James E. Brown
Executive Vice President
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February 23, 2015

By Electronic Mail
Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F. Street, N.E.
Washington, DC 20549-1090
rule-comments@sec.gov

Re: *File No. SR-OCC-2015-02: Notice of Filing of a Proposed Rule Change by The Options Clearing Corporation 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*

The Options Clearing Corporation ("OCC")[1] is submitting this letter in response to comments from BATS Global Markets, Inc. ("BATS")[2] and BOX Options Exchange ("BOX")[3] on OCC's recent rule filing regarding its proposed capital plan (the "Proposal").[4] OCC appreciates the opportunity to respond to these comments.

The Proposal sets forth a plan for raising additional capital (the "Capital Plan") that would support OCC's function as a SIFMU and facilitate OCC's compliance with SEC Proposed Rule 17Ad-22(e)(15) (the "Proposed Rule"). The Proposed Rule would require OCC to have liquid net assets funded by equity sufficient to cover potential general business losses so that OCC can continue operations and services as a going concern if those losses materialize, and that must in all cases cover the greater of either (i) six months of OCC's current operating expenses, or (ii) the amount determined by the Board of Directors (the "Board") to be sufficient to ensure a

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[1] OCC is registered as a clearing agency with the SEC and as a derivatives clearing organization with the Commodity Futures Trading Commission. The Financial Stability Oversight Council has designated OCC as a systemically important financial market utility ("SIFMU").

[2] Letter from Eric Swanson, General Counsel & Secretary, BATS Global Markets, Inc. (February 19, 2015) ("BATS Letter").

[3] Letter from Tony McCormick, Chief Executive Officer, BOX Options Exchange (February 19, 2015) ("BOX Letter").

[4] Exchange Act Release No. 74136 (34-74136) (January 26, 2015), 80 FR 5171 (January 30, 2015) (SR-OCC-2015-02). OCC also filed the Proposal as an advance notice under Section 806(e)(1) of the Payment, Clearing, and Settlement Supervision Act of 2010. 12 U.S.C. 5465(e)(1). *See* File No. SR OCC-2014-813.

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recovery or orderly wind-down of critical operations and services of OCC, as contemplated by the Recovery and Wind-Down Plan that OCC will be required to create and maintain pursuant to SEC Proposed Rule 17Ad-22(e)(3)(ii). OCC would further be required under the Proposed Rule to maintain a viable plan, approved by the Board and updated at least annually, for raising additional equity capital should its equity fall close to or below the amount required under the Proposed Rule.[5]

As of February 23, 2015, the Commission has received four comment letters on the Proposal, including the BATS Letter, BOX Letter, a letter submitted by counsel on behalf of six market maker firms (the "MM Letter")[6] and a letter submitted by the Securities Industry and Financial Markets Association.[7] OCC has also submitted a response to the MM Letter containing a number of responses that apply with equal force to the BATS Letter and BOX Letter, and will be submitting a response to the SIFMA Letter. Accordingly, for the avoidance of repetition, OCC makes reference to the description of the background of the Proposal and to its responses to the MM Letter in certain sections of this letter. As noted in the MM Letter, the Board and OCC's management ("Management") have determined, both for business reasons and in order to address current and proposed regulatory requirements, that OCC's capital is too low for a SIFMU. OCC continues to believe that the approval of the Proposal is entirely consistent with the Exchange Act.

RESPONSES TO THE BATS & BOX COMMENTS

BOX COMMENT: THE CAPITAL PLAN MAKES NO MENTION OF ITS DURATION.

Among the objections to the Capital Plan raised by BOX is the assertion that the Capital Plan makes no mention of its duration and, consequently, indicates it will remain in place "in perpetuity." In fact, the Capital Plan represents a negotiated change to the capital structure of OCC currently in place, demonstrating that the capital structure in fact can change over time as circumstances change. Moreover, the Board has certain fiduciary duties under corporate law to consider proposals that might be advantageous to OCC, which duties would apply to possible changes to its capital structure that may be proposed in the future or might otherwise be necessary to address evolving regulatory capital requirements. As discussed in the MM Letter, alternatives that involved limiting the amount of time the dividend would be paid were considered by the Board and Management, but they were deemed unworkable for both regulatory and business reasons. Consequently, for the present time, the Board has determined that the negotiated terms of the dividend set forth in the Proposal represented the most favorable transaction possible in light of all the circumstances.

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[5] *See* Securities Exchange Act Release No. 71699 (March 12, 2014), 79 FR 29507 (May 22, 2014).

[6] Letter from Howard L. Kramer, Willkie Farr & Gallagher (February 20, 2015).

[7] Letter from Ellen Greene, Vice President, Financial Services Operations, SIFMA (February 20, 2015) ("SIFMA Letter").

<u>BATS/BOX COMMENT</u>: THE PROPOSAL FAILS TO ADEQUATELY ADDRESS THE POTENTIAL BURDEN ON COMPETITION.

1. *The proposed dividend does not subsidize the cost of execution services that the Stockholder Exchanges provide to their members and does not provide the Stockholder Exchanges with a competitive advantage over non-stockholder exchanges.*

The Proposal would not impose any burden on competition. Although the BOX Letter in particular emphasizes that the investment of the Stockholder Exchanges is "low risk" and provides a "virtually guaranteed" return, as discussed in detail in OCC's response to the MM Letter, the funded and unfunded capital commitments of the Stockholder Exchanges under the Proposal in fact involve a substantial amount of risk, including the risk inherent in the $150 million equity investment, the unusual nature of the investment in OCC as an industry utility, the Stockholder Exchanges' cost of capital, the dire financial circumstances under which the $200 million replenishment capital commitments would be funded, and the lack of "upside" to the investment based on the interaction of the Fee, Refund and Dividend Policies described in the Proposal and the MM Letter. It is accurate that the non-stockholder exchanges, including BATS and BOX, will not receive dividends, if any are declared. However, they also are not contributing any equity capital whatsoever, nor are they committing to the substantial risk of providing replenishment capital.[8] Similarly, none of the non-stockholder exchanges have presented a proposal under which they would provide a meaningful source of additional equity capital for OCC. As noted above, the Board has certain fiduciary duties under corporate law to consider proposals that might be advantageous to OCC, which duties would apply to possible changes to its capital structure that may be proposed by the non-stockholder exchanges in the future. The Board has determined that the Stockholder Exchanges are receiving only what the Board, with the assistance of its financial advisors and in the exercise of its business judgment, has deemed to be fair and in the best interests of OCC, in light of the nature of the investment and the risks inherent in the funded and unfunded capital commitments of the Stockholder Exchanges as described above. Therefore, OCC does not believe that there is any competitive disadvantage to non-stockholder exchanges.

Potential dividends, if declared, should not be considered additional revenue that simply can be used to subsidize the cost of services that the Stockholder Exchanges provide, but instead as fair compensation for the substantial capital contribution, limited "upside" and future risks that would be shouldered by the Stockholder Exchanges under the Proposal. The implicit argument that the non-stockholder exchanges are competitively burdened because they will not receive dividends has no merit.

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[8] Instead, under OCC's ownership structure as reflected in Article VIIB of its By-Laws (which have been previously approved by the Commission), "Non-Equity Exchanges" such as BATS and BOX are noteholders of OCC and are paid the interest provided for in their individual promissory notes. As such, unlike the Stockholder Exchanges, they have received a return on their capital, and that return will not change under the Proposal.

2. *The details of the Proposal provided in the rule filing are sufficient, and redactions from the rule filing do not support the argument that the Proposal cannot be analyzed, that a competitive advantage exists or that its extent is unknown.*

BATS and BOX both assert that the Proposal lacks sufficient clarity and detail to analyze its terms. For example, BATS notes that because the exact dollar values relating to the dividend are not included in the Proposal, any potential competitive advantage provided to the Stockholder Exchanges cannot be fully analyzed. Contrary to the assertions contained in the BATS and BOX Letters, OCC has described in the Proposal the considerations that went into setting the specific terms of the Capital Plan, including the Fee Policy, Refund Policy and Dividend Policy.[9] As further discussed in OCC's response to the MM Letter, the negotiated return to be received by the Stockholder Exchanges, determined by OCC's Board with the assistance of its financial advisers to be reasonable, will not change materially over time in relation to the cumulative amount of capital contributed. The term sheet related to the Proposal does not contain any material terms that were not already disclosed and described in detail in the Proposal. For example, the formulas related to determining the proposed dividend and the dividend's treatment in the event replenishment capital is outstanding are all described in the Proposal under the headings "Dividend Policy" and "Replenishment Capital Plan" substantially as set forth in the term sheet.

3. *OCC has in fact considered a wide range of potential alternatives to the Proposal, none of which were deemed viable, and the Board ultimately concluded that a longer process was not likely to produce a different result.*

The BATS Letter and BOX Letter both suggest incorrectly that OCC has not properly addressed potential alternatives to the Proposal or explained the evolution of its views on which alternative capital plan was most viable and in the best interests of OCC. In fact, the Board and Management engaged in a nearly year-long process during which they analyzed a wide range of alternative methods to increase OCC's capital to a level considered to be sufficient given OCC's role in the critical market infrastructure supporting the U.S. equity and options markets, as well as sufficient to achieve compliance with each aspect of the Proposed Rule by the expected effective date, culminating in the determination that the viable alternatives were in fact quite limited and that the Proposal was the best and most viable of those limited alternatives.

