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October 9, 2018

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

**Re: File No. SR-OCC-2015-02**

Dear Mr. Fields:

On September 21, 2018, the Options Clearing Corporation ("OCC") submitted a report by Russell Rhoads of the TABB Group in further support of OCC's Capital Plan ("Plan").[1] On October 8, however, Mr. Rhoads published another report for the TABB Group, entitled "The OCC Capital Plan – The Other Side of the Coin." Petitioners submit that report along with this letter.

Mr. Rhoads explains that the TABB Group's views have "evolved."[2] While the Group still "believe[s] that the OCC needs to have the capital to run, manage, and improve the clearinghouse based upon its SIFMU designation," it recognizes that "the current plan seems to foster incentives to reward the clearinghouse for not managing the institution as cost effectively as possible, with the resultant profits flowing back to OCC's investors."[3] The TABB Group therefore recognizes "beneficial arguments on both sides" of this debate: "The OCC does need to be capitalized and its infrastructure upgraded; however, **there shouldn't be an imbedded incentive for increasing costs over and above those needed to manage the clearinghouse**."[4]

Fortunately, the Commission need not choose between a well-capitalized OCC and the absence of the improper incentives embedded in the current arrangement. As we have explained, there are many ways in which OCC could fund any reasonable capital needs without unduly rewarding the shareholder exchanges and without creating incentives for increased operating

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[1] *See* Letter from Jeffrey B. Korn, Willkie Farr & Gallagher LLP, to Brent J. Fields, Secretary, SEC (Sept. 21, 2018).
[2] RUSSELL RHOADS, THE OCC CAPITAL PLAN – THE OTHER SIDE OF THE COIN 3 (Oct. 8, 2018).
[3] *Id.*
[4] *Id.* (emphasis added).

costs.[5] The TABB Group's current views therefore strongly support Petitioners' submission that the Plan must be rejected.

Dated: October 9, 2018

x______________________________

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[5] *See, e.g.*, Letter from David H. Thompson, Cooper & Kirk, PLLC, to Brent J. Fields, Secretary, SEC at 6–7, 13–14 (Sept. 27, 2018).

TABB FORUM
WHERE CAPITAL MARKETS SPEAK

# The OCC Capital Plan – The Other Side of the Coin

**Russell Rhoads, TABB Group**
**08 October 2018**

*While the Options Clearing Corporation's capital plan has been approved by the SEC three times, it is once again under review, as it is unpopular with many segments of the industry. The main thrust of the argument is that the plan overly enriches the OCC and its shareholder exchanges and penalizes the rest of the industry. TABB's Russell Rhoads examines the arguments against the current plan.*

A couple of weeks ago I wrote a piece for TABB discussing the plan that was implemented in response to the Options Clearing Corporation's (OCC) designation as a Systemically Important Financial Market Utility (SIFMU) ("OCC's Capital Plan: The Value of a Bird in the Hand"). Since that piece was published I have heard from many of the plan's detractors.

While the plan has been approved by the SEC three times, it is once again under review, as it is unpopular with many segments of the industry. The main thrust of the argument is that the plan overly enriches the OCC and its capital-providing firms (the shareholder exchanges), and penalizes the industry, outside of those firms that provided capital to the OCC. The current OCC capitalization review is the result of a court order in which the SEC has been directed to reevaluate the plan, which has been in place for a couple of years.

