

to be appropriate and publishes its reasons for so finding or (ii) as to which the Exchange consents, the Commission will:

A. By order approve or disapprove such proposed rule change, or

B. institute proceedings to determine whether the proposed rule change should be disapproved.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

##### *Electronic Comments*

- Use the Commission's internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-CboeBZX-2019-004 on the subject line.

##### *Paper Comments*

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-1090.
- All submissions should refer to File Number SR-CboeBZX-2019-004. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street NE, Washington, DC 20549 on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly. All

submissions should refer to File Number SR-CboeBZX-2019-004, and should be submitted on or before March 13, 2019.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>51</sup>

**Eduardo A. Aleman,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-85121; File No. SR-OCC-2015-02]

### Self-Regulatory Organizations; The Options Clearing Corporation; Order Disapproving Proposed Rule Change Concerning The Options Clearing Corporation's Capital Plan

February 13, 2019.

#### I. Introduction

The Options Clearing Corporation ("OCC") submitted a proposed rule change in January 2015 that implements a plan to significantly increase OCC's capitalization ("Capital Plan" or "Plan"). After being approved by the Securities and Exchange Commission ("Commission" or "SEC"),<sup>1</sup> the Capital Plan is now before the Commission on remand from the Court of Appeals for the District of Columbia Circuit ("Court" or "D.C. Circuit").<sup>2</sup> As discussed in more detail below, upon further review, the Commission is disapproving the proposed rule change because the information before us is insufficient to support a finding that the Plan is consistent with the Securities Exchange Act of 1934 ("Exchange Act" or "Act") and the rules and regulations thereunder.

In particular, we conclude that the Commission does not have sufficient information to determine that the Capital Plan was adopted in a manner consistent with OCC's own rules, as required by Exchange Act Section 19(g). OCC's By-laws require that exchanges which are not shareholders of OCC be promptly provided with notice of certain matters that the Executive

<sup>51</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> Release No. 34-77112, File No. SR-OCC-2015-02 (Feb. 11, 2016), 81 FR 8294 (Feb. 18, 2016) ("Approval Order").

<sup>2</sup> See *Susquehanna Int'l Grp., LLP v. SEC*, 866 F.3d 442, 443 (D.C. Cir. 2017) ("*Susquehanna Opinion*"). OCC implemented the Capital Plan in 2015. Neither the Commission nor the Court stayed the implementation of the plan on review, and the D.C. Circuit did not vacate the Commission's approval order on remand. The Capital Plan therefore has remained in effect.

Chairman of OCC considers to be of competitive significance to those exchanges. No such notice was given during consideration of the Capital Plan. Based on the information before us, we cannot determine whether or how the Executive Chairman concluded that the Capital Plan lacked competitive significance such that notification was not required.

In addition, we conclude that we lack sufficient information to determine whether the Capital Plan imposes a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act, as prohibited by Section 17A(b)(3)(I) of that Act. Specifically, we cannot determine whether the Capital Plan, as implemented, has burdened competition. Nor do we have sufficient information to determine whether the dividend policy incorporated in the Capital Plan advantages the recipients of the dividends in a manner inconsistent with the Exchange Act.

We recognize that the Commission previously approved this proposed rule change. But we did so, in significant part, in reliance upon OCC's representations regarding the process through which the Plan was negotiated and developed by OCC and its Board.<sup>3</sup> The D.C. Circuit's *Susquehanna Opinion* makes clear that relying on such representations, without more, is insufficient. Rather, the Commission must critically evaluate the representations made and the conclusions drawn by OCC.<sup>4</sup> After conducting such an analysis on remand, and after giving the parties the opportunity to submit additional materials to the Commission, we have determined that OCC has failed to meet its burden to demonstrate that the Capital Plan is consistent with the Exchange Act in at least two respects, as noted above and explained below.

#### II. Background

OCC is registered with the Commission as a clearing agency and, as such, is a self-regulatory organization ("SRO") under the Exchange Act.<sup>5</sup> OCC is the only clearing agency for standardized U.S. securities options listed on SEC-registered national securities exchanges ("listed options").

<sup>3</sup> See, e.g., Approval Order at 8301, 8302, and 8305.

<sup>4</sup> *Susquehanna*, 866 F.3d at 447 ("the [Commission] should have critically reviewed OCC's analysis or performed its own."); *id.* at 448 ("the [Commission] cannot rely on OCC's process totally divorced from any examination of the Plan.').

<sup>5</sup> See 15 U.S.C. 78c(a)(26). OCC is also registered with the U.S. Commodity Futures Trading Commission as a derivatives clearing organization.

Of the national securities exchanges on which listed options are traded, five are equal owners of OCC (“Stockholder Exchanges”).<sup>6</sup> These Stockholder Exchanges are also affiliated, through various ownership structures, with several other national securities exchanges on which listed options are traded.<sup>7</sup> There are three national securities exchanges on which listed options are traded that have no ownership stake in OCC (“Non-Stockholder Exchanges”).<sup>8</sup>

OCC clears and settles listed options trades executed on the Stockholder and Non-Stockholder Exchanges. OCC also has clearing members that clear and settle options trades for their customers through the exchanges, and that pay fees and receive refunds from OCC. In addition, OCC serves other financial markets, including the commodity futures, commodity options, security futures, securities lending, and the over-the-counter options markets. OCC provides central counterparty (“CCP”) clearing services for all of these markets and performs critical functions in the clearance and settlement process. OCC’s role as the sole CCP for all listed options contracts in the U.S. makes it an integral part of the national system for clearance and settlement. The Financial Stability Oversight Council designated OCC as a systemically important financial market utility (“SIFMU”) in 2012.<sup>9</sup>

<sup>6</sup> The five owners are the Chicago Board Options Exchange, Inc., International Securities Exchange LLC, NASDAQ OMX PHLX, LLC, NYSE MKT LLC, and NYSE Arca, Inc. The NYSE exchanges are owned by a common parent, Intercontinental Exchange, Inc., and both NASDAQ OMX PHLX and the International Securities Exchange are owned by NASDAQ. As a result, OCC’s ownership essentially consists of three entities, although each exchange retains one vote on the OCC Board. See The Options Clearing Corporation Disclosure Framework for Financial Market Infrastructures, <https://www.theocc.com/components/docs/risk-management/pfmi-disclosures.pdf>.

<sup>7</sup> As of the date of this order, CBOE operates Cboe Options Exchange and is owned by CBOE Global Markets, which also owns the entities that operate Cboe C2 Options Exchange, Cboe BZX Exchange (formerly known as Bats BZX Exchange), and Cboe EDGX Exchange (formerly known as Bats EDGX Exchange). Nasdaq, Inc. owns NASDAQ OMX PHLX, LLC as well as International Securities Exchange, LLC, and operates other options exchanges: NASDAQ BX, NASDAQ GEMX, NASDAQ MRX, and NASDAQ Options Market.

<sup>8</sup> References to “Non-Stockholder Exchanges” throughout this order should be understood to mean “Non-Equity Exchanges” as defined in Article VIIB of OCC’s By-Laws. See OCC By-laws, Article VIIB § 1. The Non-Stockholder Exchanges are: Miami International Securities Exchange, LLC, MIAX PEARL, LLC (together “MIAX”), and BOX Options Exchange, LLC (“BOX”). Miami International Holdings, Inc. is the common owner of Miami International Securities Exchange, LLC and MIAX PEARL, LLC.

