OCC

April 27, 2018

VIA EMAIL

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

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 Systematically Important Financial Market Utility; File No. SR-OCC-2018-004: Notice of Filing and Immediate Effectiveness of a Proposed Rule Change to Revise The Options Clearing Corporation's Schedule of Fees

Dear Mr. Fields:

The Options Clearing Corporation ("OCC") respectfully submits this response to the belated comment letter from SIFMA, dated April 10, 2018, challenging the Capital Plan. Even though SIFMA initially submitted a comment letter on February 20, 2015, SIFMA decided not to challenge the Commission's March 6, 2015 and February 11, 2016 orders approving the Capital Plan. SIFMA also elected not to make any submissions by the November 13, 2017 deadline set forth in the Commission's September 14, 2017 Corrected Order Scheduling Filing of Statements on Review. OCC is therefore at a loss to understand why SIFMA has now resurfaced, after more than three years, to take issue with the Capital Plan.

As discussed below, nothing that SIFMA says can or should alter the Commission's prior conclusion that the Capital Plan should be approved. Instead, SIFMA's comment letter reflects a fundamental misunderstanding of the requirements of the Exchange Act, the meaning of competition, and the Capital Plan. We address each of the requirements of the Exchange Act, in turn, below.

I. The Capital Plan Is Designed, In General, To Protect Investors And The Public Interest.

As discussed previously, OCC has been designated as a SIFMU by the Financial Stability Oversight Council and is therefore required to satisfy specific regulatory requirements, including

Rule 17Ad-22(e)(15).[1] These requirements are designed to ensure that, notwithstanding shocks to the financial markets and other business risks, OCC can continue to perform its essential role in the options and all other markets for which it clears trades.

SIFMA's letter is most remarkable for what it does not say and does not dispute. SIFMA does not dispute that OCC is required to maintain sufficient capital *funded by equity* to comply with Rule 17Ad-22(e)(15), and must also have a viable plan for raising additional equity should its equity fall close to or below this amount. SIFMA also does not dispute that OCC's Board in fact determined, based on a comprehensive analysis by Oliver Wyman and hard data about comparable CCPs provided by Barclays, that OCC needed to maintain $247 million in capital funded by equity and that its existing capital reserves of $25 million were woefully deficient.[2] Further, as a DCO, OCC is regulated by the CFTC, which requires that OCC have capital equivalent to 12 months of operating expenses, which requires OCC to maintain a minimum of $245 million. And SIFMA ignores that the Stockholder Exchanges, to satisfy OCC's regulatory obligations, contributed a total of $150 million in equity capital to OCC and entered into agreements to provide OCC with a Replenishment Capital Commitment of up to an additional $200 million on a *pro rata* basis. This was a major capital investment and commitment by the Stockholder Exchanges, resulting in $150 million (and potentially $350 million) being tied up indefinitely on OCC's balance sheet.

SIFMA does not, and cannot, take any issue with any of these facts. Instead, SIFMA focuses on the dividend established by the Capital Plan to compensate the Shareholder Exchanges for their significant capital infusion and commitment, and asserts that it has transformed OCC into a "for profit" institution, even though OCC has always been organized as a Delaware corporation and at no time operated as a not-for-profit entity. SIFMA then claims without any legal support, much less explanation, that "OCC fails to meet any of the Exchange Act rules imposed on clearing agencies."[3]

SIFMA's conclusory assertion that the Capital Plan does not comply with the requirements of the Exchange Act is based on a fundamental misunderstanding of the Exchange Act. The Exchange Act does not prohibit OCC from compensating its shareholders for making equity contributions or capital commitments. Rather, it requires OCC's rules to be "designed . . . in general, to protect investors and the public interest."[4] There can be no question that maintaining adequate capital protects investors and is in the public interest—and SIFMA does not assert otherwise. Indeed, the notion that stockholders cannot be compensated for their equity contributions and capital commitments defies logic, law, and common sense, and is impossible to square with how all of SIFMA's members (many of which are regulated by the Commission) do business day in and day out.

[1] OCC Post-Remand Br. at 3-4.
[2] OCC Post-Remand Br. at 5-9, 14.
[3] SIFMA Letter at 5.
[4] 15 U.S.C. § 78q-1(b)(3)(F).