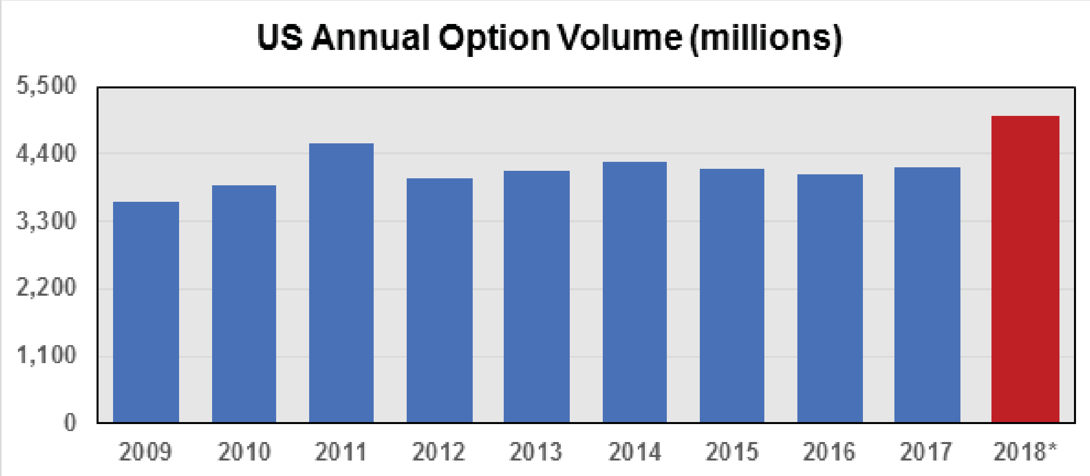
The original OCC plan determined an equity capital raise of $150 million was needed to bring the clearinghouse in line with its responsibilities as a designated SIFMU. The five exchanges that were owners of OCC at that time contributed $30 million each. Through industry consolidation, those five exchanges are now represented by three exchange groups. The exchanges that were excluded from the capital raising and thus were not original OCC shareholder exchanges were BATS Exchange (now part of Cboe Global Markets), the Miami International Securities Exchange, and BOX Options Exchange. Both of the remaining non-shareholder exchanges (Miami and BOX), along with two market making firms and a clearing firm, continue to fight for an alternative to the current capital plan. From feedback I received, there are other firms that share their view on this topic.

A primary concern of the industry is the transformation of OCC from a low-cost clearing provider to a for-profit entity. While, legally, OCC has always been a for-profit entity, it has not acted as one for the majority of its history. Traditionally (before the implementation of the current plan), the OCC would estimate expenses and revenues each year, set clearing fees accordingly, and rebate excess income or profits to the clearing members. This process changed under the 2015 capital plan, cutting the refund to the clearing members to 50% of OCC profits, while the remaining 50% are distributed to the shareholder exchanges after taxes are paid on this portion of the annual profits.

The basis of the current court review focused on the level of the dividends being received by the shareholder exchanges. During the years the plan has been in place, the shareholder exchanges have received dividends of $19.7 million in 2015, $25.6 million in 2016, and $32.5 million in 2017. This resulted in annual returns of 13.1%, 17.1%, and 21.7%, respectively – a nice return for investing in an entity with a very high credit rating such as OCC. We still have three months to go in 2018, but it appears that the dividend distributed to shareholder exchanges will greatly exceed the 2017 figure of $32.5 million. Even if it matches the 2017 figure, more than $100 million in dividends will have been paid in just four years to the shareholder exchanges for an equity infusion of $150 million.

Cleared option volumes have been in a long-term uptrend for the past few years, but 2018 is on track for record cleared option volume. Figure 1, *below*, shows cleared option volume for each year back to 2009. TABB Group estimates cleared option volume could reach 5 billion contracts in 2018. This volume, combined with the per-side transaction fee of $0.05 (charged to traders on both sides of a trade) that is in place for 2018, should result in a large increase in the dividend payout to the shareholder exchanges when they close the books on 2018.