<sup>9</sup> See Financial Stability Oversight Council (“FSOC”) 2012 Annual Report, Appendix A, <https://www.treasury.gov/initiatives/fsoc/>

### III. Procedural History

On January 14, 2015, OCC filed the proposed rule change implementing the Capital Plan with the Commission pursuant to Section 19(b)(1) of the Exchange Act<sup>10</sup> and Rule 19b-4 thereunder.<sup>11</sup> On January 30, 2015, the Commission published the proposed rule change for comment in the **Federal Register**.<sup>12</sup> On March 6, 2015, the Division of Trading and Markets, for the Commission pursuant to delegated authority,<sup>13</sup> issued an order approving the proposal (“Delegated Order”).<sup>14</sup> The Delegated Order assessed whether the proposal was consistent with the requirements of the Exchange Act and the applicable rules and regulations thereunder, specifically finding that the Capital Plan was consistent with Exchange Act Sections 17A(b)(3)(A), 17A(b)(3)(F), 17A(b)(3)(D) and 17A(b)(3)(I) and should therefore be approved.<sup>15</sup>

In March 2015, BATS Global Markets, Inc. (“BATS”), BOX, KCG Holdings, Inc. (“KCG”), MIAX, and Susquehanna International Group, LLP (“SIG”) (collectively “Petitioners”) petitioned for review of the Delegated Order by the Commission.<sup>16</sup> On February 11, 2016, after a *de novo* review of the Capital Plan and comments received, the Commission issued an order setting aside the Delegated Order and approving the Capital Plan (“Approval Order”).<sup>17</sup> In doing so, the Commission found the Capital Plan consistent with Exchange Act Sections 17A(b)(3)(A), 17A(b)(3)(D), 17A(b)(3)(F), and 17A(b)(3)(I).<sup>18</sup>

On February 12, 2016, BOX, KCG, MIAX, and SIG<sup>19</sup> filed a petition for review in the D.C. Circuit, challenging the Commission’s Approval Order as inconsistent with both the Exchange Act and the Administrative Procedure Act.

*Documents/2012%20Annual%20Report.pdf* (last visited February 12, 2019).

<sup>10</sup> 15 U.S.C. 78s.

<sup>11</sup> 17 CFR 240.19b-4.

<sup>12</sup> Release No. 34-74136 (Jan. 26, 2015), 80 FR 5171 (Jan. 30, 2015) (SR-OCC-2015-02) (“Notice”).

<sup>13</sup> 17 CFR 200.30-3(a)(12).

<sup>14</sup> Release No. 34-74452 (Mar. 6, 2015), 80 FR 13058 (Mar. 12, 2015) (SR-OCC-2015-02).

<sup>15</sup> See 15 U.S.C. 78q-1(b)(3)(A); 15 U.S.C. 78q-1(b)(3)(F); 15 U.S.C. 78q-1(b)(3)(D); 15 U.S.C. 78q-1(b)(3)(I).

<sup>16</sup> See BATS Petition for Review (Mar. 16, 2015); BOX Petition for Review (Mar. 20, 2015); KCG Petition for Review (Mar. 20, 2015); MIAX Petition for Review (Mar. 20, 2015); SIG Petition for Review (Mar. 20, 2015).

<sup>17</sup> Release No. 34-77112, File No. SR-OCC-2015-02 (Feb. 11, 2016), 81 FR 8294 (Feb. 18, 2016).

<sup>18</sup> See 15 U.S.C. 78q-1(b)(3)(A); 15 U.S.C. 78q-1(b)(3)(D); 15 U.S.C. 78q-1(b)(3)(F); 15 U.S.C. 78q-1(b)(3)(I).

<sup>19</sup> BATS was initially a petitioner but later withdrew.

On August 8, 2017, the Court issued an opinion concluding that the Approval Order failed to meet the standards of the Administrative Procedure Act and remanding the case to the Commission for further proceedings.<sup>20</sup> In so ruling, the Court did not address Petitioners’ arguments that the Plan was inconsistent with applicable provisions of the Exchange Act. Rather, the Court emphasized that the Commission was required under the Exchange Act either to perform an independent analysis of the Capital Plan or to critically evaluate OCC’s analysis of the Plan, and found that the Commission’s analysis relied too heavily on OCC’s representations.<sup>21</sup> The Court also described several illustrative areas where the Commission’s Approval Order failed under the Administrative Procedure Act to adequately support its reasoning, including: (i) The reasonableness of the dividend rate under the Capital Plan; (ii) the reasonableness of the target capital amount established by the Capital Plan; (iii) the effect of the Capital Plan on net fees; (iv) the difference in treatment of refunds to clearing members and dividends to shareholders in certain circumstances under the Capital Plan; and (v) whether OCC complied with its own By-laws in adopting the Capital Plan.<sup>22</sup>

The Court did not vacate the Approval Order on remand, instead leaving the Plan in place and remanding “to give the [Commission] an opportunity to properly evaluate the Plan.”<sup>23</sup> The Court determined not to unwind the plan at that time because “the [Commission] may be able to approve the Plan once again, after conducting a proper analysis on remand,” and because of assurances from the parties that, should the Commission disapprove the Plan, “it will be possible to unwind the Plan at a later time.”<sup>24</sup> The Capital Plan therefore remained in effect during the pendency of the Commission’s review.

On September 14, 2017, the Commission issued an order scheduling the filing of statements on review of the Capital Plan (“September 2017 Scheduling Order”).<sup>25</sup> On October 13, 2017, OCC filed a post-remand submission to the Commission in support of re-approval of the Capital Plan (“OCC October 2017 Post-Remand

<sup>20</sup> *Susquehanna*, 866 F.3d at 443.

<sup>21</sup> *Id.* at 446, 447.

<sup>22</sup> *Id.* at 448–50.

<sup>23</sup> *Id.* at 451.

<sup>24</sup> *Id.*

<sup>25</sup> Release No. 34-81629, File No. SR-OCC-2015-02 (Sept. 14, 2017), 82 FR 44239 (Sept. 21, 2017) (“September 2017 Scheduling Order”).