Moreover, in a misguided effort to make the Capital Plan seem more favorable to the Stockholder Exchanges than it is, SIFMA misstates its terms. According to SIFMA, "clearing members must be concerned that excessive revenue collections at OCC will not simply revert to refunds but will also, in roughly equal proportions, divert into oversized dividends."[5] That is wrong. To meet the requirements of the Capital Plan, the difference between revenue and expenses (net income) must equal at least 25% of revenue. This is the business risk buffer, and it is designed to make sure that OCC has enough money to cover unexpected fluctuations in operating expenses, business capital needs, and regulatory obligations. If, however, net income actually received turns out to be *greater* than 25% of projected revenue, OCC can decrease its clearing fees and/or choose to refund some or all of the excess to clearing members. And since the adoption of the Capital Plan, OCC has done both. For example, on March 1, 2016, OCC reduced clearing fees on average by 19%, and recently announced a special refund of $25.7 million for 2017 clearing fees in addition to its regular refund of approximately $53 million.[6]

In addition, contrary to SIFMA's suggestion, the Stockholder Exchanges do not receive the same amount in dividends as clearing members receive as refunds. Rather, while clearing members are refunded half of OCC's net income, the Stockholder Exchanges only receive the remainder of the remaining half of OCC's net income *after* sufficient funds are withheld to pay taxes. As a result, the size of OCC's stockholder dividends will always be significantly less than the size of OCC's refunds to clearing members.

In short, unlike typical "for profit" organizations, OCC is required to refund at least half of its net income (and often more) to its customers, and has a cap on the amount paid to its shareholders.

II. The Capital Plan Does Not Impose Any Burden On Competition Not Necessary Or Appropriate In Furtherance Of The Purposes Of The Act.

SIFMA's competition argument is incoherent. According to SIFMA, "the Capital Plan imposes an unnecessary burden on competition by setting the Target Capital Requirement absent an open, competitive process."[7] SIFMA also states that the Capital Plan "lacks a competitive offering process or transparent pricing data to support fairness of the proposal."[8] Neither of those things has anything to do with competition in the marketplace.

The Target Capital Requirement was set by OCC's Board of Directors based on analyses by Oliver Wyman and Barclays. This is completely consistent with Rule 17Ad-22(e)(15), which

[5] SIFMA Letter at 3.

[6] Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Revise The Options Clearing Corporation's Schedule of Fees, Release No. 34-77041 (SR-OCC-2016-001) (Feb. 3, 2016); Press Release, "OCC Declares Nearly $80 Million Clearing Member Refund for 2017," (March 1, 2018), https://www.theocc.com/about/newsroom/releases/2018/March-1-OCC-Declares-Nearly-80-Million-Clearing-Member-Refund-for-2017.jsp.

[7] SIFMA Letter at 6.

[8] *Id.*

requires OCC to maintain sufficient capital funded by equity "equal to the greater of either six months of [its] current operating expenses **or** the amount determined by the board of directors to be sufficient to ensure a recovery or orderly wind-down of critical operations and services of the covered clearing agency."[9] To suggest that the Target Capital Requirement must be set through "an open, competitive process" does not make any sense.

In addition, SIFMA is also wrong that OCC was required to conduct "a competitive offering process" with "transparent pricing data" to support the "fairness" of the Capital Plan. Neither the Exchange Act nor Delaware law requires OCC to conduct a "competitive offering process"—whatever that may be construed to mean—to raise capital funded by equity. To the contrary, as discussed previously, OCC's shareholders have a right not to be diluted and not to accept additional shareholders, and these rights were approved by the Commission at the inception of OCC. While the Exchange Act prohibits proposed rules from imposing "any burden on competition not necessary or appropriate in furtherance of the purposes of" the Act,[10] nothing in the Exchange Act dictates how OCC—or any other SRO—must develop its own rules to comply with this requirement.

Simply put, nothing SIFMA says in its comment letter suggests that competition would be "burdened" in any way by OCC's compensating the Stockholder Exchanges for their significant and illiquid capital contribution and commitments. Because clearing members are all treated the same under the Capital Plan, the only conceivably affected competition here is between exchanges. As noted previously by the Commission, exchanges principally compete for order flow.[11] That competition is fierce, with fifteen equity options exchanges competing for order flow.[12] The prices charged by any equity options exchange for execution services is therefore constrained by the availability of 14 other substitutes. Competition is not—and cannot be—impacted by the fact that the Stockholder Exchanges receive dividends in exchange for their significant capital infusions and commitments.