As discussed in detail in OCC's response to the MM Letter, after determining that the proposal put forth by the Stockholder Exchanges was the only viable proposal to increase OCC's capital to an acceptable level and to meet the requirements of the Proposed Rule and achieve compliance on or before the anticipated regulatory deadline for compliance, certain directors representing the Clearing Member and certain directors representing the Stockholder Exchanges negotiated the terms of the proposed Capital Plan, and the Board determined that the negotiated terms represented the most favorable transaction possible in light of all the circumstances. The resulting Proposal and its submission to the Commission were then approved by the required super-majority of the Board. There is no reason to believe that a longer process that revisits the

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[9] *See* SR-OCC-2015-02 at p. 25.

analyses and determination already made by the Board would produce a different result or garner more support from OCC's various constituencies or its regulators.

4. *Contrary to the assertions of BATS and BOX, the Capital Plan does not propose to pay dividends to Stockholder Exchanges instead of paying refunds to the Clearing Members*.

The BATS Letter and BOX Letter both appear to simply misunderstand the interplay between fees, refunds, and dividends as set forth in the Proposal. As repeatedly stated in the Proposal, the reason that Clearing Member refunds will be 50% of the available Business Risk Buffer is to retain the current low fee industry utility model (by providing refunds to the Clearing Members), while at the same time compensating the Stockholder Exchanges for the substantial initial capital contribution, the continued funding of future capital requirements, and future replenishment capital obligations undertaken by them, which will provide OCC with the capital that all the constituencies agree is required. However, it is important to recognize that the additional capital cushion will allow OCC to operate safely with a smaller business risk buffer margin than it does currently, giving Clearing Members the benefit of a lower fee structure. The interaction of the Fee Policy, Dividend Policy and Refund Policy has the effect of substantially limiting the return of the Stockholder Exchanges at a rate deemed by the Board and its financial advisors to be reasonable in consideration of relevant factors. It is mistaken, therefore, to characterize the plan as "reduc[ing] rebates to some customers in exchange for enhanced dividends." Rather, consistent with OCC's industry utility model, OCC will effectively refund 100% of the amount not required to be paid in compensation for the necessary initial and ongoing capital contributions and replenishment commitments of the Stockholder Exchanges. The split between refunds and dividends paid from excess earnings is a reflection of the cost of meeting the regulatory capital requirements and the substantial funded and unfunded capital commitments of the Stockholder Exchanges. OCC has discussed the Fee Policy, Refund Policy, and Dividend Policy at length in its rule filing and in its response to the MM Letter, discussions which OCC incorporates by reference in this response.

5. *The Capital Plan <u>does</u> better align the interests of Stockholder Exchanges and Clearing Members with respect to expenses, and it does <u>not</u> place undue pressure on Clearing Member fees or on OCC to increase its earnings to fund dividends*.

BATS flatly asserts that it "cannot possibly be true" that the Capital Plan will better align the interests of the Stockholder Exchanges with those of the Clearing Members with respect to OCC's expenses because the Stockholder Exchanges will be more concerned about profitability, which will put pressure on increasing Clearing Member fees and maximizing earnings to fund dividends. BOX also calls into question whether the Capital Plan will better align the interests of the Stockholder Exchanges and the Clearing Members. This is simply not the case and again reflects an incomplete understanding of the features of the Capital Plan as fully described in the rule filing. As the proposed Fee Policy, Refund Policy, and Dividend Policy are structured, the Stockholder Exchanges' returns are materially limited as described in the Proposal. Fees will be reviewed quarterly by OCC and adjusted as necessary in order to ensure that the Business Risk Buffer, from which both refunds and dividends are paid, will be maintained as closely as possible to the 25% level as described in the rule filing. Again, the return on the cumulative amount of capital contributed to OCC is materially limited by the interaction of the Fee, Refund and Dividend Policies, and dividends cannot be paid to Stockholder Exchanges above that amount. OCC refers to the rule filing and its responses to the MM Letter where it has set forth a more detailed explication of the ways in which the Capital Plan better aligns the interests of the Stockholder Exchanges with those of the Clearing Members.

6. *The Capital Plan is not biased in favor of the Stockholder Exchanges simply because of the potential for refunds to be eliminated if replenishment capital is not repaid within the required amount of time*.

The BATS Letter, BOX Letter and MM Letter each suggest that the Capital Plan is biased in favor of the Stockholder Exchanges because, if replenishment capital is required from the Stockholder Exchanges and has not been repaid in full or shareholders' equity has not been restored to the Target Capital Requirement within 24 months, OCC would no longer pay refunds to Clearing Members, even if the Target Capital Requirement is restored and all replenishment capital is repaid at a later date, whereas dividends would be resumed once the Target Capital Requirement has been restored. While it is true that refunds will cease under these circumstances, this does not reflect any "bias" in favor of the Stockholder Exchanges. Instead, this aspect of the Capital Plan recognizes that, for this unanticipated situation whereby the Stockholder Exchanges have funded the replenishment capital on something other than a "bridge" basis, the investment by the Stockholder Exchanges (both the initial capital contribution and any unpaid replenishment capital) is likely of a different, and much more risky, type than originally envisioned, for which a greater return is appropriate. OCC's projections indicate that, based on fees established using the 25% Business Risk Buffer, it is likely that the replenishment capital could be repaid under the 24-month period. However, if that does not appear to be feasible at the time, under the Proposal, OCC's Board (on which the Stockholder Exchanges hold only five out of 20 director positions) would have the right, pursuant to proposed changes to the By-Laws, to increase fees or reduce expenses (without reducing fees), causing an increase in the 25% Business Risk Buffer, in order to accumulate retained earnings sufficient to repurchase any paid-in replenishment capital to the Stockholder Exchanges and restore capital to the Target Capital Requirement. This mechanism was specifically designed to provide flexibility to the Board to maintain the status quo of 50%/50% sharing of excess net income between Clearing Members (in the form of refunds) and Stockholder Exchanges (in the form of after-tax dividends) and to limit the circumstances under which future refunds to Clearing Members would be eliminated. OCC has discussed this point in detail in its response to the MM Letter, which it incorporates by reference in its response to this comment.

7. *The demands and interests of outside investors are distinctly different from those of the Stockholder Exchanges, which was one reason, among many, that the Board determined that outside investment was not in the interest of OCC in comparison to the Proposal*.

BATS contests OCC's conclusion that outside investors would have differing interests and demands from the Stockholder Exchanges with respect to a capital investment in OCC. This is one of the many reasons articulated here and in OCC's response to the MM Letter, which OCC references here, that the Board determined an outside investment was less desirable than the Proposal. The Stockholder Exchanges have an interest in making this investment that is separate and apart from the return that they earn on the investment. Specifically, it is elemental that the Stockholder Exchanges have an inherent and special interest in ensuring that OCC remains a viable clearing facility to clear transactions executed on their and other exchanges. From the perspective of the Board and Management, the Stockholder Exchanges are already stockholders of OCC and therefore no fundamental changes in OCC's governance structure are necessary in connection with the Capital Plan. The Board examined the possibility of involving outside investors and determined in the course of its nearly year-long investigation into potential alternative capital plans that nearly all of the alternatives examined, including using outside investors as a sources of capital, posed significant tax, compliance or governance and shareholder rights issues that made such alternatives uncertain or unfeasible.[10] While the non-stockholder exchanges share the interest in ensuring that OCC remains a viable clearing facility, they have and would continue to receive the benefit of the Stockholder Exchanges' investment without being required to make a similar investment, and the basic governance provisions are already in place with respect to the Stockholder Exchanges.

<u>BATS COMMENT</u>: OCC'S REQUEST FOR ACCELERATED EFFECTIVENESS SHOULD BE DENIED.

1. *The argument that accelerated approval is unwarranted because the Proposed Rule has not yet been adopted is misguided*.

BATS submits that OCC's request for accelerated approval is unsupported, noting in particular that the Proposed Rule has not yet been adopted. This is misguided. OCC has articulated in its rule filing and in its response to the MM Letter the pressing time constraints for adopting a capital plan that complies with the Proposed Rule on or before its expected effective date. This is based on numerous discussions with the Commission and is particularly important given the unique ownership structure of OCC and the difficulty of quickly raising capital for an industry utility. OCC has received no indication that the Commission would provide a delay of the effective date.