Submission”).<sup>26</sup> That submission included certain material submitted by OCC pursuant to a request for confidential treatment. Separately, OCC and Petitioners reached an agreement that allowed Petitioners to access information subject to that request, and therefore Petitioners generally have been able to respond to the material in their submissions to the Commission.<sup>27</sup> On November 30, 2017, Petitioners (now consisting of SIG, BOX, MIA, and Virtu)<sup>28</sup> filed a post-remand submission to the Commission in opposition to the Capital Plan (“Petitioners November 2017 Post-Remand Submission”).<sup>29</sup> On December 20, 2017, OCC filed a reply to the Petitioners November 2017 Post-Remand Submission (“OCC December 2017 Reply”).<sup>30</sup> On January 10, 2018, Petitioners filed a surreply to OCC’s reply (“Petitioners January 2018 Surreply”).<sup>31</sup>

On August 23, 2018, OCC submitted an additional comment letter that included an analysis by Marc Brown of AlixPartners LLP (“AlixPartners”) of the reasonableness of the expected rate of return for the Stockholder Exchanges under the Capital Plan (“AlixPartners August 2018 Report”), as well as an inventory of documents and submissions that OCC stated were provided to the Commission during the course of these proceedings.<sup>32</sup> On

August 24, 2018, Petitioner SIG submitted an additional comment letter (“SIG August 2018 Post-Remand Letter”).<sup>33</sup> On August 29, 2018, OCC submitted a response to the SIG August 2018 Post-Remand Letter.<sup>34</sup>

On September 4, 2018, OCC submitted an additional comment letter and accompanying PowerPoint slide deck describing how, in its view, the Commission could reapprove the Capital Plan consistent with the D.C. Circuit’s opinion (“OCC September 2018 Path to Re-Approval”).<sup>35</sup> On September 21, 2018, OCC submitted a comment letter attaching a Market Note from Russell Rhoads, CFA of the TABB Group (“TABB September 2018 Report”).<sup>36</sup> On September 27, 2018, Petitioners submitted a comment letter responding to both the AlixPartners August 2018 Report and the OCC September 2018 Path to Re-Approval as well as reiterating Petitioners’ view that the Commission is required by the Exchange Act to disapprove the Capital

Counsel for OCC (Sept. 4, 2018). For a list of materials for which OCC seeks confidential treatment (“Confidential Materials”), see AlixPartners August 2018 Report, Exhibit B. In general, OCC asserted that the Confidential Materials were entitled to confidential treatment because they contained confidential and proprietary information, including detailed financial information and proprietary commercial or financial information, the disclosure of which would be highly detrimental to OCC’s business functions or would be highly likely to cause significant competitive harm to OCC. The Commission is not required to make public statements filed with the Commission in connection with a proposed rule change of a self-regulatory organization if the Commission could withhold the statements from the public in accordance with the Freedom of Information Act (“FOIA”), 5 U.S.C. 552. The Commission has reviewed the documents for which OCC requests confidential treatment and concludes that they could be withheld from the public under the FOIA. FOIA Exemption 4 protects confidential commercial or financial information. 5 U.S.C. 552(b)(4). If, as here, the information was not required to be submitted, commercial or financial information is treated as confidential if it is not customarily disclosed to the public by the submitter. *Critical Mass Energy Project v. NRC*, 975 F.2d 871, 879 (D.C. Cir. 1992). In its requests for confidential treatment, OCC stated that it has not disclosed the Confidential Materials to the public and there is no indication to the contrary in the record. Thus, the Commission has determined to accord confidential treatment to the Confidential Materials.

<sup>33</sup> Letter from David H. Thompson, Counsel for SIG (Aug. 24, 2018) (“SIG August 2018 Post-Remand Letter”).

<sup>34</sup> Letter from Jeffrey B. Korn, Counsel for OCC (Aug. 29, 2018).

<sup>35</sup> Letter from Jeffrey B. Korn, Counsel for OCC (Sept. 4, 2018) and attached slide deck *The Path Forward for the Commission’s Re-Approval of the OCC Capital Plan* (“OCC September 2018 Path to Re-Approval”).

<sup>36</sup> Letter from Jeffrey B. Korn, Counsel for OCC (Sept. 21, 2018) and attached Market Note from Russell Rhoads, CFA of the TABB Group, *OCC’s Capital Plan: The Value of a Bird in the Hand* (Sept. 2018) (“TABB September 2018 Report”).

Plan on remand. Petitioners also attached an expert report from Professor Peter Easton of University of Notre Dame challenging the conclusions in the AlixPartners August 2018 Report (“Easton September 2018 Rebuttal Report”).<sup>37</sup> On October 9, 2018, Petitioner SIG submitted a comment letter attaching another Market Note from Russell Rhoads, CFA of the TABB Group (Oct. 8, 2018) (“TABB October 2018 Follow-Up Report”).<sup>38</sup> On October 15, 2018, OCC submitted a comment letter replying to the Easton September 2018 Rebuttal Report and attached an expert report addressing the issues raised in the Easton September 2018 Rebuttal Report.<sup>39</sup> In addition to the comments from OCC and the Petitioners, the Commission also received further comments pursuant to the September 2017 Scheduling Order, which generally support Petitioners’ comments and overall opposition to the Capital Plan.<sup>40</sup>

#### IV. Description of the Plan

In its rule filing, OCC stated that the Capital Plan was designed to raise additional capital in connection with its increased responsibilities as a SIFMU and to facilitate prompt compliance with certain rules that the Commission proposed in March 2014 pertaining to SIFMUs and others.<sup>41</sup> Then-proposed Rule 17Ad-22(e)(15), which the Commission later adopted substantially as proposed,<sup>42</sup> required, in part, that a covered clearing agency establish, implement, maintain and enforce written policies and procedures reasonably designed to identify, monitor, and manage its general business risk and hold sufficient liquid net assets funded by equity to cover potential general business losses so that it can continue operations and services

<sup>37</sup> Letter from David H. Thompson, Counsel for Petitioners (Sept. 27, 2018) (“Petitioners September 2018 Expert Rebuttal”) and attached Expert Report of Professor Peter D. Easton, Ph.D. (Sept. 24, 2018) (“Easton September 2018 Rebuttal Report”).

<sup>38</sup> Letter from David H. Thompson, Counsel for Petitioners (Oct. 9, 2018).

<sup>39</sup> Letter from Jeffrey B. Korn, Counsel for OCC (Oct. 15, 2018) (“OCC October 2018 Expert Reply”) and attached Expert Report of Marc J. Brown, CFA (Oct. 15, 2018) (“AlixPartners October 2018 Reply”).

<sup>40</sup> Comments provided pursuant to the September 2017 Scheduling Order are available on the Commission’s website at <https://www.sec.gov/comments/sr-occ-2015-02/occ201502.shtml>. These additional comments do not raise substantive issues beyond those raised by Petitioners. Accordingly, we consider these additional comments together with the submissions and comments made by OCC and Petitioners described above.

<sup>41</sup> See Notice, *citing* Release No. 34-71699 (Mar. 12, 2014), 79 FR 29507 (May 22, 2014).

<sup>42</sup> See Release No. 34-78961 (Sept. 28, 2016), 81 FR 70786 (Oct. 13, 2016).

<sup>26</sup> Letter from Joseph P. Kamnik, General Counsel, OCC (Oct. 13, 2017) (“OCC October 2017 Post-Remand Submission”). OCC’s submission included a declaration made by Craig S. Donohue, OCC’s Executive Chairman and Chief Executive Officer (“Donohue Declaration”).

<sup>27</sup> See Release No. 34-82067, File No. SR-OCC-2015-02 (Nov. 13, 2017), 82 FR 54439, 54440 (Nov. 17, 2017) (stating that Petitioners represented that they have entered into a confidentiality agreement with OCC). As discussed below, the Commission has reviewed the requests for confidential treatment submitted by OCC and has determined to accord confidential treatment to the Confidential Materials. See *infra* note 32.

<sup>28</sup> On November 2, 2017, Virtu Financial Inc. and Virtu Financial LLC (together, “Virtu”) filed a motion to substitute Virtu for KGG.

<sup>29</sup> Letter from David H. Thompson, Counsel for Petitioners Susquehanna International Group, LLP, Miami International Securities Exchange, LLC, BOX Options Exchange, Inc., Virtu Financial, Inc., and Virtu Americas, LLC (Nov. 30, 2017) (“Petitioners November 2017 Post-Remand Submission”).