[9] 17 C.F.R. 240.17Ad-22(e)(15) (emphasis added).

[10] 15 U.S.C. § 78q-1(b)(3)(I).

[11] Order Setting Aside Action by Delegated Authority and Approving Proposed Rule Change Relating to NYSE Arca Data, Exchange Act Release No. 34-59039 (Dec. 2, 2008), 73 Fed. Reg. 74770, at 74782-84 (Dec. 9, 2008), *vacated on other grounds by NetCoalition v. S.E.C.*, 615 F.3d 525, 539 (D.C. Cir. 2010) (agreeing with the Commission's conclusion that competition for order flow is "fierce" and remanding to allow the Commission to make more specific findings regarding the competitive forces in pricing ArcaBook).

[12] Gunjan Banerji, "Plan for New Trading Pit Triggers Feud in U.S. Options Market," Fox Business (July 9, 2017) http://www.foxbusiness.com/features/2017/07/09/plan-for-new-trading-pit-triggers-feud-in-u-s-options-market.html; NYSE Amex Options, "Two Market Models Powered by One Cutting Edge Technology 4 (2012) https://www.nyse.com/publicdocs/nyse/markets/american-options/How_NYSE_Amex_Options_NYSE_Arca_Options_Work.pdf ("With twelve exchanges competing for liquidity and order flow, the US Options market is one of the most competitive markets in the world – which helps to drive down exchange fees and tighten quoted prices."); Howard Tai, "Seven, Eleven, and Now Twelve: How Many U.S. Equity Options Exchanges Are Enough?" Aite Group (Oct. 1, 2013) http://aitegroup.com/report/seven-eleven-and-now-twelve-how-many-us-equity-options-exchanges-are-enough.

For its part, SIFMA completely fails to acknowledge this marketplace reality in its submission, and does not engage in any competition-based analysis. This is particularly remarkable in light of SIFMA's positions in the *NetCoalition* litigation, where SIFMA told the D.C. Circuit:

> As a matter of basic economics, whether competition constrains a seller in pricing a product depends on the response of buyers to changes in the price of that product (the elasticity of demand). *See* 2B Phillip E. Areeda, Herbert Hovenkamp & John L. Solow, *Antitrust Law* § 506a, at 125 (3d ed. 2007). Elasticity of demand is determined by "the substitutability of other products, or the same product offered by other sellers, for the product in question." Richard A. Posner & Frank H. Easterbrook, *Antitrust* 351 (2d ed. 1981); *see also FTC v. H.J. Heinz Co.*, 246 F.3d 708, 718 (D.C. Cir. 2001); *Whole Foods*, 548 F.3d at 1037-38. When substitutes are available, demand for a product is elastic and market power is limited.[13]

Here, there is no question that numerous substitutes—15 in total—are available, market power is limited, prices are constrained, and competitive behavior is dictated by competitive forces that have nothing whatsoever to do with Capital Plan dividends. Nevertheless, ignoring its own prior analysis, SIFMA now baldly asserts without any supporting evidence that Stockholder Exchanges "could be incentivized to lower their own processing fees to drive more volume away from other exchanges."[14] No basis exists for this statement and it is contrary to the existence of the actual, robust competition that exists in the marketplace—and that has continued without burden or impediment for three years under the Capital Plan. Not surprisingly, SIFMA does not identify any exchange that has engaged in the conduct it posits, does not explain why it would make any economic sense to do so, and does not explain how dividends in the relatively small amounts paid could even affect the multi-billion-dollar market for options execution services.

Rather than discuss competitive dynamics, SIFMA instead turns this into an argument about how much OCC has increased its budget under the Capital Plan, with corresponding fee increases. As discussed in OCC's submission in response to the Commission's Order, dated February 28, 2018, suspending and instituting proceedings to determine whether to approve or disapprove of OCC's proposed rule change to revise its schedule of fees, OCC's current budget, together with its proposed fee increase, is necessary to satisfy its regulatory obligations as a SIFMU and comply with the Capital Plan.