An important component of the Proposal is that it permits OCC to make a substantial refund to Clearing Members for 2014, since OCC would not reduce its regulatory capital by making a refund for 2014 in the absence of the capital contribution from the Stockholder Exchanges. In December 2014, in anticipation of the Proposal being approved, OCC's Board declared a refund for 2014 (to be paid in 2015). However, the refund declared by the Board can be changed by the Board at any time prior to its payment. OCC is required by Rule 213 of its Rules to provide to Clearing Members its audited financial statements within 60 days following

[10] Under OCC's Certificate of Incorporation, its By-Laws and the Stockholders Agreement to which OCC and the Stockholder Exchanges are parties (all of which have been filed with, and approved by, the SEC), and under Delaware corporate law, the Stockholder Exchanges have certain rights with respect to proposed changes to OCC's capital structure. These include the right not to have their investment in OCC diluted through the issuance of additional equity capital, as well as the right to elect directors to OCC's Board. The Board determined that it was not likely to be the case that all five Stockholder Exchanges would agree to changes to the capital structure that would be to their detriment, at least on a timetable that would permit OCC to raise the necessary capital "funded by equity" to achieve compliance with the Proposed Rule. As noted above, however, the Board of Directors of OCC has certain fiduciary duties under corporate law to consider proposals that might be advantageous to OCC, which duties would apply to possible changes to its capital structure that may be proposed in the future or might otherwise be necessary to address evolving regulatory capital requirements.

the close of OCC's fiscal year (February 27, 2015). Further, those financial statements cannot be finalized without knowing that the amount and likelihood of payment of the 2014 refund is "probable." Therefore, if the Proposal is not approved in a timely manner, it is likely that the Board would eliminate the 2014 refund. OCC desires to avoid this result, which is why it is imperative that the Proposal be approved in a timely manner.

CONCLUSION

OCC's Board has exhaustively considered numerous alternatives for raising sufficient capital to comply with the Proposed Rule by its anticipated effective date and has reached agreement with Stockholder Exchanges to provide sufficient capital on an ongoing basis for OCC's needs. To undo any of the carefully negotiated terms, could prove fatal to the agreement and reset the entire, nearly year-long process OCC's Board and Management have pursued to bolster OCC's capital and to achieve compliance with the Proposed Rule. OCC continues to believe that the Proposal was and remains the only viable alternative offered for achieving this compliance and would do so without a very large increase in fees that could prove harmful to the options markets. Accordingly, the Proposal is entirely consistent with the Exchange Act and the rules and regulations thereunder applicable to OCC as well as with the public interest and protection of investors. OCC, therefore, respectfully requests that the Commission approve the Proposal.

Sincerely,

James E. Brown
General Counsel

OCC

James E. Brown
Executive Vice President
General Counsel and Secretary

February 23, 2015

By Electronic Mail
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Secretary
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Re: *File No. SR-OCC-2015-02: Notice of Filing of a Proposed Rule Change by The Options Clearing Corporation 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*

The Options Clearing Corporation ("OCC")[1] is submitting this letter in response to comments from Howard L. Kramer on behalf of six market maker firms (the "MMs")[2] on OCC's recent rule filing regarding its proposed capital plan (the "Proposal").[3] For the reasons set forth below, OCC believes that the criticism raised in the MM Letter is based upon an incorrect interpretation of the Proposal and unsupported predictions about its consequences.

The Proposal sets forth a plan for raising additional capital (the "Capital Plan") that would support OCC's function as a SIFMU and facilitate OCC's compliance with SEC Proposed Rule 17Ad-22(e)(15) (the "Proposed Rule"). The Proposed Rule would require OCC to have liquid net assets funded by equity sufficient to cover potential general business losses so that OCC can continue operations and services as a going concern if those losses materialize, and that must in all cases cover the greater of either (i) six months of OCC's current operating expenses, or (ii) the amount determined by the Board of Directors (the "Board") to be sufficient to ensure a

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[1] OCC is registered as a clearing agency with the SEC and as a derivatives clearing organization with the Commodity Futures Trading Commission. The Financial Stability Oversight Council has designated OCC as a systemically important financial market utility ("SIFMU").

[2] Letter from Howard L. Kramer, Willkie Farr & Gallagher, on behalf of Belvedere Trading, et al. (February 20, 2015) (the "MM Letter").

[3] Exchange Act Release No. 34-74136 (34-74136) (January 26, 2015), 80 FR 5171 (January 30, 2015) (SR-OCC-2015-02). OCC also filed proposals in this proposed rule change as an advance notice under Section 806(e)(1) of the Payment, Clearing, and Settlement Supervision Act of 2010. 12 U.S.C. 5465(e)(1). *See* File No. SR OCC-2014-813.

recovery or orderly wind-down of critical operations and services of OCC, as contemplated by the Recovery and Wind-Down Plan that OCC will be required to create and maintain pursuant to SEC Proposed Rule 17Ad-22(e)(3)(ii). OCC would further be required under the Proposed Rule to maintain a viable plan, approved by the Board and updated at least annually, for raising additional equity capital should its equity fall close to or below the amount required under the Proposed Rule.[4]

BACKGROUND

OCC's Board of Directors (the "Board") and its management ("Management") have determined, both for business reasons and in order to address current and proposed regulatory requirements, that OCC's capital is too low for a SIFMU. OCC had shareholders' equity of only $11.6 million as of December 31, 2012, the year in which OCC was designated as a SIFMU. By December 31, 2013, shareholders' equity was only $25.4 million following the declaration and payment of a $47.0 million refund to clearing members ("Clearing Members").

Systemically important clearinghouses, including OCC, were put on notice that standards for capital levels were being raised in the 2012 Principles for Financial Market Infrastructures ("PFMI"),[5] and the CFTC and the Board of Governors of the Federal Reserve System, in 2013 and 2014, respectively, incorporated the PFMI capital standards into their regulatory requirements and supervisory processes. OCC's supervisory agency, the SEC, has now proposed to incorporate these standards into rules affecting OCC.

In March 2014, the Board and Management determined that OCC's capital still remained too low for a systemically important institution that is part of the critical market infrastructure supporting the U.S. equity and options markets. The Board and Management further determined that OCC needed to accumulate substantial additional capital in order to comply with the SEC's proposed requirements. At that time, the Board approved and implemented the elimination of OCC's discounted fee schedule and the potential reduction or suspension of refunds.[6] By December 31, 2014, OCC had accumulated $97.1 million in shareholders' equity after giving effect to the declaration of a refund to the Clearing Members for 2014.[7] As set forth in the Proposal submitted to the SEC, the Board and Management, with the assistance of outside advisors that have worked with other SIFMUs, determined that OCC would need to meet a Target Capital Requirement[8] of $247.0 million in addition to having a replenishment capital plan

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[4] *See* Securities Exchange Act Release No. 71699 (March 12, 2014), 79 FR 29507 (May 22, 2014).

[5] Adopted jointly by the Bank of International Settlements' Committee on Payment and Settlement Systems and the International Organization of Securities Commissions.

[6] *See* Proposed Rule Change by The Options Clearing Corporation to Reflect the Elimination of a Discount to the Clearing Fee Schedule, Securities Exchange Act Release No. 71769 (March 21, 2014), 79 FR 17214 (March 27, 2014) (SR-OCC- 2014-05).

[7] The refund declared by the Board in December 2014 can be changed by OCC's Board at any time prior to its payment. As discussed below, if the Proposal is not approved in a timely manner, the Board is expected to reduce the refund to $0.

[8] As defined in the Proposal, the "Target Capital Requirement" consists of (i) a "Baseline Capital Requirement" equal to the greatest of (x) six months operating expenses for the following year, (y) the

that could be called upon in case of large, unexpected business losses, which would need to provide $117.0 million at the current level of operating expenses. In total, therefore, a capital plan for OCC would require OCC to have access to financial resources of approximately $364.0 million.

Under the Proposal, OCC's five stockholder exchanges (the "Stockholder Exchanges") would (i) contribute $150 million ($30 million each) in equity capital to OCC promptly upon regulatory approval of the Proposal, (ii) bear the cost (by foregoing dividends they otherwise would have received) of 50% of incremental capital required in the future in order to achieve the Target Capital Requirement due to increases in operating expenses, recovery and wind-down costs, or the costs associated with OCC's plausible loss scenarios as described in footnote 8 below, and (iii) enter into contractual commitments to provide up to an additional $200 million in replenishment capital, on a *pro rata* basis, to meet the requirement that OCC have a viable plan to replenish its capital in the event that OCC has general business losses causing its capital to fall below specified levels. As already described in the Proposal, in order to compensate the Stockholder Exchanges for this substantial commitment of capital, the Proposal includes the payment of dividends according to a formula carefully designed to materially limit the amount of dividends paid to the Stockholder Exchanges. Accordingly, the Proposal includes a Fee Policy, Refund Policy and Dividend Policy under which fees will be adjusted periodically to cover OCC's projected operating expenses and maintain a 25% Business Risk Buffer.[9] To the extent that actual revenues exceed actual expenses at year end, *and after funding any incremental increase in the Target Capital Requirement*, 50% of the excess will be refunded to the Clearing Members. After paying taxes on the remaining 50%, the after-tax amount will then be paid as dividends to the Stockholder Exchanges. To the extent that OCC's capital requirements increase over time, the increase will be met from earnings, thereby reducing funds available for both refunds and dividends. These terms, along with additional details regarding the Proposal, are set forth in the rule filing. It is important to understand that, by using the 25% Business Risk Buffer as the source for necessary additions to capital going forward, and absent very exceptional circumstances, future additions to capital will be contributed in equal amounts by the Exchange Stockholders (through the reduction of dividends) and the Clearing Members (through reduction of clearing fee refunds). This is in contrast to the manner by which OCC has historically accumulated capital: exclusively from the accumulation of retained earnings, which resulted in the reduction of clearing fee refunds.