<sup>30</sup> Letter from Joseph P. Kamnik, General Counsel, OCC (Dec. 20, 2017) (“OCC December 2017 Reply”).

<sup>31</sup> Letter from David H. Thompson, Counsel for Petitioners Susquehanna International Group, LLP, Miami International Securities Exchange, LLC, BOX Options Exchange, Inc., Virtu Financial, Inc., and Virtu Americas, LLC (Jan. 10, 2018) (“Petitioners January 2018 Surreply”).

<sup>32</sup> Letter from Jeffrey B. Korn, Counsel for OCC (Aug. 23, 2018) and attached Expert Report of Marc J. Brown, CFA (Aug. 23, 2018) (“AlixPartners August 2018 Report”). Many of the documents and submissions listed by OCC included requests for confidential treatment pursuant to 17 CFR 200.83 and the Freedom of Information Act (“FOIA”), 5 U.S.C. 552. See, e.g., Letter from Jeffrey B. Korn,

as a going concern if those losses materialize.<sup>43</sup> The then-proposed rule also required “a viable plan” for raising additional equity should OCC’s equity fall below an amount required by the Rule.<sup>44</sup>

OCC represented that it reviewed a range of risk scenarios and modeled potential losses arising from business, operational, and pension risks, and, based on those results, believed that it was appropriate to significantly increase its capital. OCC also represented that, after evaluating alternate sources of capital funding, including increasing fees or suspending refunds to clearing members, OCC’s Board of Directors (the “Board”) opted to approve the proposed Capital Plan.<sup>45</sup>

Under the Capital Plan, OCC annually will determine a target capital requirement (“Target Capital Requirement”) consisting of the baseline amount of capital OCC believes is required as well as a buffer amount to offset potential losses. To assist OCC in meeting the initial Target Capital Requirement, the Stockholder Exchanges provided capital to OCC (“Capital Contribution”) upon implementation of the Plan in March 2015 and entered into an agreement (“Replenishment Capital Agreement”) to provide additional replenishment capital (“Replenishment Capital”) under specific circumstances, as detailed below. In return for this initial investment and the obligation to provide additional capital, the Stockholder Exchanges are eligible to receive dividends from OCC pursuant to an OCC internal policy (“Dividend Policy”). Additionally, OCC will set its fees annually to cover its estimated operating expenses plus a “Business Risk Buffer” pursuant to an OCC internal policy (“Fee Policy”). Finally, clearing members will be eligible to receive refunds annually, under certain circumstances, pursuant to an OCC internal policy (“Refund Policy”). The individual components of the Capital

Plan are described in greater detail below.

#### A. Target Capital Requirement

The Target Capital Requirement consists of: (i) A “Baseline Capital Requirement” plus (ii) a “Target Capital Buffer.” The Baseline Capital Requirement is equal to the greater of: (a) Six months budgeted operating expenses for the following year; (b) the maximum cost of the recovery scenario from OCC’s recovery and wind-down plan; or (c) the cost to OCC of winding down operations, as set forth in its recovery and wind-down plan. The Target Capital Buffer is linked to plausible loss scenarios from business, operational, and pension risks and is designed to provide a significant capital cushion to offset potential business losses.<sup>46</sup>

#### B. Capital Contribution and Replenishment Capital Agreement

To assist OCC in meeting the initial Target Capital Requirement, the Capital Plan requires OCC’s Stockholder Exchanges to provide a Capital Contribution pursuant to their Class B Common Stock on a *pro rata* basis. When it filed the Capital Plan with the Commission, OCC proposed the Capital Contribution to be \$150 million, and each of the Stockholder Exchanges contributed their *pro rata* share of that amount to OCC pursuant to the Capital Plan.<sup>47</sup>

In addition to the Capital Contribution, the Stockholder Exchanges agreed to a Replenishment Capital Agreement, under which they each commit to provide Replenishment Capital if OCC’s total shareholders’ equity falls below certain thresholds. The first of these thresholds—referred to as the Hard Trigger—would be reached if OCC’s shareholders’ equity fell below 125% of the Baseline Capital Requirement. Upon such occurrence, the Board would determine whether to attempt a recovery or a wind-down of OCC’s operations,<sup>48</sup> or a sale or similar

transaction, subject in each case to any necessary stockholder consent.<sup>49</sup> OCC stated that the Hard Trigger would occur only as the result of a significant, unexpected event. The Hard Trigger is a sign that corrective action must be taken in the form of a mandatory Replenishment Capital call.

If the Hard Trigger is reached, under the Capital Plan, the Stockholder Exchanges would be obligated to provide a committed amount of Replenishment Capital on a *pro rata* basis. The provision of Replenishment Capital is capped at the excess of: (i) The lesser of either the Baseline Capital Requirement at the time of relevant funding or \$200 million,<sup>50</sup> minus (ii) outstanding Replenishment Capital (collectively, the “Cap”).<sup>51</sup> In exchange for any Replenishment Capital made under the Replenishment Capital Agreement, OCC would issue the Stockholder Exchanges a new class of OCC common stock (“Class C Common Stock”).

The Replenishment Capital Agreement also contains a “Soft Trigger,” which is a warning sign that OCC’s capitalization has fallen to a level that requires action to prevent it from falling to certain levels that OCC deems unacceptable. The Soft Trigger is reached, under the Capital Plan, when

83928 (Aug. 23, 2018), 83 FR 44109 (Aug. 29, 2018) (SR–OCC–2017–810). Under the RWP, if the Board decides to wind-down OCC’s operations, then OCC will access Replenishment Capital in the amount the Board determines is sufficient to fund the wind-down, subject to the maximum amount the Stockholder Exchanges would be obligated to provide under the Capital Plan (*see infra* note 51 and accompanying text). If the Board decides to attempt a recovery of OCC’s capital and business, then OCC will access Replenishment Capital in the amount sufficient to return shareholders’ equity to \$20 million above the Hard Trigger, subject to the maximum amount the Stockholder Exchanges would be obligated to provide under the Capital Plan (*see infra* note 51).

<sup>49</sup> Article IV of OCC’s Certificate of Amendment of Certificate of Incorporation requires the approval of a majority of the issued and outstanding shares of each series of Class B Common Stock, voting separately as a series, to authorize or consent to the sale, lease, or exchange of all or substantially all of the property and assets of the Corporation, or to authorize or consent to the dissolution of the corporation.

<sup>50</sup> According to OCC, the \$200 million takes into account projected growth in the Baseline Capital Requirement for the foreseeable future, and OCC estimated that the Baseline Capital Requirement would not exceed \$200 million before 2022.

<sup>51</sup> For example, if the Baseline Capital Requirement is greater than \$200 million, then the Replenishment Capital that could be accessed by OCC would be capped at \$200 million minus any outstanding Replenishment Capital. Therefore, if there is no outstanding Replenishment Capital, OCC could access up to \$200 million. If on the other hand, the Baseline Capital Requirement is \$100 million, then OCC could access Replenishment Capital up to \$100 million minus any Replenishment Capital outstanding.

<sup>43</sup> See Release No. 34–71699 (Mar. 12, 2014), 79 FR 29508 (May 22, 2014); 17 CFR 240.17Ad–22(e)(15)(ii).