For decades, OCC refunded all fees collected in excess of expenses, leaving virtually no resources for necessary capital improvement. While this meant that OCC would be viewed as a low-cost clearing services provider, it also meant that money that should have been retained and invested in improving and maintaining a clearing system, a risk management system, systems and operational resiliency, and technological infrastructure was instead rebated to clearing members. When OCC was designated as a SIFMU—when the Treasury department determined

[13] Reply Brief of Petitioners NetCoalition And Securities Industry And Financial Markets Association, at 17-18, filed on December 16, 2009, in *NetCoalition v. SEC*, Nos. 09-1042 & 09-1045 (D.C. Cir.).
[14] SIFMA Letter at 9.

that a failure of OCC could threaten the stability of the financial system of the United States—that had to change.

As a SIFMU and a Covered Clearing Agency, OCC is required to comply with heightened regulatory obligations. This has required OCC to enhance its resiliency to systemic risk and strengthen its capital structure to ensure loss absorption and recovery capabilities. For example, in addition to Rule 17Ad-22(e)(15) and other regulatory requirements established in 2016 for Covered Clearing Agencies, OCC must also comply with Regulation SCI, which requires OCC, as an SCI entity, to "establish, maintain, and enforce written policies and procedures reasonably designed to ensure that its SCI systems and, for purposes of security standards, indirect SCI systems, have levels of capacity, integrity, resiliency, availability, and security, adequate to maintain [OCC's] operational capability and promote the maintenance of fair and orderly markets."[15]

Starting in 2012, when OCC was designated, OCC began to devote considerable additional resources towards enhancing its resiliency, capacity, security, and integrity. Even before the Capital Plan was implemented, OCC's operating expenses increased by 43%, from $152.1 million in 2012 to $217.6 million in 2015. In the two years since, with the enactment of Regulation SCI and finalization of rules governing Covered Clearing Agencies, OCC's operating expenses have continued to rise, by an additional 37%.

Most of the increase in OCC's operating expenses has come from two areas—employee costs and professional fees and outside services. These increases were needed to pay new employees and outside consultants and professionals to enhance OCC's security, enterprise risk management, resiliency and compliance capabilities—that is, these are expense directly necessitated by OCC's designation as a SIFMU. Since its designation as a SIFMU, OCC's staff increased overall by more than 130% and most of those increases came in crucial areas for a SIFMU—namely, in compliance, legal, enterprise risk management, financial risk management, internal audit and IT. To put things in perspective the table below reflects the change in headcount in OCC's functional areas between 2011 and 2017:

[15] Regulation SCI, Rule 1001(a)(1).

Changes in the Number of Full Time Employees

Function	2011	2017	Change
Compliance	1	23	22
Legal	8	18	10
Enterprise Risk Management	1	33	32
Financial Risk Management	13	67	54
Internal Audit	2	20	18
Technology	181	294	113

The increase in technology personnel, in particular, reflects the need to develop new capabilities and the challenge and cost of delivering services in an aging environment with components approaching the end of their useful life.

None of this expense growth should be surprising at all to SIFMA, which has no basis to claim that "SIFMU-related regulatory costs do not substantiate the depth and degree of the OCC's new budgetary approach."[16] Unlike other CCPs, OCC started from a much worse position because it had been operating as a low-cost provider that refunded all its earnings to its members and had not invested in its infrastructure and control functions. Indeed, as the Commission observed in the CCA Proposing Release to amend Rule 17Ad-22 and add Rule 17Ab2-2, OCC was the only clearing agency that needed to source new funding to satisfy SIFMU requirements.[17] And that is why in 2011, shortly before OCC was designated as a SIFMU, OCC had virtually no compliance or enterprise risk management departments, and its primary technology platform (ENCORE) was aging. OCC has thus transformed itself in a few short years from an organization that operated as a low-cost provider to a robust clearing platform with significantly improved security, integrity and resiliency. And OCC, as the Commission knows, still has work to do.

Beyond the need to add human capital to meet regulatory expectations, OCC has also addressed the significant underfunding of its employee pension plan consistent with its fiduciary duties to plan participants. As of the end of 2014, OCC's plan was approximately 64.1% funded. To address the underfunded status, OCC established an objective to fully fund the plan on an official accounting basis via employer contributions, while minimizing the Plan's effect on OCC's financials. To that end, OCC has made contributions of approximately $50 million between

[16] SIFMA Letter at 2.

[17] Release No. 34-71699; File No. S7-03-14, Standards for Covered Clearing Agencies, at 376.