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maximum cost of the recovery scenario from the Recovery and Wind-Down Plan, and (z) the cost to OCC of winding down operations as set forth in the Recovery and Wind-Down Plan, plus (ii) a "Target Capital Buffer" linked to plausible loss scenarios from operational risk, business risk and pension risk. The Baseline Capital Requirement currently is $117 million, the Target Capital Buffer currently is $130 million, and the Target Capital Requirement currently is $247 million.

[9] "Business Risk Buffer," as defined in the Proposal, means the amount of fee revenue that OCC targets above its projected operating expenses in order to manage business risk to $0, when expressed as a percentage as follows: Annual Revenue Target = Forward 12 Months Expense Forecast / (1 – Business Risk Buffer). For example, if OCC's expense forecast is $240 million and its Business Risk Buffer is 25%, then the revenue target would be $320 million ($240 million divided by (1 minus .25)).

RESPONSES TO THE MMs' COMMENTS

<u>MM COMMENT</u>: THE MMS SUPPORT THE GREATER CAPITALIZATION OF OCC.

OCC notes and appreciates the support offered in the MM Letter for OCC's development of a capital plan. The MM Letter states that it "understand[s] the need for OCC to raise capital" and "do[es] not dispute that OCC has significant new regulatory costs or that its current status of operating as a not-for-profit entity makes financing challenging." This is an important acknowledgment and area of agreement—one that the Board and Management have worked to articulate to OCC's stockholders and to market participants. OCC, its exchanges, and its Clearing Members, therefore, are aligned on these fundamental points. It is important to reiterate, however, that OCC believes it is in the best interests of all of its constituents to have a capital plan, addressing the fundamental capital needs of OCC as set forth in the Proposal, as quickly as possible and in no event later than the anticipated effective date for the Proposed Rule. The remaining question, then, is how OCC can accomplish this.

<u>MM COMMENT</u>: THE CAPITAL PLAN NEEDS MORE VETTING BY THE OPTIONS INDUSTRY.

1. *The MM Letter questions the need to approve the Proposal now*.

The MM Letter questions the timeline proposed for implementing the Capital Plan and suggests that there is time to revisit, re-negotiate, and even reformulate entirely the Capital Plan but does not seem to appreciate the time constraints imposed by the anticipated effective date of the Proposed Rule. In raising these questions, the MM Letter fails to recognize two key facts: that (i) Management and the Board have determined for business reasons that OCC's capital is too low for a SIFMU irrespective of the Proposed Rule, and (ii) in order to ensure OCC's timely compliance with the Proposed Rule, affirmative steps must be taken now in order to have a fully negotiated and implemented capital plan in place by the expected effective date.

OCC believes that the Proposed Rule may be adopted soon, perhaps with a delayed effective date of up to six months, so that the capital requirement may become applicable to OCC as soon as the end of the third quarter of 2015. While there is no assurance as to the adoption or effective date, OCC's Board and Management believe that it would be imprudent to wait and that OCC must take steps now to ensure that it complies with the proposed requirements by the time they become effective, particularly given the unique ownership structure of OCC and the difficulty of quickly raising capital for an industry utility. The Board and Management have duly considered the possibility that OCC might obtain a delay of the effective date for the Proposed Rule to give further consideration to alternative means of increasing its capital. However, the Board and Management have determined that this is very unlikely. OCC has received no indication that the SEC would provide a delay of the effective date. As noted above, the international standards on which the Proposed Rule is based were adopted in 2012. Given the time that has already passed and the regulatory mandate to enhance the financial resiliency of SIFMUs, it is highly unlikely that such relief would be granted.

As discussed in further detail below, the Board and Management engaged in a lengthy process over a period of approximately 10 months during which they analyzed a wide range of alternative methods for achieving compliance with each aspect of the Proposed Rule by a reasonably anticipated effective date, culminating in the determination that the viable alternatives were in fact quite limited and that the Proposal was the best and most viable of those limited alternatives for achieving compliance by the expected effective date. There is no reason to believe, as suggested by the MM Letter, that a longer process that revisits the analyses and determinations already made by the Board would produce a different result at present. Moreover, an important component of the Proposal is that it permits OCC to make a substantial refund to Clearing Members for 2014, since OCC would not reduce its regulatory capital by making a refund for 2014 in the absence of the capital contribution from the Stockholder Exchanges. In December 2014, in anticipation of the Proposal being approved, OCC's Board declared a refund for 2014 (to be paid in 2015). However, the refund declared by the Board can be changed by the Board at any time prior to its payment. OCC is required by Rule 213 of its Rules to provide to Clearing Members its audited financial statements within 60 days following the close of OCC's fiscal year (February 27, 2015). Further, those financial statements cannot be finalized without knowing that the amount and likelihood of payment of the 2014 refund is "probable." Therefore, if the Proposal is not approved in a timely manner, it is likely that the Board would eliminate the 2014 refund. OCC desires to avoid this result, which is why it is imperative that the Proposal be approved in a timely manner.

Furthermore, among the reasons the MM Letter raises concerns about the need for further industry vetting is the assertion that the Capital Plan will remain in place "in perpetuity." In fact, the Capital Plan represents a negotiated change to the capital structure of OCC currently in place, demonstrating that the capital structure in fact can change over time as circumstances change. Moreover, the Board has certain fiduciary duties under corporate law to consider proposals that might be advantageous to OCC, which duties would apply to possible changes to its capital structure that may be proposed in the future or might otherwise be necessary to address evolving regulatory capital requirements.

2. *The MM Letter asserts that industry participants need more details and a more transparent process for the Proposal to be fully vetted by industry participants*.

The notion that industry participants were not involved in the negotiation and adoption of the Proposal is inaccurate. The Board engaged in a lengthy process since early 2014 during which it investigated, reviewed and weighed various alternative models and engaged in extensive discussions with regulators, Clearing Members, Stockholder Exchanges, and outside advisors. This process culminated in the Board's determination that the proposed Capital Plan was the best option that would allow OCC to increase its capital to a level appropriate for a SIFMU and to ensure compliance with the capital and liquidity requirements on or before the expected effective date for the Proposed Rule.

Directors representing Clearing Members have been actively involved in the examination and negotiation of the Capital Plan, including the proposed dividend, throughout the entire process. The involvement in the process by representatives of market participants in conjunction with the public materials and statements provided by OCC is, therefore, sufficient to fully analyze the Proposal, and OCC has no reason to believe that more time would produce a different result or one that would garner greater support from its various constituencies or regulators.

At the March 6, 2014 Board meeting, the Board authorized Management to devote resources to explore the benefits and feasibility of various approaches to address OCC's need for additional financial resources and liquidity in order to comply with the Proposed Rule. From March 2014 through December 2014, OCC, with the assistance of its financial and legal advisors, studied and carefully considered several alternative methods for achieving additional capital and liquidity, including: (i) issuing capital stock to Clearing Members; (ii) securing capital contributions from existing Stockholder Exchanges; (iii) issuing perpetual preferred shares to outside institutional investors; (iv) undertaking a complete recapitalization of OCC based upon a strategic realignment of OCC's governance structure and its industry utility business model; and (v) accumulating retained earnings by removing OCC's then-existing discounted fee schedule. Nearly all of the alternatives that were examined posed significant tax, compliance or governance and shareholder rights issues that made such alternatives uncertain or unfeasible.[10] Therefore, the Board initially determined to accumulate retained earnings by removing OCC's then-existing fee schedule and potentially reducing or suspending further refunds.[11] The Board was mindful, though, that OCC's capital plan needed to not only provide for a capital infusion to improve its financial resources in the near-term, but also, as the MM Letter acknowledges, provide for an ongoing, viable source of replenishment capital.

In November 2014, the Stockholder Exchanges developed a proposal (the "Exchange Proposal"), which was refined and then presented to the Board in December 2014. The Board, with the assistance of its financial and legal advisors, analyzed the Exchange Proposal, along with another alternative involving organic accumulation of capital through retained earnings. This latter alternative was rejected by the Board because it would not result in the accumulation of sufficient capital to ensure OCC's ability to improve its capitalization and comply with the Proposed Rule by September 2015. Instead, the projections provided to OCC by its financial advisors indicated that, under this latter alternative and its current fee structure, OCC would not achieve compliance with the requirements of the Proposed Rule until the fourth quarter of 2017. The Board also considered analyses indicating that the current fees would need to be increased by as much as 162% in order to comply with the Proposed Rule by its expected effective date. After determining that the Exchange Proposal was the only remaining viable proposal to both meet the requirements of the Proposed Rule and achieve compliance on or before a reasonably

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[10] Under OCC's Certificate of Incorporation, its By-Laws and the Stockholders Agreement to which OCC and the Stockholder Exchanges are parties (all of which have been filed with, and approved by, the SEC), and under Delaware corporate law, the Stockholder Exchanges have certain rights with respect to proposed changes to OCC's capital structure. These include the right not to have their investment in OCC diluted through the issuance of additional equity capital, as well as the right to elect directors to OCC's Board. The Board determined that it was not likely to be the case that all five Stockholder Exchanges would agree to changes to the capital structure that would be to their detriment, at least on a timetable that would permit OCC to raise the necessary capital "funded by equity" to achieve compliance with the Proposed Rule. As noted above, however, the Board of Directors of OCC has certain fiduciary duties under corporate law to consider proposals that might be advantageous to OCC, which duties would apply to possible changes to its capital structure that may be proposed in the future or might otherwise be necessary to address evolving regulatory capital requirements.