<sup>44</sup> See Release No. 34–71699 (Mar. 12, 2014), 79 FR 29508 (May 22, 2014); 17 CFR 240.17Ad–22(e)(15)(iii). Specifically, the Rule, as adopted, requires, in part, that a covered clearing agency establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable, maintain a viable plan, approved by the board of directors and updated at least annually, for raising additional equity should its equity fall close to or below the amount required by Rule 17Ad–22(e)(15)(ii).

<sup>45</sup> See OCC’s Written Statement in Support of Affirming March 6, 2015 Order Approving Capital Plan (October 7, 2015) (“OCC October 2015 Support Statement”).

<sup>46</sup> OCC determined that an appropriate initial “Target Capital Requirement” was \$247 million, reflecting a “Baseline Capital Requirement” of \$117 million, which was equal to six-month projected operating expenses, plus a “Target Capital Buffer” of \$130 million.

<sup>47</sup> See OCC October 2015 Support Statement.

<sup>48</sup> On August 23, 2018, the Commission issued a no objection to an advance notice and approved a proposed rule change by OCC to adopt a Recovery and Wind-Down Plan (“RWP”) and to implement enhanced tools for managing a potential recovery scenario (“Tools”). Release No. 34–83916 (Aug. 23, 2018), 83 FR 44076 (Aug. 29, 2018) (SR–OCC–2017–020); Release No. 34–83927 (Aug. 23, 2018), 83 FR 44083 (Aug. 29, 2018) (SR–OCC–2017–809); Release No. 34–83918 (Aug. 23, 2018), 83 FR 44091 (Aug. 29, 2018) (SR–OCC–2017–021); Release No. 34–

OCC's shareholders' equity falls below the sum of: (i) The Baseline Capital Requirement and (ii) 75% of the Target Capital Buffer. Upon such occurrence, OCC's senior management and the Board will evaluate options to restore the shareholders' equity to the Target Capital Requirement, including, but not limited to, increasing fees and/or decreasing expenses.

In addition, the Board will review the Replenishment Capital Agreement on an annual basis. While the Replenishment Capital amount will increase as the Baseline Capital Requirement increases, if the Baseline Capital Requirement approaches or exceeds \$200 million, the Board will review and revise the Capital Plan, as needed, to address potential future needs for Replenishment Capital higher than the \$200 million cap. OCC also stated that its management will monitor OCC's shareholders' equity to identify additional triggers or reduced capital levels that may require action.

### C. Fee Policy, Refund Policy, and Dividend Policy

Under the Capital Plan, OCC also implemented a Fee Policy, Refund Policy, and Dividend Policy designed to maintain OCC's shareholders' equity above the Baseline Capital Requirement. Changes to the Fee Policy, Refund Policy, and Dividend Policy require the affirmative vote of two-thirds of the directors then in office and unanimous approval by the holders of OCC's outstanding Class B Common Stock. Any changes are subject to the filing requirements of Section 19(b) of the Exchange Act and the rules and regulations thereunder.

#### 1. Fee Policy

Under the Fee Policy, OCC will set its fee structure at a level that will cover OCC's estimated operating expenses plus a Business Risk Buffer. OCC stated that the purpose of the Business Risk Buffer is to ensure that OCC accumulates sufficient funds to cover unexpected fluctuations in operating expenses, business capital needs, and regulatory capital requirements. Specifically, in setting fees each year, OCC will calculate an annual revenue target based on a forward twelve months expense forecast divided by the difference between one and the Business Risk Buffer of 25% (*i.e.*, OCC will divide the expense forecast by 0.75).<sup>52</sup> OCC stated that establishing the Business Risk Buffer at 25% would

allow OCC to manage unexpected fluctuations in expenses or revenue.<sup>53</sup>

OCC stated that the 25% Business Risk Buffer would be lower than OCC's historical ten-year average buffer of 31%. OCC stated that the lower buffer would permit it to charge lower upfront fees to market participants, and thus become less reliant on refunds to clearing members to return any excess fees paid.<sup>54</sup> In addition, by capitalizing OCC through shareholders' equity (*i.e.*, the Capital Contribution), OCC represented that it would be positioned to charge lower fees that are more closely tied to its projected operating expenses, rather than annually generating a larger surplus to address business, operational, and pension risks. OCC stated that the Business Risk Buffer will remain at 25% as long as OCC's shareholders' equity remains above the Target Capital Requirement. OCC represented that it will review its fee schedule on a quarterly basis to manage revenues as close to the 25% Business Risk Buffer as possible, and, if the fee schedule needs to be changed to achieve the 25% Business Risk Buffer, OCC would file a proposed rule change with the Commission.<sup>55</sup>

<sup>53</sup> For example, fees could generate less revenue than expected if trading volume decreases. According to OCC, because OCC's clearing fee schedules typically reflect different rates for different categories of transactions, fee projections will include projections of relative volume in each category. Therefore, the clearing fee schedule will be set to achieve the annual revenue target through a blended or average rate per contract, multiplied by total projected contract volume.

<sup>54</sup> OCC stated that the Capital Plan would allow OCC to refund approximately \$40 million from 2014 fees to clearing members and to reduce fees in an amount to be determined by the Board. See Notice at 5174. On December 17, 2015, OCC issued a press release announcing the declaration of a refund, dividend, and fee reduction, pursuant to the Capital Plan. See OCC Press Release, "OCC Declares Clearing Member Refund and Dividend for 2015 and Reduction of Fees under Approved Capital Plan," [http://www.optionsclearing.com/about/newsroom/releases/2015/12\\_17.jsp](http://www.optionsclearing.com/about/newsroom/releases/2015/12_17.jsp) (last visited February 12, 2019) ("OCC December 2015 Press Release"). For 2016, OCC declared a refund of approximately \$46.6 million to clearing members and a dividend of approximately \$25.6 million to Stockholder Exchanges. See OCC Press Release, "OCC Declares Clearing Member Refund and Dividend for 2016," <https://www.theocc.com/about/newsroom/releases/2017/March-28-OCC-Declares-Clearing-Member-Refund-Dividend-2016.jsp> (last visited February 12, 2019) ("OCC March 2016 Press Release").

<sup>55</sup> On January 20, 2016, OCC filed a proposed rule change to revise its Schedule of Fees, which OCC stated would lower clearing fees by an average of 19%. See Release No. 34-77041 (Feb. 3, 2016), 81 FR 6917 (Feb. 9, 2016). On March 2, 2016, OCC filed a proposed rule change that modified its fee schedule from four tiers to two. See Release No. 34-77336 (Mar. 10, 2016), 81 FR 14153 (Mar. 16, 2016). OCC stated that the fee change was revenue neutral when compared to its existing fee structure, but the fee change raised the per contract fee for trades with contracts between 500 and 2,000, lowered the

#### 2. Refund Policy

Under the Refund Policy, except at a time when Replenishment Capital is outstanding, OCC will declare a refund to clearing members in December of each year using the formula set out in the Refund Policy. Specifically, the refund will equal 50% of the excess of: (i) Pre-tax income for the year in which the refund is declared over (ii) the sum of the following: (a) The amount of pre-tax income after the refund necessary to produce after-tax income for such year sufficient to maintain shareholders' equity at the Target Capital Requirement for the following year; and (b) the amount of pre-tax income after the refund necessary to fund any additional reserves or additional surplus not already included in the Target Capital Requirement.