2014 and 2017 to enhance plan funding levels. As of the end of the first quarter 2018, OCC has increased the plan funding status to approximately 93.8%.[18]

This all costs money that must come from OCC's only real source of income—clearing fees. OCC management accordingly devotes a considerable amount of time projecting how much OCC needs to spend to fund its operations and pay for its ongoing improvement efforts. OCC then calculates how much it needs to charge to obtain the resources to pay for its expenses while maintaining the 25% Business Risk Buffer required under its Capital Plan. As part of this analysis, OCC forecasts volume based on historical activity levels because OCC has no reasonable basis to make any other assumption at the time it is setting its budget. OCC's budget is then presented by management first to the Compensation and Performance Committee ("CPC") and then to the full Board of Directors for approval. Both the CPC and full Board are composed of a majority of directors who are not affiliated with Stockholder Exchanges; indeed, Clearing Members on the Board significantly outnumber Stockholder Exchanges. Neither clearing members nor independent directors have any motivation to approve budgetary expenses that are not necessary for OCC to effectively and efficiently execute its responsibilities.

This is all to say that, contrary to SIFMA's suggestions, OCC has a real and urgent need to charge clearing fees that are sufficient to collect the revenues it needs to satisfy its regulatory obligations. Having received $750 million in refunds and the lowest fees in the clearing industry over many years at the expense of OCC's technology infrastructure, and risk management capabilities, clearing members should not now be heard to complain that fees are too high and capital is required for OCC to operate its business, satisfy its regulatory obligations, and fulfill its role as a SIFMU.

III. The Capital Plan Was Not Designed To Permit Unfair Discrimination Among Participants In The Use Of The Clearing Agency.

SIFMA does not seriously dispute that the Capital Plan is non-discriminatory. Instead, while admitting that the Capital Plan treats all market participants on an "equal basis," SIFMA asserts that the Capital Plan "diminish[es] the prospects of all market participants."[19] SIFMA offers no support for this sweeping assertion and does not explain how any market participant's "prospects" have been diminished in any way.

In addition, SIFMA points out that the Capital Plan benefits Stockholder Exchanges but does not offer those same benefits to non-Stockholder Exchanges. As discussed previously, however, OCC has no obligation to treat Stockholder Exchanges with respect to the Capital Plan the same as non-Stockholder Exchanges because they are differently situated. The former have provided $150 million in capital and have committed to provide an additional $200 million under the Capital Plan. The non-Stockholder Exchanges have not made any such contribution and have no such commitment. And the Stockholder Exchanges, as stockholders, have certain rights under

[18] OCC elected to freeze its defined benefit plan in 2014.
[19] SIFMA Letter at 10.

OCC bylaws, including anti-dilution rights. Barclays also advised OCC that raising capital from third parties would have been more difficult and complex to accomplish than raising capital from existing stockholders.

Because the Stockholder Exchanges and non-Stockholder Exchanges are differently situated, OCC has not discriminated against the latter by establishing the Dividend Policy to compensate the former for the capital they have contributed and the risks they have undertaken. This would be the case even if Exchange Act Section 17A(b)(3)(F) applied to the Dividend Policy—which it does not because it has nothing to do with the "use" of the clearing agency.

At bottom, SIFMA contends that OCC should be required to engage "in a public and transparent process . . . to obtain and maintain necessary capital on terms and at prices that are fair, reasonable, and efficient."[20] But Rule 17Ad-22(e)(15) requires capital to be funded by equity, and nothing in the Exchange Act requires OCC to conduct a "process"—much less force—OCC's existing stockholders to accept dilution. And, as a practical matter, OCC's existing stockholders have the clear right under OCC's bylaws and Delaware law to prevent any such attempt to dilute them. SIFMA's suggested approach—which it now demands three years after the Capital Plan was approved by the Commission with not a word from SIFMA since—is thus completely impractical, contrary to the Exchange Act, and contrary to Rule 17Ad-22(e)(15).

Accordingly, OCC respectfully submits that the Commission should approve the Capital Plan because it is consistent with all the requirements of the Exchange Act and is necessary to allow OCC to fulfill its critical role as a SIFMU.

Sincerely,

Joseph Kamnik
Senior Vice President & Chief Regulatory Counsel

[20] *Id.*