[11] *See* Rule Change Filed for Immediate Effectiveness by The Options Clearing Corporation to Reflect the Elimination of a Discount to the Clearing Fee Schedule, Securities Exchange Act Release No. 71769 (March 21, 2014), 79 FR 17214 (March 27, 2014) (SR-OCC- 2014-05).

anticipated regulatory deadline for compliance, certain directors representing the Clearing Members and certain directors representing the Stockholder Exchanges negotiated the terms of the proposed Capital Plan, and the Board determined that the negotiated terms represented the most favorable transaction possible in light of all the circumstances. The resulting Proposal and its submission to the SEC were then approved by the required super-majority of the Board.

The MM Letter complains at a number of points about the proposed dividend contemplated by the Proposal. This element obviously was a key component of the Capital Plan. In determining the reasonableness of the expected rate of return for the Stockholder Exchanges, the Board considered a number of factors, including the risk inherent in the $150 million investment, the unusual nature of the investment in OCC as an industry utility, the Stockholder Exchanges' market cost of equity capital, the $200 million replenishment capital commitments made by the Stockholder Exchanges and the circumstances under which such capital may be required to be contributed, and the various safeguards in the policies controlling fees, dividends, and refunds contemplated by the Proposal, including, in particular, the material limitations on dividends and the related lack of material "upside" to the investment.

The market costs of equity capital for the contributing Stockholder Exchanges for which information was publically available were obtained on November 18, 2014 from Bloomberg, which utilizes the capital asset pricing model (CAPM) for determining a public company's cost of capital. The base rate of 10% was determined by taking into account each exchange's cost of capital. The Board further recognized that investing in OCC is different from many other investment opportunities for many reasons, including OCC's structure as an industry utility and the specific features and design of the Proposal. The structure of the dividend reflects the customary expectation of a return that is appropriately accretive to the Stockholder Exchanges' cost of capital as well the lack of material "upside" on the investment, the Stockholder Exchange's ongoing contributions to capital in the form of reduced dividends as the Target Capital Requirement increases over time, and the Stockholder Exchanges' commitment to provide replenishment capital of up to $200 million when OCC's risk profile is potentially greatly heightened.

The terms reflected in the Proposal were negotiated principally by Board members representing both the Stockholder Exchanges and the Clearing Members. The largest group of Board members is those that represent the Clearing Members ("Member Directors"). The Capital Plan was approved by a two-thirds majority of the Board, including four Member Directors, constituting a majority of the Member Directors voting on the Capital Plan.[12] It is fair to say, then, that industry representatives were not only apprised of but closely involved in the development, negotiation and approval of the Proposal. They have had a more than adequate opportunity to vet the Proposal.

[12] Out of nine Member Directors, one did not attend the Board meeting at which the Capital Plan was approved, one abstained, four voted in favor, and three voted against.

<u>MM COMMENT</u>: OCC HAS NOT FULLY JUSTIFIED THE NEED FOR SUCH DRAMATIC ACTION.

In this comment, the MM Letter asserts, among other things, that the exact amount OCC's Target Capital Buffer and Baseline Capital Requirement are not mandated under the Proposed Rule and that OCC's reference to Principle 15 of the PFMIs is "questionable." This insinuates that the increased regulatory requirements under the Proposed Rules are a mere pretext for the Proposal. That is simply out of touch with the new regulatory reality. As OCC has articulated in detail in its rule filing relating to the Proposal and elsewhere in this letter: (i) the Board, in the exercise of its business judgment, determined that the amount of OCC's capital should be significantly increased given its role in the critical market infrastructure supporting the U.S. equity and options markets, regardless of the Proposed Rule – in fact, the Board determined to increase OCC's capital by eliminating the discounted fee schedule and suspending the Clearing Member refund prior to the publication of the Proposed Rule, (ii) complying with the requirements of the Proposed Rule will have a substantial impact on the operations of all SIFMUs, and (iii) OCC believes that the adoption of the Proposed Rule is imminent, and its expected effective date places critical constraints on OCC's ability to timely comply with its requirements. Given the obvious difficulty that OCC faces in substantially increasing its capital while maintaining is status as an industry utility, OCC's Board determined that it must be proactive.

There are other ways in which the MMs do not seem to appreciate the development of the regulatory landscape for SIFMUs in the last few years. For example, the MM Letter notes that the Proposal's reference to the PFMIs is "questionable" because Principle 15 has been "in effect" since April 2012 but the effect of the PFMIs has not been reflected in OCC's prior statements regarding its capital requirements. The comment begins and ends with a misstatement of fact. The PFMIs were published in 2012 but were not "in effect" as to OCC. Initially, there was no certainty that the PFMIs would ever be adopted by U.S. regulators. As it became increasingly clear that OCC would be subject to heightened regulatory capital requirements, OCC began to anticipate meeting those requirements, and in 2014, OCC did eliminate the discounted fee structure as a result, as acknowledged in the rule filing and discussed in this letter. At that time, the MMs and their legal counsel vigorously protested the fee increases intended to meet regulatory capital requirements.[13] The MM Letter also claims that OCC has made "no case" for the amount of funds it determined would be required under a capital plan. This is entirely incorrect and ignores the lengthy and involved process employed by OCC in developing and negotiating the Proposal. As described above and in the Proposal, OCC undertook a major effort with consultants involving multiple factors, and the Board, in the exercise of its business judgment, ultimately approved the Capital Plan, including the amount of capital needed. As discussed in the rule filing and elsewhere in this letter, in accordance with its duties, the Board's process involved fulsome analyses of multiple alternative approaches to raising capital, including legal analysis and financial modeling.

[13] *See*, *e.g.*, Letter from Howard L. Kramer, Willkie Farr & Gallagher, on behalf of Belvedere Trading, et al. (April 24, 2014).

<u>MM COMMENT</u>: THE CAPITAL PLAN IS A DRAMATIC DEPARTURE FROM OCC'S HISTORICAL BUSINESS MODEL.

Any proposal for raising a substantial amount of capital will draw criticism from some constituents, as has already been demonstrated with respect to previous proposals.[14] The MM Letter mischaracterizes the Proposal as a "complete departure" from OCC's historical industry utility model. That assertion is baseless. The Proposal is in fact consistent with and preserves OCC's historical role as an industry utility. The industry utility model under which OCC sets its fees at levels sufficient to cover its operating expenses plus reasonable reserves is deeply embedded in the history of OCC dating back to the 1974 "Plan to Establish Common Clearing Facility for all Exchange-traded Options." This plan was developed under the oversight of the SEC and with cooperation among interested exchanges and Clearing Members. OCC's rule filing specifically states that the Proposal is not intended as a departure from the industry utility model. Rather it permits the preservation of that model by providing OCC a means of obtaining the large amount of additional initial capital, incremental required capital, and commitments to replenish capital OCC will be required to maintain as a SIFMU.

As set forth in the Proposal, the Capital Plan includes a Fee Policy that requires fees to be set at a level sufficient to cover projected operating expenses and maintain a Business Risk Buffer of 25%, which is less than the historical pre-refund operating margin of 31%. The Fee Policy requires the Board to dynamically adjust fees based on expenses, volumes and revenues, among other things. In the event that projections for the remainder of any calendar year show that then-current fee levels would achieve more than a 25% Business Risk Buffer (for example, because volumes are higher than projected or operating expenses are lower than budgeted), the fees will be reduced to levels that are projected to achieve the 25% Business Risk Buffer. Thus, all Clearing Members and market participants (and particularly those customers that do not receive a pass-through of refunds from their clearing member firms) will reap the advantage of lower fees.

Additionally, the Proposal fully describes the material aspects of the Refund Policy, which requires that 50% of OCC's earnings in excess of amounts necessary to be retained in order to maintain its Target Capital Requirement be refunded to Clearing Members, which, together with the Fee Policy and the 25% Business Risk Buffer required by that policy, materially limits the amount of the dividends available to be paid to the Stockholder Exchanges. As a result, OCC believes that the Proposal does not disrupt the historical model, but instead better aligns the interests of market participants and exchanges with respect to fees.

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[14] *See* Letter from Howard L. Kramer, Willkie Farr & Gallagher, on behalf of Belvedere Trading, et al. (March 26, 2014), Letter from Ellen Greene, Vice President of Financial Services Operations, Securities Industry and Financial Markets Association (April 17, 2014), Letter from John Daley, Stifel, Nicolaus, Chairman of the Board, and James Toes, President & CEO, Security Traders Association (April 17, 2014), Letter from Howard L. Kramer, Willkie Farr & Gallagher, on behalf of Belvedere Trading, et al. (April 24, 2014) (each commenting on Rule Change Filed for Immediate Effectiveness by The Options Clearing Corporation to Reflect the Elimination of a Discount to the Clearing Fee Schedule, Securities Exchange Act Release No. 71769 (March 21, 2014), 79 FR 17214 (March 27, 2014) (SR-OCC- 2014-05)).