The Refund Policy states that OCC will declare refunds, if any, in December of each year, and such refunds would be paid in the following year after OCC issues its audited financial statements, provided that: (i) The payment does not result in total shareholders' equity falling below the Target Capital Requirement and (ii) the payment is otherwise permitted by Delaware law, federal laws, and regulations.<sup>56</sup>

OCC will not make refund payments while Replenishment Capital is outstanding and will resume refunds after the Replenishment Capital is repaid in full and the Target Capital Requirement is restored. However, OCC will not resume paying refunds and will recalculate how refunds are made if, for more than twenty-four months: (i)

threshold for the flat per trade fee from greater than 2,000 to greater than 1,370 contracts, and raised the flat fee on such contracts from \$46 to \$55. On September 30, 2016, OCC filed a proposed rule change to revise its Schedule of Fees to implement an increase in clearing fees to maintain the 25% Business Risk Buffer. See Release No. 34-79028 (Oct. 3, 2016), 81 FR 69885 (Oct. 7, 2016). That proposed fee change lowered the threshold for the \$55 per trade fee from 1,370 to 1,100+, and increased fees for contracts of 1-1,100 from \$0.041 per contract to \$0.050 per contract. On January 30, 2018, OCC filed a proposed rule change to revise its Schedule of Fees to implement an increase in clearing fees to maintain the 25% Business Risk Buffer. See Release No. 34-82596 (Jan. 30, 2018), 83 FR 4944 (Feb. 2, 2018). On August 1, 2018, OCC withdrew that filing, leaving the threshold for the \$55 per trade fee at 1,100+, and the fee for contracts of 1-1,100 at \$0.050 per contract.

<sup>56</sup> In 2015, OCC announced a 2014 refund of \$33.3 million, a 2015 refund of \$39 million, and special refund of \$72 million. See OCC December 2015 Press Release. In 2016, OCC announced a refund of \$46.6 million. See OCC March 2016 Press Release. In 2017, OCC announced a refund of \$78.7 million. See OCC 2017 Annual Report at 40, note 9; <https://www.theocc.com/components/docs/about/annual-reports/occ-2017-annual-report.pdf> (last visited February 12, 2019) ("OCC 2017 Annual Report").

<sup>52</sup> Put another way, the annual revenue target will be the forward twelve months expense forecast plus 33% of that forecast.

Replenishment Capital remains outstanding or (ii) the Target Capital Requirement is not restored.

### 3. Dividend Policy

Under the Dividend Policy, OCC will pay dividends to Stockholder Exchanges as consideration for their Capital Contribution and commitment to provide Replenishment Capital under the Replenishment Capital Agreement. OCC will declare dividends, if any, in December of each year, and such dividends would be paid in the following year after OCC issues its audited financial statements, provided that: (i) The payment does not result in total shareholders' equity falling below the Target Capital Requirement and (ii) the payment is otherwise permitted by Delaware law, federal laws, and regulations.

Pursuant to the Dividend Policy, except at a time when Replenishment Capital is outstanding, OCC will declare a dividend on its Class B Common Stock in December of each year in aggregate equal to the excess of: (i) After-tax income for the year, after application of the Refund Policy<sup>57</sup> over (ii) the sum of: (A) The amount required to be retained to maintain total shareholders' equity at the Target Capital Requirement for the following year, plus (B) the amount of any additional reserves or additional surplus not already included in the Target Capital Requirement.<sup>58</sup>

Similar to the Refund Policy, if Replenishment Capital is outstanding, OCC will not pay dividends. OCC would, however, resume dividends after the Replenishment Capital is repaid in full and the Target Capital Requirement is restored through the accumulation of retained earnings, even if the time of repayment exceeds twenty-four months. In the event that refunds are not tax-deductible, OCC represents that it will amend the Refund Policy and Dividend Policy to restore the relative economic benefits between the recipients of the refunds and the Stockholder Exchanges to what the Capital Plan currently provides.

### V. Discussion

Under Section 19(b)(2)(C) of the Exchange Act, the Commission must approve a proposed rule change of an SRO if the Commission finds that the

proposed rule change is consistent with the requirements of the Exchange Act and the applicable rules and regulations thereunder.<sup>59</sup> If it does not make such a finding, the Commission must disapprove the proposed rule change.<sup>60</sup> Under Rule 700(b)(3) of the Commission's Rules of Practice, the "burden to demonstrate that a proposed rule change is consistent with the Exchange Act and the rules and regulations issued thereunder . . . is on the [SRO] that proposed the rule change."<sup>61</sup> The description of a proposed rule change, its purpose and operation, its effect, and a legal analysis of its consistency with applicable requirements must all be sufficiently detailed and specific to support an affirmative Commission finding.<sup>62</sup> Any failure of an SRO to provide the information elicited by Form 19b-4 may result in the Commission not having a sufficient basis to make an affirmative finding that a proposed rule change is consistent with the Exchange Act and the rules and regulations issued thereunder that are applicable to the SRO.<sup>63</sup>

The Commission is disapproving the proposed rule change implementing the Capital Plan because the information before us is insufficient to support a finding that the Plan is consistent with the Exchange Act. Specifically, as explained below, we find that OCC has failed to meet its burden to demonstrate that the Capital Plan is consistent with the requirements of: (1) Exchange Act Section 19(g)(1), and (2) Exchange Act Section 17A(b)(3)(I).

First, Exchange Act Section 19(g)(1) states, in part, that "[e]very [SRO] shall comply with the provisions of this chapter, the rules and regulations thereunder, and *its own rules*. . . ."<sup>64</sup> One of OCC's rules—Article VIIB of its By-laws—states that Non-Stockholder Exchanges "will be promptly provided with information that the Executive Chairman considers to be of competitive significance to such [Non-Stockholder Exchanges] that was disclosed to Exchange Directors at or in connection with any meeting or action of the Board of Directors or any Committee of the Board of Directors."<sup>65</sup> The By-laws further provide that a "requesting [Non-Stockholder Exchange] shall be afforded the opportunity to make presentations to the Board of Directors or an

appropriate Committee of the Board of Directors."<sup>66</sup> The Non-Stockholder Exchanges were not notified of the Capital Plan before its adoption, and the Commission cannot determine whether or how the Executive Chairman concluded that the Capital Plan lacked competitive significance such that notification to the Non-Stockholder Exchanges was not required. Thus, there are questions as to whether OCC complied with its By-laws and, if not, whether the proposed rule change is consistent with Section 19(g) of the Act. As explained further below, based on the information before us, the Commission is unable to resolve these questions.

Second, Petitioners have questioned whether the Plan's Dividend Policy is consistent with Section 17A(b)(3)(I) of the Exchange Act, which prohibits the rules of a clearing agency from imposing a burden on competition not necessary or appropriate in furtherance of the purposes of the Act.<sup>67</sup> As explained further below, based on the information before us, we cannot determine whether the Plan, as implemented, has burdened competition. Nor do we have sufficient information to determine that the rate of return provided by the dividends under the Plan is reasonable, such that the Stockholder Exchanges are not unfairly advantaged in a manner inconsistent with the Act.

