UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of the Application of

LEK SECURITIES CORPORATION

For Review of Actions Taken by

The Options Clearing Corporation

File No. 3-20665

LEK SECURITIES CORPORATION'S REPLY BRIEF ON THE COMMISSION'S JURISDICTION OVER THIS APPEAL

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As stated in the Lek Securities Corporation ("LSC") Opening Brief dated January 24, 2022 ("LSC Brief"), LSC believes that the Commission has jurisdiction to review the Protective Measures because, in imposing them, the Options Clearing Corporation ("OCC") limited LSC's access to the services it provides to LSC as a member of OCC and, alternatively, because the Protective Measures constitute final disciplinary sanctions[1] under OCC Rules.[2]

Although OCC's February 23, 2022 Brief ("OCC Brief") frames the Protective Measures as "risk management controls" under OCC Rules 306, 601 and 609, OCC's application of its rules was based on either an erroneous understanding of the facts or faulty assumptions, or both. OCC was informed by LSC of the correct facts in advance of imposing the Protective Measures, during the process of imposing the July Protective Measures discussed in the LSC Brief, and yet imposed the Protective Measures in October anyway. These actions are subject to review by the Commission. OCC does not have unfettered discretion to act contrary to the interests of its members without a rational basis. Nor can it expect deference from the Commission when it arbitrarily limits a member's access to its services without a rational basis, even if it does not entirely cut off the member's access to its services.

ARGUMENT

I. There Was No Rational Basis for OCC to Impose the Protective Measures.

As a clearing agency registered with the Commission pursuant to Section 17A of the Exchange Act ("Clearing Agency"), OCC has the authority to manage risk among its members.[3]

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1 The Protective Measures became final when OCC denied LSC the right to an internal hearing. At that point, appeal to the Commission became appropriate.

2 Capitalized terms not defined herein shall have the meanings ascribed in the LSC Brief.

3 Clearing Agencies, including OCC, are also self-regulatory organizations ("SROs") pursuant to Section 19 of the Exchange Act.

It does not, however, have the authority to take actions that impose onerous burdens and significant costs on its members without a rational basis for doing so.

OCC posits that the Protective Measures were imposed solely as risk-management controls under OCC Rules 306, 601 and 609. As set forth the LSC Brief, OCC Rule 601 provides, in pertinent part, that "[n]otwithstanding any other provision of this Rule 601, the [OCC] may fix the margin requirement for any account or any class of cleared contracts at such amount as it deems necessary or appropriate *under the circumstances to protect the respective interests of Clearing Members, the [OCC], and the public*" (emphasis added).[4] OCC Rule 609 repeats this limitation, stating, in pertinent part, that "[OCC] may require the deposit of such additional margin ('intra-day margin') by any Clearing Member in any account at any time during any business day, as such officer deems advisable to reflect changes in … (iv) *the financial position of the Clearing Member, or otherwise to protect the [OCC], other Clearing Members or the general public*…" (emphasis added).[5] Rule 306 permits OCC to require specified reports or other information so that OCC can determine whether a member is meeting its financial requirements.

Neither Rule 601, nor Rule 609, grants OCC unfettered authority to impose protective measures or risk controls that are untethered to existing facts or circumstances. Rather, these actions can only be taken for the legitimate protection of OCC, its members and the public. As discussed in the Application and LSC Brief, the Protective Measures were imposed based on incorrect assumptions and an inaccurate understanding of LSC's operations. The OCC Brief alleges that these factual errors are "unsupported" and "unexplained" in the LSC Brief.[6] This is

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4 OCC Rule 601, *see* LSC Brief at 11.

5 OCC Rule 609, *see* LSC Brief at 11.

6 OCC Brief at 1, 9.

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simply wrong. LSC made efforts to clarify or correct the specific factual errors made by OCC when it was first informed about the Protective Measures in the October 15, 2021 Letter to LSC.[7] LSC's efforts to correct or clarify these errors were explained and supported in the Application, in the Factual Background section of the LSC Brief, and in Exhibit 2 to the LSC Brief, the October 22, 2021 Letter from LSC to OCC. We describe these efforts again here.