Finally, in the development of the Proposal, OCC took into account that the SEC will continue to expect that OCC's pricing structure/fee levels, and operating margins reflect its industry utility status. This concept is well understood by the entire Board, including those directors representing the Stockholder Exchanges.

The Board and Management have determined that the Proposal is balanced and fair to all constituencies, and OCC believes that there are no viable alternatives that would ensure OCC's ability to meet the requirements of the Proposed Rule in a timely manner have been proposed.

<u>MM COMMENT</u>: THE CAPITAL PLAN WILL CREATE CONFLICTS OF INTEREST IN SETTING OCC'S BUDGETS.

The MM Letter claims that the Capital Plan will result in ever-increasing budgets that would thereby increase the dividend payments to the Stockholder Exchanges, which in turn would have an incentive to artificially inflate budgets to maximize dividend payments. To be clear, OCC disputes that an increase in operating expenses will result in a material change to the rate of return for the Stockholder Exchanges. The financial models that the Board relied upon accounted for these dynamics and resulted in what the Board believes is a reasonable rate of return. What the MM Letter appears to ignore is that higher operating expenses will result in an increased Target Capital Requirement, which will require additional capital contributions to be withheld from both dividends and refunds. Thus, an increase in operating expenses results in larger cumulative capital contributions from the Stockholder Exchanges. If an increase in the Business Risk Buffer does result in an increase in dividends, the larger cumulative capital contributions will have the effect of reducing any increase in the rate of return that would otherwise result from the increase in dividends. The MMs, therefore, are attacking a straw man by "question[ing] how [the Stockholder Exchanges] could fairly guide OCC on budget efficiencies in years to come when larger budgets would serve to increase their dividend." The MMs also complain that OCC's budget has "routinely grown at a high rate over recent years" and speculate as to OCC's projected revenues, expenses and refunds. It is widely known in the industry, and naïve not to recognize, that the costs that financial infrastructures face in complying with heightened regulatory requirements have increased substantially in the last several years. This is particularly true for entities that have been designated as SIFMUs, as is the case with OCC. The focus, in any event, should be on the merits of the Capital Plan.

In that regard, irrespective of the interests of the constituencies that elect each member of the Board, the notion that the Board as a whole would be conflicted is false. The MM Letter protests that "if ever-larger budgets occur, it should not happen without the ability of market participants, who ultimately finance OCC through transaction fees, to be assured that OCC… continues to operate with the public marketplace foremost in mind." But this is precisely what the Proposal contemplates. The Proposal's own terms, as explained in the rule filing, require the ongoing participation and assent of industry representatives on the Board. The Fee Policy, Dividend Policy and Refund Policy each provides that any exception or amendment to the policy requires the affirmative vote of two-thirds of the directors then in office as well as the approval of each of the Stockholder Exchanges. Under the current composition of the Board, a two-thirds majority of the directors in office cannot be achieved without the votes of at least some of the Member Directors. The Member Directors as a group therefore have an effective veto over any change in these policies. Any change in the composition of the Board of Directors would also, pursuant to Article XI, Section 1 of OCC's By-Laws, require a two-thirds vote of the directors then in office as well as unanimous approval of stockholders, and the same is required to amend Article XI, Section 1 itself.

While approval of OCC's annual budget requires only a simple majority vote of the Board, there are only five exchange directors out of a total of 21 directors, after increasing the number of public directors from 3 to 5 and hiring a new CEO who will also serve as a director. Even if joined by votes of two management directors, it would be necessary for the exchange directors to obtain additional support either from public directors or member directors or a combination of the two in order to approve a budget with increased expenses. And in any event, as noted above, the effect of approving a budget with an increase in operating expenses is offset by a resulting increase in the Target Capital Requirement in terms of its impact on the Stockholder Exchanges' investment return.

Clearing Members have additional protections against changes in expenses that would result in fee increases because any future change in the Fee Policy would also require SEC approval. This need for approval would provide an opportunity for Clearing Members and other market participants to object to any proposed changes. In addition, any change in OCC's fee schedule also requires an SEC rule filing, and the Commission has the authority to disapprove a fee filing as inconsistent with the requirement of Section 17A of the Exchange Act that fees of a clearing agency be "reasonable."

The proposed Refund Policy and Dividend Policy, which work hand-in-hand with the Fee Policy, are similarly subject to SEC review and approval and would again provide Clearing Members with the opportunity to object to proposed changes in those policies. These policies work together to ensure that Clearing Members will continue to have the benefit of OCC's low fee structure.

MM COMMENT: OCC SHOULD HAVE ADOPTED A CAPITAL PLAN RELIANT ON RAISING CAPITAL THROUGH THE FEE INCREASES AND SUSPENSION OF REFUNDS THAT BEGAN IN 2014.

It is an inherent problem for a public or common utility that all the users want it but are much less likely to agree about how to pay for it. The rule filing acknowledges the increase in fees of 70% in 2014 that resulted from the elimination of the discounted fee schedule, which was intended to raise equity capital, but fee increases are not a viable source of capital for purposes of complying with each of the requirements under the Proposed Rule. The MM Letter asserts that the fee increases instituted in 2014 have and will provide for additional capital through retained earnings and further proposes that suspending refunds from those increased fees would allow OCC to "address much of the capital concern" contemplated by the Proposal. The MMs at some points in their letter appear to be objecting to increasing shareholders' equity through higher fees yet also objecting to OCC's refunding of amounts related to those fee increases. It is not clear whether the MMs would ultimately prefer that greater amounts be refunded to Clearing Members, as they argue in a number of instances in their letter, or that greater amounts be retained by OCC, as suggested by this comment. On the one hand, the MM Letter argues that OCC should not depart from its historical practice where "excess revenues would be largely rebated" back to Clearing Members. On the other, it proposes that OCC suspend all refunds to increase its capitalization. Finally, a proposed solution that addresses "much" of the capital concern is not a solution – OCC is obligated to address *all* of the concern, including the requirement to maintain a viable plan for replenishment capital, which the Proposal accomplishes.

It is not, in any event, possible to accumulate in a timely manner the large amount of capital required under the Capital Plan without dramatically increasing fees and potentially affecting order flow, effective spreads, and trading volumes. Accumulating capital through retained earnings would likely have a more adverse impact on investors and the options markets. When OCC filed a proposed rule change in March 2014 to suspend the fee discount and clearing member refunds in an effort to increase retained earnings to meet capital requirements that were then estimated to be lower than the currently projected requirements, even that relatively modest increase in the effective fee schedule met with vigorous opposition from certain market participants who predicted severe negative consequences including widened spreads, reduced liquidity and higher costs for investors. While OCC believed those predictions to be exaggerated given the relatively small size of the effective fee increase then adopted ($.02 per side for the smallest trades), those concerns would become far more severe at the fee levels that would be required to achieve the currently proposed target capital levels within the anticipated time frame for regulatory compliance.

The MMs themselves filed comment letters with the SEC in 2014 vigorously protesting the very fee increase and refund suspension they now champion. On April 24, 2014, the MMs submitted a comment letter concerning the proposed elimination of OCC's discounted fee schedule in which it decried the "extreme size and nature of the fee increases and their likely effect on the options market." They similarly complained that the "owners of OCC (the major options exchanges) *were not being asked to absorb or finance any of these new expenses*." (Emphasis added.). At that time, the MMs opposed using clearing fees to meet new regulatory costs and questioned why OCC was not exploring "alternative means of raising funds," noting in particular that, in the view of the MMs and their counsel, the Proposed Rule "seem[s] to contemplate OCC raising funds through capital contributions and equity issuances rather than fee increases."

Whatever the true preference of the MMs may be, even on its own terms, the high-level outline of a capital plan proposed in the MM Letter, which focuses on using retained earnings and the suspension of refunds as the source of capital, fails to allow OCC to even approach meeting the capital requirements contemplated by the Proposed Rule by the expected effective date of the Proposed Rule, nor would it provide OCC with a viable plan for accessing replenishment capital. As previously noted, the projections provided by OCC's financial advisors indicate that, under this model and OCC's current fee structure, OCC would not achieve compliance with the requirements of the Proposed Rule by accumulating the required $364.0 million until the fourth quarter of 2017, or current fees would need to be increased by as much as 162% in order to comply with the Proposed Rule by its expected effective date. This failure validates the Board's determination after its nearly year-long process of evaluating alternative capital plans that the Proposal is the only remaining viable option for meeting the requirements of the Proposed Rule on or before its expected effective date.