***Figure 1***

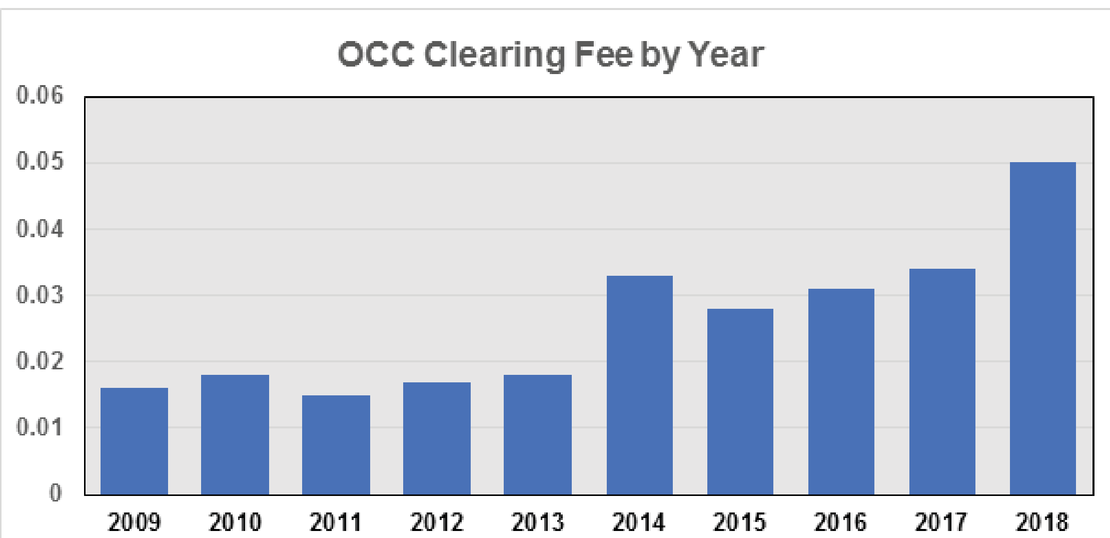



*Data Source: OCC and TABB Group Estimates*

A major objection to the capital plan is that there is an incentive for the OCC to actually increase expenses (we explore this later in this article). The main source of income for OCC is clearing fees, so when higher expenses are expected, OCC institutes higher transaction fees. In 2017, 82% of revenues came directly from clearing fees. While this number is high, it actually is lower than average, as in most years fees account for more than of 90% of OCC revenues.

What is concerning about the per-side clearing fee is how much it has risen since 2012, when the OCC's SIFMU designation was first announced. Figure 2, *below*, shows the per-side fee OCC charges to clear transactions by year back to 2009. In 2012, the year that OCC received the SIFMU designation, the per contract fee was $0.017. This year the fee is $0.05, which is about three times the 2012 level.

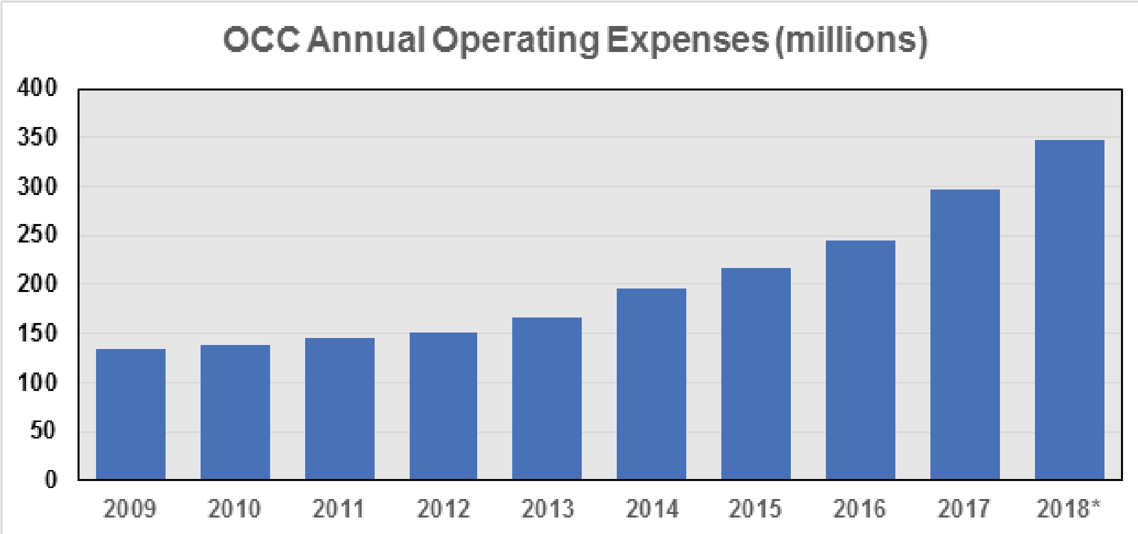
***Figure 2***




*Data Source: OCC*

OCC says the current fee of $0.05 per contract side is needed to cover expenses associated with the SIFMU designation. However, the extent of this potential increase was downplayed when the plan initially was debated. Expenses have increased, but the extent of these increases is concerning. In 2012, the year OCC was designated a SIFMU, operating expenses were $152.1 million. The budget for 2018 is for operating expenses of $347.6 million, more than double in just six years. Figure 3, *below*, shows the actual expenses for 2009 to 2017 and includes the projection for 2018.