The OCC stated its factual position in the October 15, 2021 Letter to LSC, as described in the LSC Brief:

> In the October 15, 2021 Letter, OCC stated that LSC's liquidity risks had increased due to a phased reduction by BMOH, ending ultimately in termination, of LSC's line of credit, and Texas Capital Bank's termination of a $25 million line of credit it extended to LSC. OCC stated that LSC's operational risks also had increased due to restrictions implemented by the Depository Trust Company ("DTC") and the National Securities Clearing Corporation ("NSCC," and, together with DTC, the "DTCC Entities") in connection with those entities' purported concerns over LSC's liquidity risk. [Footnote omitted.] OCC further stated that LSC's regulatory risks had increased because LSC received a "Wells Notice" from the Financial Industry Regulatory Authority ("FINRA") in connection with a line of credit that LSC has with its parent, Lek Securities Holdings Limited ("Lek Holdings").[8]

On October 22, 2021, LSC explained to OCC that the Protective Measures were imposed based on inaccurate information and requested a hearing on OCC's actions.[9] In its October 29, 2021 response, OCC stated that the Protective Measures are discretionary risk management tools implemented under OCC Rules 306, 601 and 609.[10] As set forth in the LSC Brief, LSC's $100 million promissory note program with Lek Holdings, together with its $30 million credit facility with Lakeside Bank, and robust securities lending arrangements with more than a dozen

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7 LSC Brief, Exhibit 1.

8 LSC Brief at 2; *see* LSC Brief, Exhibit 1.

9 LSC Brief, Exhibit 2.

10 LSC Brief, Exhibit 3.

counterparties, more than satisfied LSC's liquidity needs at the time.[11] Any operational risk perceived by OCC as a result of the restrictions imposed by the DTCC Entities was based on the same erroneous assessment of LSC's liquidity as OCC's misunderstanding of that liquidity. Additionally, LSC could not have had increased regulatory risk due to its receipt of a Wells Notice from FINRA because LSC never received such a notice.

The OCC Brief emphasizes that OCC "has broad authority to establish, implement, maintain, and enforce a sound risk-management framework to manage the risks posed by clearing members" and that it generally has authority to adopt appropriate protective measures to meet those risk management goals.[12] LSC does not disagree. OCC Rules 601 and 609, however, each require that the Protective Measures have the purpose of protecting OCC, its members or the public. That purpose is entirely absent here. LSC had sufficient liquidity at all times during and after the eventual process by which BMOH Harris wound down its LSC line of credit. There was no basis in fact for OCC's perception of increased operational risk for LSC, because the DTCC Entities imposed their limitations on LSC under the same factual misapprehensions regarding LSC's liquidity that OCC had, and there was no basis in fact for OCC's perception that LSC's regulatory risk increased because LSC never received the Wells Notice OCC claimed it had received.

The OCC Brief also cites the OCC requirement in Rule 306 that LSC (and other members) provide information regarding its financial condition as requested by OCC.[13] LSC has done so and, in so doing, clarified the condition of its liquidity position for OCC.

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11 LSC Brief at 3.

12 OCC Brief at 8-9.

13 OCC Rule 306; *see* OCC Brief at 4.

The OCC Brief entirely misses the point when it states that "LSC's application thus claims nothing more than that OCC exercised discretion authorized under its rules, took actions expressly provided for in its rules, and did so for reasons explicitly contemplated by the rules."[14] The discretion exercised by OCC lacked any rational basis and OCC ignored and disregarded LSC's efforts to clarify the relevant facts. As described in the LSC Brief and above, the factual bases provided by OCC for the Protective Measures were simply wrong. The discretion afforded to OCC and other Clearing Agencies under the Exchange Act is not intended to be exercised arbitrarily without any factual support. Because it was exercised arbitrarily and without any rational basis here, the resulting Protective Measures had no genuine protective purpose and thus failed the requirements of the OCC's own rules.

With regard to the Commission's practice of granting deference to SRO rules, the OCC Brief cites *Heath v. Securities and Exchange Commission* only for the proposition that the Commission generally defers to an interpretation by an SRO of its own rules.[15] The OCC Brief alludes to the fact that deference is due only when two requirements—rationality and good faith—are met by the SRO.[16] The Protective Measures, however, fail the rationality test due to the factual errors on which they purport to be based.

When a Clearing Agency takes an action that is harmful to one of its members and does so without a rational basis, the Commission must be permitted to review the action, whether or not the Clearing Agency agrees that the action is reviewable, and regardless of how the Clearing Agency characterizes the action (*e.g.*, a risk management measure). If the Commission were not

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14 OCC Brief at 9.