The MM Letter also states in this comment that the Proposal creates a structure whereby the Stockholder Exchanges could ultimately monetize their ownership of OCC. This, of course, is not intended, nor is it feasible for a variety of regulatory and market-related reasons. Neither the Board nor the Stockholder Exchanges have any plans to monetize the Stockholder Exchanges' ownership of OCC through a sale to investors. Additionally, there are many hurdles that would need to be overcome for the Stockholder Exchanges to monetize their interest in OCC. Any such change would require amendments to provisions of the By-Laws and other governing documents including the Amended and Restated Stockholders Agreement. For example, the terms of the Amended and Restated Stockholders Agreement are a significant barrier to any such monetization because (i) shares of OCC stock are generally not transferrable to any person other than OCC or another stockholder exchange, (ii) a stockholder exchange wishing to dispose of its shares generally must dispose of all of its shares of stock absent OCC's consent, (iii) OCC and the other stockholder exchanges have rights of first refusal to purchase the shares of any exchange desiring to transfer its stock, and (iv) even if a stockholder exchange transferred its shares, the price paid for shares transferred pursuant to OCC's or another stockholder exchange's purchase right is the lowest of (x) aggregate book value, (y) total capital contribution paid to OCC by the selling stockholder exchange, and (z) the price offered (if any) by any proposed transferee.

Changes to these documents and the constraints contained therein could not be accomplished without the consent of all Stockholder Exchanges as well as the approval of the Board in each case and the affirmative vote of two-thirds of the directors then in office in the case of the By-Laws. Furthermore, changes to these documents and OCC's ownership structure generally require the approval of the SEC and would be the subject of a rule filing process that will permit public comment. As noted above, the directors representing the Stockholder Exchanges do not constitute a majority of the Board. OCC believes, therefore, that a change to a for-profit model could not be effected without very broad support from the Clearing Members as well as the exchanges and the regulators, and OCC does not believe that any such support exists or is likely to exist in the future.

MM COMMENT: THE BUSINESS RISK BUFFER HAS NOT BEEN FULLY EXPLAINED.

Contrary to the MMs' assertions regarding a lack of transparency and explanation, OCC has described in the rule filing the considerations that went into setting the terms of the Proposal. This applies with equal force to the Business Risk Buffer: it was described in detail, the method for its calculation was set forth, and its interaction with the new policies was explained. All material terms regarding the Business Risk Buffer have already been disclosed and described in detail in the Proposal, and the Proposal can be adequately analyzed on that basis.

The numbers set forth in MMs' comment are based on the MMs' misunderstanding of the calculation of the Business Risk Buffer. The Business Risk Buffer of 25% is based on the total revenues received by OCC. Using the example in the MM Letter, total revenues of $312 million with expenses of $234 million yields operating profit of $78 million, which is 25% of $312 million. This method for calculating the Business Risk Buffer is the same method that was used to derive the 31% historic 10-year average. Accordingly, it *does* represent a reduction. Neither the Stockholder Exchanges nor Management may simply modify or increase the target Business Risk Buffer. The Business Risk Buffer of 25% is fixed and can only be changed by a two-thirds vote of the Board (and unanimous stockholder consent). The protections in place to ensure this (including the fact that any such change would require the consent of multiple Member Directors) have been described in detail in the rule filing and elsewhere in this letter.

<u>MM COMMENT</u>: THE REPLENISHMENT CAPITAL COMMITMENT IS MORE LOAN THAN CAPITAL.

The MM Letter attempts to argue that the replenishment capital commitment contained in provided for by the Proposal is more like debt than equity because it is intended to be repurchased by OCC over the allotted period of time and therefore does not meet the "funded by equity" requirements of the Proposed Rule.[15] The replenishment capital will clearly be equity. It would be listed on the balance sheet as stockholders' equity, would be funded in exchange for the issuance of Class C common stock, would be treated as equity for tax purposes, and, most importantly, the holders of the Class C common stock would be subordinated to those of creditors of OCC in the event of any bankruptcy or liquidation. Even though the replenishment capital is not intended to remain outstanding indefinitely, there is no legal requirement that it be repurchased and it is far from assured, given the circumstances under which it would be funded, that it would ever be repurchased. The MM Letter's complaint of the "draconian" measure of terminating refunds if replenishment capital is not repurchased within two years demonstrates why the repurchase mechanism is an important feature, not a bug, of the Proposal. Specifically, if replenishment capital is required from the Stockholder Exchanges and has not been repurchased in full or shareholders' equity has not been restored to the Target Capital Requirement within 24 months, OCC would no longer pay refunds to Clearing Members, even if the Target Capital Requirement is restored and all replenishment capital is repurchased at a later date (in each case after such 24 month period). The example relates to a situation where replenishment capital is required and is furnished to OCC by the Stockholder Exchanges. Such an event could occur only if OCC were to suffer an unanticipated and unprecedented substantial loss of capital (in excess of $100 million at present), and any additional capital contributed to OCC in those circumstances would likely be at significant risk. OCC would have a 24-month period to repurchase the replenishment capital and restore its shareholders' equity to the Target Capital Requirement. If OCC is able to repurchase the replenishment capital and restore its shareholders' equity to Target Capital Requirement within the allotted time, that recovery of its financial position would result in a return to the *status quo ante* under the Capital Plan. However, if OCC is unable to do so, the investment by the Stockholder Exchanges (both the initial capital contribution and any unpaid replenishment capital) is likely of a different, and much more risky, type than originally envisioned, for which a greater return is appropriate.

After discussion and negotiation, it was determined that the appropriate solution for this unanticipated situation whereby the Stockholder Exchanges have funded the replenishment capital on something other than a "bridge" basis was to provide the Stockholder Exchanges with the customary rights associated with being the owner of a corporation – the right to receive the

[15] The MMs also argue that an unfunded capital commitment is "not justification for the payment of a dividend," failing to recognize that commitments to fund both equity and debt customarily involve an economic benefit as compensation for the commitment. The fact that the Stockholder Exchanges are compensated for their commitment to provide replenishment capital through the proposed dividend structure, rather than a stand-alone commitment fee, does not change the appropriateness of the economic return to stockholder exchanges or the equity nature of the replenishment capital.

earnings and profits of the corporation in consideration for providing the capital – so the payment of refunds would cease. It should be noted that the most likely reasons for this outcome are that (i) the fees set by the Board (still significantly controlled by Clearing Members) during the period when replenishment capital remains outstanding do not generate sufficient revenue to allow OCC to repurchase the replenishment capital in a timely manner, or (ii) OCC suffers another significant, unexpected loss during the 24-month period, emphasizing again the increased risk associated with this investment. The Fee Policy and OCC's governance structure would not be affected and no dividends could be paid to the Stockholder Exchanges until the Target Capital Requirement is restored. OCC's projections indicate that, based on fees established using the 25% Business Risk Buffer, it is likely that the replenishment capital could be repaid under the 24-month period. However, if that does not appear to be feasible at the time, under the Proposal, OCC's Board (on which the Stockholder Exchanges hold only five out of 20 director positions) would have the right, pursuant to proposed changes to the By-Laws, to increase fees or reduce expenses (without reducing fees), causing an increase in the 25% Business Risk Buffer, in order to accumulate retained earnings sufficient to repurchase any paid-in replenishment capital to the Stockholder Exchanges and restore capital to the Target Capital Requirement. This mechanism was specifically designed to provide flexibility to the Board to maintain the status quo of 50%/50% sharing of excess net income between Clearing Members (in the form of refunds) and Stockholder Exchanges (in the form of after-tax dividends) and to limit the circumstances under which future refunds to Clearing Members would be eliminated. Finally, in the unlikely event that Stockholder Exchanges would become more like typical equity owners in the sense of being entitled to receive profits without refunding fees to Clearing Members, they would still be subject to substantial constraints in fee-setting (pursuant to the Fee Policy) and governance (given the composition of the Board as set forth in the By-laws). OCC believes it safe to say that neither OCC, nor Clearing Members, nor the Stockholder Exchanges hope or expect that such an extreme event will ever occur. However, the Board determined that if such an extreme event were to occur, the remedy in the proposed Refund Policy would be a fair outcome. It is the consequence of a failure of the intended structure and provides protection for the Stockholder Exchanges and incentive for Clearing Members to ensure that the replenishment capital is restored in a timely fashion.

MM COMMENT: OCC IS PRIMARILY SUPPORTED WITH FEES PAID BY MARKET PARTICIPANTS.

The MM Letter asserts that one of the indications that the Proposal, if approved, would convert OCC into a "profit tool for the five owners" is the adoption of the proposed Fee, Refund and Dividend Policies discussed above and in the rule filing. The Proposal, including those policies, in no way creates a for-profit model. Rather, the MM Letter appears to misunderstand the relationship among the Fee, Refund and Dividend Policies.

For example, contrary to the suggestions contained in the MM Letter, the Stockholder Exchanges cannot enhance their dividend stream at the expense of ever-higher clearing fees. The Stockholder Exchanges have no authority or ability to increase fees in order to increase or pay dividends to themselves. Under the Fee Policy incorporated in the proposed Capital Plan, OCC's fees are required to be set as follows: OCC's Board reviews fees quarterly to maintain a fee schedule that establishes fees at a level to (1) cover projected operating expenses plus a Business Risk Buffer of 25%; (2) maintain such reserves as are deemed by the Board to be reasonably necessary for the conduct of OCC's business; and (3) accumulate such additional surplus as the Board may deem advisable to permit OCC to meet its obligations to Clearing Members and the general public. Under this formula, dividends to Stockholder Exchanges and refunds to Clearing Members can be paid only from the Business Risk Buffer since the other two categories represent additions to capital.