For these reasons, we are unable to find on the record before us that the Capital Plan is consistent with the Exchange Act.

#### *A. The Commission Lacks Sufficient Information To Determine Whether OCC Complied With Its By-Laws in Adopting the Capital Plan*

Petitioners contend that the Capital Plan is inconsistent with Section 19(g) of the Exchange Act because the Capital Plan was of competitive significance to the Non-Stockholder Exchanges, yet OCC failed to notify the Non-Stockholder Exchanges of the Plan or provide them the opportunity to make presentations to the Board. According to Petitioners, OCC's actions in this regard do not comply with its By-laws. In addressing Petitioners' contention in the Approval Order, we noted that we would not approve a proposed rule change of an SRO before the SRO had completed all actions required to be taken by its constitution, articles of incorporation, By-laws, rules, or corresponding instruments. But OCC represented that it had done so. Petitioners' contention also raised what

<sup>57</sup> If the Refund Policy has been eliminated, the refunds shall be deemed to be \$0.

<sup>58</sup> In 2015, OCC announced a dividend of approximately \$17 million for 2015 pursuant to the Capital Plan. See OCC December 2015 Press Release. In 2016, OCC announced a dividend of approximately \$25.6 million for 2016. See OCC March 2016 Press Release. In 2017, OCC announced a dividend of approximately \$32.5 million for 2017. See OCC 2017 Annual Report at 32.

<sup>59</sup> See 15 U.S.C. 78s(b)(2)(C)(i).

<sup>60</sup> 15 U.S.C. 78s(b)(2)(C)(ii).

<sup>61</sup> 17 CFR 201.700(b)(3).

<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> 15 U.S.C. 78s(g)(1) (emphasis added).

<sup>65</sup> OCC By-laws, Article VIIB § 1.01.

<sup>66</sup> OCC By-laws, Article VIIB § 1.02.

<sup>67</sup> 15 U.S.C. 78q-1(b)(3)(I).

we viewed as the distinct question of whether, while nominally taking the required actions, the Board nonetheless failed to comply with its responsibilities under relevant corporate governance principles, but we concluded that the issue was “not appropriately addressed by the Commission in the context of reviewing this rule filing.”<sup>68</sup>

On review, however, the D.C. Circuit found that the Commission’s analysis regarding OCC’s compliance with its By-laws gave “short shrift” to Petitioners’ objection and relied too heavily on OCC’s representation that it had completed all actions required. As a result, the Court instructed that “[o]n remand, the [Commission] must resolve Petitioners’ argument that OCC could not reasonably have considered the Plan to be competitively insignificant. Or, if the [Commission] concludes that this does not matter, it must give a reasoned explanation why.”<sup>69</sup>

On remand, OCC contends first that the Petitioners misconstrue the application of Section 19(g) in this context, asserting that the notification requirements of Article VIIB are merely “procedural” and therefore not relevant to the Commission’s approval of the Capital Plan. OCC next contends that, even if compliance with Article VIIB were relevant to the Commission’s approval of the Plan, its provisions do not apply here, both because the Executive Chairman never made an affirmative determination that the Capital Plan was of competitive significance and because there has been no showing that the Plan was of competitive significance. Finally, OCC asserts that even if it did not comply with its By-laws, any violation was harmless because Petitioners have had ample time and opportunity throughout the Commission review process to present their views on the Plan.<sup>70</sup>

As discussed in more detail below, the notification provisions in Article VIIB of OCC’s By-laws serve an important role in ensuring that OCC meets its obligations to its participants under the Exchange Act. Therefore, compliance with these provisions is relevant to our consideration of the Capital Plan. Based on the information before us, however, we cannot determine whether or how the Executive Chairman concluded that the Capital Plan lacked competitive significance such that notification to the Non-Stockholder Exchanges was not

required. Nor do we have sufficient information to ourselves determine that the Plan was of no competitive significance. We are therefore unable to find that OCC’s adoption of the Plan complied with its own rules. Finally, we disagree with OCC’s contention that violating its own By-laws in this respect would be harmless.

#### 1. Compliance With Article VIIB of OCC’s By-Laws Is Relevant to Our Analysis of the Capital Plan

OCC first asserts that Petitioners misconstrue the application of both Section 19(g) and the D.C. Circuit’s *Susquehanna* Opinion in focusing on the merits of the Executive Chairman’s determination of competitive significance under Article VIIB of its By-laws. According to OCC, the Exchange Act requires the Commission to review the substance of the Capital Plan, not the process by which it was adopted. Thus, any purported violation of a “procedural” By-law—as OCC characterizes Article VIIB—is not relevant to the Commission’s consideration of whether to approve the Capital Plan under Section 19(b).<sup>71</sup>

Petitioners counter that the By-laws are not merely procedural but rather provide substantive protection to the Non-Stockholder Exchanges.<sup>72</sup> Therefore, Petitioners argue, any determination made by the Executive Chairman pursuant to those By-laws is subject to Commission review under the Exchange Act and judicial review by the courts.

We recognize that in the Approval Order we concluded that whether the Board complied with its governance obligations was not the focus of our review of the rule filing.<sup>73</sup> But, in light of the D.C. Circuit’s specific instruction, we have revisited the record and this conclusion. And, for the reasons discussed below, we now conclude that, in the context of this proposed rule filing, it is appropriate to review OCC’s compliance with the notification provisions in Article VIIB of its By-laws.

As an SRO, OCC is subject to the rule filing requirements in Section 19(b)(1) of the Exchange Act<sup>74</sup> and Rule 19b-4(c) thereunder.<sup>75</sup> These requirements serve several important functions, including helping to ensure that the clearing agency’s rules are consistent with all of the provisions of the Exchange Act and the rules and

regulations thereunder. Exchange Act Section 19(g)(1), in turn, requires that an SRO comply with all of its own rules, without distinction as to whether those rules are procedural or otherwise.<sup>76</sup> And Article VIIB of OCC’s By-laws furthers several substantive purposes embodied elsewhere in the Exchange Act and the rules thereunder.

In particular, Exchange Act Section 17A(b)(3)(C) requires that the rules of a registered clearing agency assure fair representation of its shareholders and participants in the selection of its directors and the administration of its affairs. And Rule 17Ad-22(d)(8), applicable to OCC at the time it adopted the Capital Plan, required OCC to establish, implement, maintain, and enforce written policies and procedures reasonably designed to have governance arrangements that, among other things, support the objectives of its owners and participants.<sup>77</sup> The Commission has explained that this obligation is designed to promote the ability of the clearing agency to serve the interests of various constituents and the interests of the general public.<sup>78</sup>

Before 2002, any new market desiring to clear options transactions through OCC was required to purchase common stock in OCC and execute a stockholders agreement, thereby becoming a Stockholder Exchange and obtaining representation on the Board.<sup>79</sup> But in 2002, OCC sought to amend its By-laws and rules to permit OCC to provide clearing services to new options exchanges without having those exchanges become stockholders.<sup>80</sup> Pursuant to that proposed rule change, although the newly created Non-Stockholder Exchanges would not have representation on OCC’s board, the members of the Non-Stockholder Exchanges that also were clearing members of OCC would be “participants” in OCC within the meaning of Section 17A(b)(3)(C) of the

<sup>76</sup> 15 U.S.C. 78s(g)(1).

