plan

- The administrative record supports the resolution of each of these issues in OCC's favor, and we understand that Staff do not dispute the following:
  1. *Reasonableness of the capital target*
     - The analyses conducted by Oliver Wyman and Barclays amply support the reasonableness of the capital target.
  2. *Likelihood of increase in net customer fees*
     - The comparison of the two alternatives developed by Barclays demonstrates that the selected option ("Exchange Capitalization") resulted in <u>lower</u> customer fees relative to the rejected option ("Organic Growth").
  3. *Possible elimination of refunds in the Replenishment Capital scenario*
     - It is inherently risky to contribute up to $200 million of additional equity capital after OCC has exhausted its operating capital.
     - Possible elimination of refunds is necessary and fair to obtain commitment where OCC cannot repay its obligations for two years and the stockholders are exposed to losses of more than twice their original contributions under the Capital Plan.
- We understand from Staff that two issues remain unresolved:
  1. Reasonableness of the dividend rate
  2. Compliance with OCC's By-Laws

# “Reasonableness of Dividends” . . .

- The dividend rate was negotiated and approved by an Ad Hoc Strategic Advisory Group comprised of a majority of non-stockholder directors.
- There is no basis under the Exchange Act to assess and reject the “price” of an illiquid investment of $150 million plus the replenishment commitments, particularly where:
  - The investment represents trapped capital;
  - The investment does not serve to develop the business;
  - The investment is in a profit-constrained firm refunding half its operating income to its clients;
  - The investment’s disposition is ultimately controlled by the governance rights of other stockholders.
- Even if the dividend is considered “high”—which is not something regulated by the Exchange Act—there is still a clear basis for the SEC to re-approve the Capital Plan.

# . . . Is Not the Standard Under the Exchange Act

- The Exchange Act requires that the Capital Plan protect investors, promote the public interest, and avoid undue burdens to competition.
  - The opinion of the D.C. Circuit should not be read to impose a *fifth* Exchange Act requirement that stockholder dividends be objectively reasonable. There is no such requirement.
- Rather, the Court stated that if the dividend rate amounts to “an unnecessary windfall for shareholders” then the Capital Plan *“may* run afoul of the Exchange Act’s prohibitions by unnecessarily or inappropriately burdening competition, harming the interests of investors and the public, or unfairly discriminating against nonshareholders and clearing members.”
  - Reasonableness is at best a rough proxy for the Exchange Act’s requirements; it is not a substitute, nor is it an additional requirement.
- Because the Capital Plan meets the four requirements of the Exchange Act, there is no need to separately address “reasonableness” of the dividends.

# Expert Report by AlixPartners

- On August 23, 2018, OCC submitted to the Commission the Expert Report of Marc J. Brown, Global Valuation Services Practice Coordinator at AlixPartners.
- OCC retained Mr. Brown to analyze the reasonableness of the expected returns of the Stockholder Exchanges through their investment in OCC under the Capital Plan.
- Mr. Brown conducted a detailed financial analysis of the returns expected by the Stockholder Exchanges in exchange for their substantial illiquid investments and replenishment commitments under the Capital Plan, and concluded that those returns fall within a reasonable range for this investment and commitment.

# Methodology and Conclusions

- Mr. Brown compared the discount rate used by Barclays against several benchmarks:
  - The average internal rate of return for private equity investors, which is 22%
  - The commonly used Capital Asset Pricing Model (CAPM), which required a rate of return of 14%
- He adjusted these rates of return for the lack of marketability of the investment, based on studies that quantify appropriate marketability discounts.
- He also took into account the Replenishment Capital Commitment, which is back-stop financing that comes with a cost.
- He concluded that, applying the correct discount rate and adjusting for the lack of marketability, the present value of the Stockholder Exchanges' expected returns at the time of the investment and commitments was between $128.6 and $137.8 million, while the investment amount was $150 million. Thus, the expected rate of return was reasonable.

# “Compliance with OCC’s By-Laws”

- OCC complied with all relevant By-Laws when it developed the Capital Plan and, if such compliance is unclear, deference should be granted to OCC’s interpretation of its own By-Laws.
- OCC has provided the Commission with a sworn declaration from the OCC Executive Chairman that he never considered the Capital Plan to be information that is of competitive significance to non-Equity Exchanges.
- Therefore, the administrative record reflects the reality that the non-Stockholder Exchanges were not entitled to notice of the Capital Plan, and thus OCC complied with all relevant By-Laws.