OCC has incorporated an additional protection to the existing fee setting provision in OCC's By-Laws by stating that setting fees at a level above projected operating expenses plus the Business Risk Buffer to obtain additional reserves and surplus can be done only in extraordinary circumstances and only after application of the full amount of the Business Risk Buffer (meaning that there will be no funds available to pay refunds or dividends). Thus, future additions to capital will be made equally by the Stockholder Exchanges and Clearing Members through reduced dividends and refunds, respectively; and only when both dividends and refunds are reduced to zero during the relevant period can further additions to capital be made exclusively from increased fees. As noted previously, this could be done only in extraordinary circumstances.

The MM Letter nevertheless maintains that the Stockholder Exchanges will be "unjustly enriched" because the Proposal will effectuate potential dividend payments to the Stockholder Exchanges "funded by monopolistic fees borne by market participants." That is obviously not the case. As repeatedly stated in the Proposal, the reason that Clearing Member refunds will be less than 100% of the available Business Risk Buffer is to compensate the Stockholder Exchanges for the substantial initial capital contribution, the continued funding of future capital requirements, and the commitment to fund replenishment capital following a significant loss (provided at a time when OCC is likely to be a very risky investment and for which no returns will be paid until capital is restored to target levels). This compensation is in order to provide OCC with the capital that all the constituencies agree is required. However, it is important to recognize that the additional capital cushion will allow OCC to operate safely with a smaller margin than it does currently, giving Clearing Members the benefit of a lower fee structure. The interaction of the Fee Policy, Dividend Policy and Refund Policy has the effect of substantially limiting the return of the Stockholder Exchanges at a rate deemed by the Board and its financial advisors to be reasonable in consideration of relevant factors. Consistent with OCC's industry utility model, OCC will effectively refund 100% of the amount not required to be paid in compensation for the necessary initial and ongoing capital contributions and replenishment commitments of the Stockholder Exchanges. The split between refunds and dividends paid from excess earnings is a reflection of the cost of meeting the regulatory capital requirements and the substantial funded and unfunded capital commitments of the Stockholder Exchanges.

MM COMMENT: THE PROPOSAL IS DEFICIENT IN COMPARISON TO OTHER ALTERNATIVES.

The MMs offer another alternative proposal that involves escrowing fee revenue that would then be used to accumulate capital over time "to a level the SEC finds appropriate" but would not be an asset of OCC and would be distributed to the payors upon a demutualization, liquidation, dissolution, or other similar event. Like the MMs' suggestion that retained earnings be used as the sole source of accumulating the required capital, this plan has the notable (and in the Board's view, fatal) defect of not permitting OCC to achieve compliance on or before the expected effective date of the Proposed Rule. On its face, it is also not clear how an escrow fund that is not an asset of OCC would satisfy the Proposed Rule's "liquid net assets funded by equity" requirement. Although the details of the alternative proposal offered by the MMs are vague, they suggest that the alternative plan for accessing replenishment capital should also involve the Stockholder Exchanges making a temporary capital contribution that would receive a "lower rate" of return, which, given the market rate of the return contemplated by the Proposal, would suggest a below-market rate. This replenishment plan conspicuously contains the very feature criticized elsewhere in the MM Letter, namely that the replenishment capital is a temporary capital contribution that is repurchased once required capital levels are restored. Unlike the Proposal's replenishment capital plan, however, this proposal is neither viable nor firmly rooted in the Proposed Rule's "liquid net assets funded by equity" requirement.

For example, the escrow fund as described in the MM Letter is expressly contemplated as not being an asset of OCC, meaning it appears to run afoul of the Proposed Rule's requirement that the regulatory capital be "liquid net assets funded by equity." It is not apparent that an escrow fund could be an asset of OCC, or equity of OCC, if it would not belong to OCC. OCC has sought clarity from the regulators concerning what constitutes a financial resource "funded by equity." OCC submitted a comment letter to the Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commission in which OCC raised the idea of a fund to which OCC's clearing members would contribute and that would be available to meet the equity funding requirement.[16] OCC also submitted a comment to the Board of Governors of the Federal Reserve System on its version of the "funded by equity" requirement.[17] Regulatory authorities, however, have not provided definitive guidance on what precisely would meet the "funded by equity" requirements of the Proposed Rule. The Federal Reserve did, however, emphasize that equity with characteristics similar to debt would not qualify.

Moreover, OCC has already considered an alternative plan to limit the amount of time dividend payments are made to the Stockholder Exchanges, for example by repaying the Stockholder Exchanges' capital contributions over a period of years. The Board rejected this alternative because it would provide no assurance that it would comply with the proposed requirement that OCC's capital be "funded by equity." Furthermore, there would not be a sufficient financial incentive for the Stockholder Exchanges to provide short-term equity financing and replenishment commitments to OCC on these terms. Again, OCC has sought clarity from the regulators concerning what constitutes a financial resource "funded by equity," including in its May 27, 2014 comment letter on the Proposed Rule in which it requested that the SEC expressly provide that preferred stock be permitted as capital "funded by equity."[18] Regulatory authorities, again, have not provided definitive guidance on whether equity instruments with debt-like features would meet the requirements of the Proposed Rule. In fact, OCC sought specific guidance on whether a form of perpetual preferred stock similar to what a

[16] Letter from William H. Navin on behalf of The Options Clearing Corporation to the Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commission (July 29, 2011).

[17] Letter from Craig S. Donohue on behalf of The Options Clearing Corporation to the Board of Governors of the Federal Reserve System (March 31, 2014).

[18] Letter from James E. Brown on behalf of The Options Clearing Corporation (May 27, 2014).

bank might issue as part of its capital structure might satisfy the "funded by equity" requirement, but did not receive any assurances that such an instrument would qualify. Creating a capital plan that requires OCC to repay the Stockholder Exchanges for their capital contributions by a given date could call into question whether OCC's capital plan is "funded by equity," which creates the risk that OCC could develop, negotiate, and implement such a plan only to have it ultimately fail to meet the requirements of the Proposed Rule. The economics of this concept were also deemed unworkable. Namely, the Stockholder Exchanges expressed no interest in providing a substantial equity capital contribution and the commitment to fund replenishment capital at the proposed rate of return where their only expectation would be to get the proposed return and their money back at the end of a fixed period of time. The duration of the proposed dividend is linked to the duration of the funded and unfunded capital commitments provided by the Stockholder Exchanges. Both are contemplated to be long-term in nature.

In its alternative proposal, and throughout their letter, the MMs also emphasize the desire that excess fees of Clearing Members be returned to the Clearing Members or their customers if OCC were to liquidate, dissolve, demutualize or effectuate some other business combination. It has always been the case, however, that retained earnings constitute shareholders' equity, and the Proposal is, therefore, in no way a departure from OCC's historical practice as an industry utility. In fact, absent the agreement of the Stockholder Exchanges to contribute the additional capital (or some alternative source of funds that has not been identified after nearly a year of extensive investigation by the Board and Management), OCC's existing rules would require OCC to set clearing fees at a level sufficient to accumulate the entire amount of the needed additions to its capital as well as the replenishment capital. As a result, there would be both substantially higher fees and no refunds to Clearing Members in the next several years, and the Clearing Members would effectively contribute 100% of the additional capital (i.e., shareholders' equity) and would still receive no distributions upon a liquidation or dissolution of OCC. Instead, under the Proposal, for the first time significant capital of the Stockholder Exchanges will be at risk in the event of a liquidation or dissolution. This is one reason that the comments set forth in the MM Letter are based on an incomplete understanding of the Proposal and its effects. The Proposal will better align incentives and risks among Clearing Members and Stockholder Exchanges in terms of ensuring adequate capitalization of OCC as a leading clearinghouse and SIFMU. In the past, Clearing Members favored lower retained earnings, in part due to the fact that such retained earnings constitute shareholders' equity. The Proposal reduces the incentive to refund needed capital while requiring the Exchange Stockholders to contribute a majority of OCC's shareholders' equity.

CONCLUSION

OCC's Board has exhaustively considered numerous alternatives for raising sufficient capital to comply with the Proposed Rule by its reasonably anticipated effective date and has reached agreement with Stockholder Exchanges to provide sufficient capital on an ongoing basis for OCC's needs. To undo any of the carefully negotiated terms could prove fatal to the agreement and reset the entire, nearly year-long process OCC's Board and Management have pursued to bolster OCC's capital and to achieve compliance with the Proposed Rule. OCC continues to believe that the Proposal was and remains the only viable alternative offered for achieving this compliance and would do so without a very large increase in fees that could prove harmful to the options markets. Accordingly, the Proposal is entirely consistent with the

Exchange Act and the rules and regulations thereunder applicable to OCC as well as with the public interest and protection of investors. OCC, therefore, respectfully requests that the Commission notify OCC that it does not object to and approves the Proposal.

Sincerely,

James E. Brown
General Counsel