***Figure 3***




*Data Source: OCC*

Since the implementation of the plan, there have been significant head count increases at OCC, and long overdue system upgrades are in process. Both are cited as part of the responsibility of being designated a SIFMU. However, under the current capital plan, the higher the budget, the greater the dividend paid to shareholder exchanges. This is core to many of the industry's complaints, as it has the consequence of increasing the owners' returns as the OCC increases expenses. This provides an incentive for the OCC to increase costs, which increases fees on the industry, diminishing revenue from market makers and brokers and returns from investors, and inflating the dividends to the shareholder exchanges.

For example, if OCC establishes its forecasted expenses at $200 million, it will set its fees based on a buffer that is in place in case there are unexpected expenses or a drop in volume. The formula, based on an expense budget of $200 million, would target a buffer of $66 million and total revenue from fees of $266 million. If the projections are spot on, the result would be $66 million in profits to be divided between the 50% rebate to members and the 50% (after tax) dividend payout to the shareholder exchanges. If OCC forecasts the following year's expenses at $300 million, it will set its fees based on targeting revenue of $399 million. Again, if all projections are spot on, $99 million will be split between a member rebate and the after-tax dividend paid to the shareholder exchanges. This was a potential issue that was pointed out at the beginning of this debate, and the rise in expenses and fees over the past three years does nothing to counter that concern.

OCC's bylaws state that the owner exchanges will not have their ownership interest diluted, which is why OCC took the initial equity infusion only from the five owner exchanges. As noted earlier, this has resulted in annual dividend payouts that already have covered half the equity capital contribution. The alternative to this was an increase in fees that the OCC chose not to implement. These were the only two options presented to the board after OCC had consultants analyze the alternatives. Those objecting to the plan that currently is in place have noted that the process did not allow for any other potential sources of capital to be considered. For example, debt solutions were offered that would have resulted in a much lower return on capital than the dividends currently being paid to the shareholder exchanges. Taking on debt is against the current rules under which OCC operates, but a rule change was never considered.

Further, opponents of the current plan argue the initial $247 million capital target was higher than necessary. Objections to the plan note that the $247 million that OCC determined was needed depends on a 99.9% certainty that the capital fund would cover any shortfalls. This translates to a once-in-a-thousand-year occurrence. If OCC used a 99.0% or 99.5% threshold of confidence, the capital needed could be lowered to a level that could have been funded by a short-term increase in fees. For example, a 99.5% confidence interval (a once-in-200-year occurrence) lowers the capital requirement to $157 million. The lower capital requirement could have been covered by a retention of capital on hand and then a resumption of the operating status quo that had been in place for 40 years.

There currently is a wide divide between the entities that are objecting to the new capital plan and its supporters. This divide has only increased based on the value of exchange shareholder dividends combined with the increases in expenses and fees charged by OCC.

While our last piece looked at the positives of the OCC plan, given the outcry we have seen since we published the paper, our view has evolved. While we firmly believe that the OCC needs to have the capital to run, manage, and improve the clearinghouse based upon its SIFMU designation, the current plan seems to foster incentives to reward the clearinghouse for not managing the institution as cost effectively as possible, with the resultant profits flowing back to OCC's investors.

While we would love to pick a winner in this fight, there are beneficial arguments on both sides. The OCC does need to be capitalized and its infrastructure upgraded; however, there shouldn't be an imbedded incentive for increasing costs over and above those needed to manage the clearinghouse. No matter how this gets adjudicated, it will be difficult to satisfy both sides of this argument. That is why we need the SEC and the courts to look at this objectively to ensure that the views of the clearinghouse, prudential regulators, market participants, and investors all are represented fairly, and their financial interests are being balanced accordingly.

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**CERTIFICATE OF SERVICE**

I, Harold S. Reeves, counsel for Petitioners Susquehanna International Group, LLP, Miami International Securities Exchange, LLC, BOX Exchange, LLC, Virtu Financial Inc., and Virtu Americas LLC, hereby certify that on October 9, 2018, I served copies of the attached Letter to the Secretary with its attachment on Joseph P. Kamnik, general counsel for the Options Clearing Corporation (OCC) by way of Federal Express, and filed the original and three copies with the Secretary by way of email and Federal Express at the following addresses:

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Dated: October 9, 2018

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