# . . . Does Not Preclude Re-Approval of the Capital Plan

- Even if the Commission concludes that OCC did not comply with its By-Laws, the Commission does not have to–and should not–allow this procedural misstep to undo years of OCC's progress towards meeting its obligations as a SIFMU.
- The D.C. Circuit stated that "if the SEC concludes that this does not matter, it must give a reasoned explanation why."
- The Commission may reasonably conclude that the failure to provide notice to the non-Stockholder Exchanges "does not matter" because those same parties have had notice and ample opportunity to assert their objections before the Commission over a years-long review process.

# Effects of Disapproval of the Capital Plan

# OCC Would Be Forced Into Non-Compliance

- Disapproval of the Capital Plan would thrust OCC into immediate non-compliance with Rule 17Ad-22(e)(15).
- Without the Capital Plan, OCC would:
  - Have insufficient liquid net assets funded by equity to cover six months of operating expenses;
  - Have no plan for raising replenishment capital;
  - Have insufficient capital to withstand operational, business, and pension risks.
- Most importantly, without the funds provided by the Capital Plan, any sort of severe operational loss at OCC would be immediately transmitted into the broader financial markets, causing disruption. The lack of Capital Plan funds not only puts OCC at risk, but also the broader financial markets.

# Higher Fees, Lower Refunds, No Progress

- Rejection of the Capital Plan would require the return of the $150 million already contributed by the Stockholder Exchanges.
  - No basis to hold funds
  - Delaware law rescission rights
  - Exchange stockholder fiduciary duties to their stockholders

- Net fees would increase dramatically because OCC would have to stop making refunds in order to rebuild capital.
  - The Capital Plan allowed OCC to raise capital via contributions and commitments from Stockholder Exchanges rather than higher fees.
  - OCC would be forced to accumulate capital solely from its fees, which would mandate a dramatically higher fee schedule.

# Clearing Fees Will Increase Substantially if the Capital Plan Is Rejected

- As discussed, OCC has limited options to comply with Rule 17Ad-22(e)(15).
  - Rule 17Ad-22(e)(15) does not allow OCC to raise capital from debt.
  - OCC cannot force stockholders to accept renegotiated terms or dilution.
    - The Stockholder Exchanges have fiduciary obligations and must answer to stockholders of their own.
    - The terms they reached in connection with the Capital Plan were the result of a lengthy negotiation.
    - There is no reason to believe that any newly negotiated terms would not meet with similar opposition, or that the Stockholder Exchanges would maintain their replenishment obligations and capital investment at lower rates of return.
    - It is unrealistic to assume that potential new investors, if agreed to by existing stockholders, would not demand similar rates of return and equity governance rights.
      - The equity governance rights have value to the existing stockholders and they would reasonably expect compensation from foregoing those rights.
- In light of these constraints, if the Capital Plan is rejected, it is highly probable that OCC would be limited to raising capital, to replace the return of stockholders' investments and satisfy replenishment obligations, through materially increased fees, which introduces tax leakage.

# OCC Capital Requirement

REDACTED

# Impact on Fees – Level and Duration

REDACTED

# The Use of Fees to Raise Capital Has Adverse Consequences to Market Participants

REDACTED

# These Outcomes Are Avoidable

- OCC worked closely with its financial advisors and the Staff over several years to develop a capital plan that complies with the Exchange Act and its obligations as a SIFMU.
- Denying OCC the ability to meet these obligations now would be directly contrary to the purposes of the Exchange Act—to protect investors and the public interest.
- Unwinding the Capital Plan would force OCC out of compliance with its regulatory obligations and put it directly at risk of not surviving market shocks or business risks.
- The Commission would not be upholding the purpose of the Exchange Act by disapproving the Capital Plan when there is a clear path forward for approval.
- The increase in fees, borne by market participants, would accrue to the benefit of the stockholders through retained earnings and stockholders equity.

# The Commission Should Re-Approve the Capital Plan

- The D.C. Circuit asked the Commission to engage in more thorough decision-making, but it said *nothing* about the merits of the Capital Plan.
- Based on the administrative record, it is clear that OCC has complied with the four requirements of the Exchange Act.
- After approving the Capital Plan three times before, the Commission is more than able to approve it for a fourth time while meeting the standard set forth by the D.C. Circuit.
- Engaging in reasoned decision-making, as required by the D.C. Circuit, demonstrates that the Capital Plan fully complies with the Exchange Act and must be approved.