



Via Electronic Mail

September 17, 2019

Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-0609

Re: File Number SR-OCC-2019-007 - FIA Response to proposed changes to OCC's rules adopting a Capital Management Policy

Dear Ms. Countryman:

We understand from OCC rule filing SR.2019-007 dated 08/09/2019 that OCC is proposing to adopt a new Capital Management Policy. As part of this policy, OCC is providing a framework for determining its target capital required to meet regulatory obligations, ensure adequate financial resources to meet general business obligations, manage equity levels by adjusting the OCC's fee schedule (as appropriate) and establishing a plan for accessing additional capital should OCC's equity falls below certain thresholds ("Replenishment Plan"). We also understand that OCC is proposing to introduce a layer of skin-in-the-game resources which can be used in the event of default losses.

We acknowledge the importance of a layer of skin-in-the game but after analyzing the proposed rule changes FIA members have concerns which we hope are addressed before the rule is approved.

1. **Introduction of Skin in the game (SITG):** OCC's proposed rule stipulates that the clearinghouse will utilize *"any current or retained earnings above 110% of the Target Capital Requirement"* to offset default losses before applying contributions of non-defaulting members. We believe that this provision for CCP skin in the game has been needed and, therefore, is a positive. Similarly, we appreciate the proposed change whereby OCC ensures that the aggregate value of the Executive Deferred Compensation Plan (EDCP) Unvested Balance would be available pro-rata with non-defaulting member clearing fund contributions as part of the waterfall. We recognize that this is a new and novel concept in the industry and acknowledge that by introducing this layer, OCC is focused on incentivizing the management team to ensure prudential risk management.

While OCC's introduction of the SITG layer and proposed use of EDCP are important steps in the right direction, it is unclear how material these contributions would be and whether they would be meaningful enough to result in an alignment of interest from a shareholder perspective. As such, we seek greater transparency on the size of these resources.



Further, in addition to the formula that allows the CCP to contribute a SITG, OCC should have a minimum amount of SITG that scales with risk and is defined and funded upfront. We note that capital expenditures planned and approved by the Board can be met through amounts in excess of Target Capital and, as such, are unclear how this may tie in with OCC's plans to contribute skin in the game. Similarly, we gather that capital levels in excess of 110% threshold could result in OCC revisiting the fee schedule, and we are unclear if/ how this may impact the funded level of skin in the game. We would urge OCC to define a level of SITG *ex ante* that would always be readily available in case of a default loss.

Finally, as a drafting matter, we note that in the section on "Managing Equity" the filing refers to capital above 100% rather than 110% being available to cover member default losses [*"(iii) use of current and retained earnings greater than 100% of the Target Capital Requirement to cover losses caused by the default of a Clearing Member"*] and would seek confirmation on the threshold and the amount of skin in the game that would be available.

2. **Allocation of capital shortfall through operational loss fee.** We understand from the proposed filing that OCC sets thresholds on its target capital and has ability to undertake specific action in case available capital falls below such thresholds. In particular, if available capital falls below the 110% of target capital, the Board would have the ability to review/ increase clearing fees. The 10% buffer over the target capital is designed to cover 2-months of net income and expected to provide sufficient time to take action. Further, if the available capital falls below 90% of target or remains below the target capital for a period of 90-days, then OCC will first use the EDCP to address the shortfall and if the EDCP is not sufficient, OCC will then levy an operational loss fee capped at ~\$ 1.4737 mm (across multiple events, until such amount is returned/ repaid) equally to all members.

We recognize that OCC has a hybrid model whereby it is owned by exchanges (and not by members) and based on the information included in Exhibit 3f of the filing gather that it does not pay dividends/ has imposed caps on the operating margin and has a mechanism to reduce fees/ provide rebates to members. We are also aware of the fact that the plan to raise capital from shareholder exchanges was rejected by the SEC earlier in the year. We understand that OCC's ability to raise further equity to meet the replenishment capital requirements is constrained as its current shareholders have not approved issuance of equity (common or preferred). As a result, OCC has proposed raising the replenishment capital through operational loss fee on members. We believe that imposing an operational loss fee on members without providing a return is inequitable. Ideally, shareholders should either be required to provide similar such commitment or allow for an equity dilution.

We also acknowledge that raising resources through retained earnings could take up to 4 years (with a half cent increase in fees), but nevertheless believe that OCC should be working towards building its own capital reserves rather than relying solely on members. While we understand that raising resources through retained earnings could have a tax



implication, we would note that receiving operational loss fee could potentially also have similar tax implications. To the extent that resources are raised from members, we agree on apportioning it equally. However, we are unclear how the mechanism for returning it would work – we recognize that to the extent that OCC believes it has sufficient buffer capital it has ability to lower costs but are unsure how this would work given fee reduction/ rebates are typically volume driven and are not provided equally to all members. Finally, we comprehend from the fee schedule that if the operational loss fee is triggered, the fee charged would be an amount that would return OCC to a capitalization of 110% of target capital and we are unsure why OCC would seek to build the 10% buffer rather than just return to the target capital levels.

3. **Governance:** Given that an increase in target capitalization levels or a shortfall in available resources have a direct implication on the operational loss fee that may be imposed upon members, it is imperative that members have a role in the governance framework at the CCP. We note that the Board has governance over capital determination and can for instance, approve potential capital expenditure (capex) plans that could lead to a trigger event. However, given that the Board has a fiduciary duty to the OCC, we believe that any decision (say for instance what is deemed justified capex) that results in the imposition of an operational loss fee must be syndicated with members and such member feedback must be presented to the Board before any decisions are taken.
4. **Mechanism for allocating non-default losses:** One of the drivers for a reduction in available capital is a non-default loss event, whereby a general business loss or operational loss can result in a decline in the amount of capital available to OCC. By allowing such shortfalls to trigger a call on the operational loss fee, the proposed change effectively allows OCC to allocate non-default losses to members.

As a general matter, we believe that non-default losses should not be allocated to clearing members and that the CCP should absorb such losses, rather than utilize capital on a discretionary basis. We are concerned with the proposed framework which effectively relies on members to address non-default losses which are the responsibility of OCC and its shareholders. Further, we note that although a provision has been proposed to introduce skin in the game in case of default losses, the application of retained earnings to address non-default losses remains discretionary. As noted in 1006 (e) (ii), in the context of a Bank or clearing organization failure, OCC may *“in its discretion, elect to charge such loss or deficiency in whole or in part against the Corporation’s current earnings or retained earnings.”* We strongly believe OCC should revisit its approach to non-default losses and ensure its own adequate capitalization to cover this.



We understand that OCC will publish important information about the target capitalization requirements on a quarterly basis on its website for members. We believe this is important for transparency purposes and would urge OCC to also provide disclosures on any expenses/ losses that could result in the operational loss fee being charged as this will assist members in their own risk management.

We appreciate the Commission's consideration of these comments. If the Commission has any questions regarding the matters discussed herein, do not hesitate to contact me at 202-773-3040 or jmesa@fia.org.

Sincerely,

A handwritten signature in black ink that reads 'Jacqueline Mesa'. The signature is fluid and cursive, with the first name 'Jacqueline' written in a larger, more prominent script than the last name 'Mesa'.

Jacqueline Mesa
Chief Operating Officer & Senior Vice President of Global Policy

cc: Jay Clayton, Chairman
Robert J. Jackson, Jr., Commissioner
Hester M. Peirce, Commissioner
Elad L. Roisman, Commissioner
Allison Herren Lee, Commissioner