15 *Heath v. SEC*, 586 F.3d 122, 138–39 (2d Cir. 2009); *see* OCC Brief at 16.

16 *Id.*

allowed to review an action by a Clearing Agency that a member credibly alleges is without a rational basis, the Clearing Agency would have unfettered authority. And that is not the case.

The Exchange Act and the Commission's rules envision that there are limits on OCC's ability to act against the interests of its members under the banner of risk management. Under the regulatory regime contemplated by Section 19(d) of the Exchange Act, Congress intended the Commission to have broad authority to review clearing agency actions that are detrimental to members of the clearing agency. The OCC Brief cites the adopting release for Rule 19d-1, promulgated by the Commission under the Exchange Act, which indicates that the Commission expects adjudicatory actions similar to disciplinary matters will be subject to review by the Commission.[17] As discussed in the LSC Brief, although OCC wants to treat the Protective Measures as ordinary-course risk management controls, when a Clearing Agency takes an action targeting a specific member without a factual basis, such an action operates as a limitation on access to services and also as a final disciplinary sanction (similar to an adjudicatory action) to the extent the action is not subject to further review by OCC.[18] This is so whether OCC chooses to label it as a limitation on access to services, as a disciplinary sanction, or as a risk management control. The Commission has obligations pursuant to the Exchange Act to ensure that Clearing Agencies act rationally in carrying out their statutory obligations.

II. The Commission Has Jurisdiction Because the Protective Measures Constitute Both Limitations on Access to Services and Final Disciplinary Sanctions.

Section 19(d) of the Exchange Act authorizes the Commission to review an action taken by a Clearing Agency on multiple grounds, including if the action "prohibits or limits any person

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[17] OCC Brief at 13-14. We note that in our original brief we referred to "administrative" actions, but we should have used "adjudicatory" because these actions are, in effect, similar to adjudicatory actions, for the reasons stated herein. LSC Brief at 5-6.

[18] LSC Brief at 4-5.

in respect to access to services offered by such organization or member thereof" or if it "imposes any final disciplinary sanction on any member." For the reasons stated in the LSC Brief, the Commission has jurisdiction on either of those grounds to review the Protective Measures, and that jurisdiction is consistent with the legislative history of Section 19(d), which explains, in relevant part, that the Commission should have the authority to broadly define the actions a Clearing Agency takes against its members for purposes of defining the limits of the Commission's jurisdiction to review such actions.[19]

The OCC Brief raises several points disputing LSC's position. First, the OCC Brief implies an implausible definition of the words "limit" and "limitation" to try to escape the fact that the Protective Measures operate as a limitation on access to services.[20] The OCC Brief states "OCC provides—and LSC utilizes—clearing and settlement services. The margin charge sets the terms by which LSC *uses* these services—it does not limit LSC's right to enter or use those services" (emphasis in original).[21] This makes little sense. Raising a cost to access a service is a concrete and obvious limit on access to that service. It is not a full bar to the use of that service, but a given action need not rise to the level of a full bar to constitute a "limitation." It is true, as the OCC Brief alleges, that any margin charge could operate as a limitation on access to the services of the Clearing Agency subject to Commission review,[22] but as explained above and in the LSC Brief, it is a Protective Measure applied without any basis in fact that operates as a limitation on access to services or as a final disciplinary sanction. A margin charge adopted in response to genuine risks or exposures would not generally be a limitation on access to services

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19 S. Comm. on Banking, Housing & Urban Affairs, Securities Acts Amendments of 1975, Accompanying S. 249, S. Rep. No. 94-75, at 24 (1975).

20 LSC Brief at 10-13.

21 *Id.* at 11.

22 *Id.* at 12-13.

or a final disciplinary sanction. These are the types of judgments the Commission is called upon to make under the Exchange Act.

Next, the OCC attempts to argue that LSC's compliance with the Protective Measures means that the Protective Measures did not operate as limitations on access to services within the meaning of the term in the Commission's Rules. This position does not make sense either. The OCC Brief suggests that merely because LSC has "access" to the OCC's clearance and settlement services, the Protective Measures are not limitations on that access.[23] LSC requires the services provided by OCC to operate its business. It chose to comply with the Protective Measures—at a cost—so that it could continue serving its customers. Maintaining access to services, at cost, and despite a limitation, does not mean that no limitation existed.

The OCC Brief appears to assume that actions that OCC characterizes as a "risk management control" cannot also operate as limitations on access to services.[24] Yet there is nothing in OCC's Rules stating that actions that constitute risk management controls, and actions that constitute limitations on access to services or disciplinary actions are mutually exclusive. The OCC Brief states that "OCC did not assert that LSC had violated any OCC Rule or that the protective measures were being imposed through OCC's disciplinary process."[25] OCC's bare assertions should not be dispositive. A purported risk management tool that does not manage a risk, but that limits access to services and operates as a sanction on a member, is reviewable by the Commission, no matter what the Clearing Agency asserts, and no matter how the Clearing Agency chooses to label the action. When, as here, a given action imposes costs on a member and has no rational basis, then it can operate as a limitation on access to services or as a final

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23 OCC Brief at 12.

24 *See* OCC Brief at 8-10, 16-20.

25 OCC Brief at 6.

disciplinary sanction on the member, even if the Clearing Agency, in good faith, did not intend it to.

OCC also argues that review by the Commission of actions like the Protective Measures would create too heavy a burden on OCC in administering its rules.[26] But even under OCC's own rules, OCC's actions require a rational basis in order to be granted deference by the Commission. The Commission must be able to review and serve as a check that OCC's actions have a rational basis. Credible allegations from members that they have been sanctioned or limited by a Clearing Agency without rational basis must be reviewable by the Commission. Otherwise, there would be no limit on the actions Clearing Agencies can take with respect to their members, no matter how harmful or arbitrary, as long as they frame their actions as ordinary-course risk management measures and not as limitations on actions to services (or final disciplinary sanctions).

The enactment of the legislation pursuant to which Clearing Agencies were registered gave Clearing Agencies considerable authority under the Exchange Act. This broad grant of authority was premised on enabling Clearing Agencies to carry out their functions, subject to oversight by the Commission. As the applicable legislative history states:

> The Committee believes that self-regulation should be preserved in the securities industry, but it also believes that the [SROs] must display a greater responsiveness to their statutory obligations and to the need to coordinate their functions and activities. In the new regulatory environment created by this bill, self-regulation would be continued, but the [Commission] would be expected to play a much larger role than it has in the past to ensure there is no gap between self-regulatory performance and regulatory need[…].[27]
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> It has become commonplace to refer to the "partnership" between the [SROs] and the [Commission], or to the "cooperative"

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[26] OCC Brief at 19-20.

[27] S. Rep. No. 94-75, *supra* n. 8, at 2.

> character of the regulatory system. The Committee concurs in the need to emphasize the mutual regulatory responsibilities of the industry and the SEC. However, it believes care should be exercised, lest the use of phrases such as "partnership" and "cooperative regulation" lead to the impression that the industry and the government fulfill the same function in the regulatory framework or that they enjoy the same order of authority or deserve the same degree of deference, whether by firms, courts or the Congress. The [SROs] exercise authority subject to [Commission] oversight. They have no authority to regulate independently of the [Commission]'s control.[28]

It would be inconsistent with the grant of authority in the Exchange Act (as carried forward in the Commission's rules) to take the position that the Clearing Agencies are not subject to Commission review of their actions, as long as those actions are labeled as "risk management controls" by the Clearing Agency.

CONCLUSION

The Commission has the necessary jurisdiction to review OCC's imposition of the Protective Measures, because they are limitations to LSC's access to services provided by OCC, and, alternatively, because they constitute final disciplinary sanctions within the meaning of Section 19(d)(1) of the Exchange Act. OCC has framed the Protective Measures as ordinary risk management controls, but they were imposed without a basis in fact and are limitations on access to services that are subject to Commission review and oversight.

Based on the LSC Brief, as well as the foregoing, the Commission has jurisdiction over this appeal pursuant to Section 19(d) of the Exchange Act and should permit LSC's appeal to proceed to a review of its merits.

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[28] *Id*. at 23.

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Respectfully submitted,

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CERTIFICATE OF SERVICE

I, Mark D. Kotwick, certify that on this 9th day of March 2022, caused a copy of the foregoing Lek Securities Corporation's Reply Brief on the Commission's Jurisdiction Over This Appeal to be served on the following via email:

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