<sup>77</sup> 17 CFR 240.17Ad-22(d)(8). The Commission has since adopted enhanced governance requirements in Rule 17Ad-22(e)(2)(vi). 17 CFR 240.17Ad-22(e)(vi). Because OCC is a covered clearing agency, the governance requirements in Rule 17Ad-22(e)(2)(vi) apply to OCC while the requirements in Rule 17Ad-22(d)(8), applicable to OCC at the time it adopted the Capital Plan, no longer apply. See Rule 17Ad-22(d), 17 CFR 240.17Ad-22(d) (“Each registered clearing agency that is not a covered clearing agency shall establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable. . . .”).

<sup>78</sup> Release No. 34-68080 (Oct. 22, 2012), 77 FR 66220, 66252 (Nov. 2, 2012).

<sup>79</sup> See Release No. 34-46469 (Sept. 6, 2002), 67 FR 58093 (Sept. 13, 2002) (SR-OCC-2002-02) (“2002 By-law Amendment”).

<sup>80</sup> See *id.*

<sup>71</sup> OCC October 2017 Post-Remand Submission at 27.

<sup>72</sup> Petitioners November 2017 Post-Remand Submission at 9.

<sup>73</sup> Approval Order at 8305.

<sup>74</sup> 15 U.S.C. 78s(b)(1).

<sup>75</sup> 17 CFR 240.19b-4(c).

<sup>68</sup> Approval Order at 8305.

<sup>69</sup> *Susquehanna*, 866 F.3d at 450-51.

<sup>70</sup> See OCC October 2017 Post-Remand Submission at 27; OCC September 2018 Path to Re-Approval at 49.

Exchange Act, and therefore would be entitled under that provision to fair representation in the selection of OCC's directors and the administration of its affairs.<sup>81</sup> As participants, the Non-Stockholder Exchanges would also benefit from Rule 17Ad-22(d)(8)'s requirement that OCC's governance arrangements support their objectives.

OCC represented to the Commission that it would assure the fair representation required under Section 17A(b)(3)(C) for the new category of "non-equity exchanges" (referred to throughout this order as "Non-Stockholder Exchanges")<sup>82</sup> through what is now Article VIIB of the OCC By-laws, and in particular the requirement that:

OCC management will (1) provide non-equity exchanges with the opportunity to make presentations to the OCC board or the appropriate board committee upon request and (2) will promptly pass on to non-equity exchanges any information that management considers to be of competitive significance to such exchanges disclosed to exchange directors at or in connection with any meeting or action of the OCC board or any board committee.<sup>83</sup>

This representation was essential to the Commission's decision to approve the 2002 By-law Amendment.<sup>84</sup> The Commission concluded that these By-law provisions "should help to ensure that no burden on competition that is not necessary or appropriate in furtherance of the [Exchange] Act will occur."<sup>85</sup> And, on that basis, the Commission found that OCC had met its burden of demonstrating that the 2002 By-law Amendment was "consistent with the requirements of Section[s] 17A(b)(3)(C) and (I)" of the Exchange Act.<sup>86</sup>

Given the pivotal function of Article VIIB in ensuring that OCC meets its obligations to the Non-Stockholder Exchanges as participants of OCC, the Commission does not agree with OCC's assertion that compliance with Article VIIB's procedures can be disregarded in the review of proposed rule changes under Exchange Act Section 19(b)(2)(C). To conclude otherwise would thwart the protection provided to OCC's participants by the notification provisions in these By-laws by depriving them of the opportunity—in appropriate circumstances—to influence the development of proposals of

competitive significance.<sup>87</sup> It would also limit the Commission's ability to ensure that OCC complies with its own rules and regulatory obligations in the first instance.<sup>88</sup>

## 2. Article VIIB of OCC's By-Laws May Have Been Implicated by the Capital Plan

OCC also contends that, even if compliance with these By-laws is generally relevant to proposed rule changes, Article VIIB was not implicated by the Capital Plan. OCC first asserts that the Executive Chairman has no obligation to share information with the Non-Stockholder Exchanges unless and until he makes an "affirmative, subjective" determination that the information is of competitive significance, and no such determination was made here.<sup>89</sup> OCC also states that its By-laws make clear that the Executive Chairman alone has the discretion to make this determination and that, in exercising his business judgment, he never considered the Capital Plan to be of competitive significance to the Non-Stockholder Exchanges.<sup>90</sup>

Petitioners, on the other hand, state that—at a minimum—the prompt notice requirement in the By-laws implies that the Executive Chairman must actually determine what information bears such competitive significance.<sup>91</sup> They also assert that the discretionary authority under the By-laws does not grant the Executive Chairman an unconditional license to engage in arbitrary and capricious decision-making, but rather requires that any such decision be both procedurally and substantively reasonable.<sup>92</sup> Petitioners suggest that the statement by the Executive Chairman in

the materials submitted by OCC does not establish that he actually made a determination that the Plan was not competitively significant and contend that OCC provided no evidence that the Executive Chairman made any such determination.<sup>93</sup>

### a. The Executive Chairman Must Consider the Issue of Competitive Significance and That Determination Is Reviewable

We reject OCC's assertion that Article VIIB requires the Executive Chairman to notify Non-Stockholder Exchanges only if the Executive Chairman decides to consider whether a matter is of competitive significance and affirmatively determines that it is, but does not require the Executive Chairman to undertake such an inquiry.<sup>94</sup> In our view, such an interpretation is inconsistent with the purpose OCC itself ascribed to this provision at the time it was proposed. As described above, OCC represented to the Commission that this provision would help to ensure that Non-Stockholder Exchanges were provided the fair representation they are entitled to as participants of OCC. The Commission relied on this representation in approving the By-law.<sup>95</sup> If the Executive Chairman is not required to assess the competitive significance of matters coming before the Board—and can avoid triggering the By-law's notice requirements by merely refraining from such consideration—this protection is illusory.<sup>96</sup>

We also disagree with OCC's contention that applying an "objective, reasonableness standard" would "directly conflict[] with the language of the bylaw," which commits the competitive significance determination to the sole discretion of the Executive Chairman.<sup>97</sup> OCC's By-laws do leave the

<sup>81</sup> *Id.* at 7–8.

<sup>82</sup> OCC September 2018 Path to Re-Approval at 38.

<sup>83</sup> See 2002 By-law Amendment at 58095.

<sup>84</sup> OCC contends that, because its By-laws generally provide OCC's Board with authority to interpret the provisions of the By-laws, deference must be given to the Board's interpretation of Article VIIB. See OCC September 2018 Path to Re-Approval at 38 (quoting Article III, Section 8 of OCC's By-laws). The Commission believes, however, that there are limits to such authority and to the deference afforded to the Board's interpretations. OCC's Board does not have the authority to interpret the provisions of its By-laws in a manner not consistent with the Exchange Act or the rules and regulations thereunder. Nor can the Board interpret its By-laws in a manner inconsistent with the purpose OCC itself ascribed to this provision at the time it was proposed, particularly where—as here—that representation formed a basis for the Commission's approval.

<sup>85</sup> OCC October 2017 Post-Remand Submission at 26–27 (internal quotation marks omitted).

<sup>87</sup> See also General Instructions for Form 19b-4, Section E, <https://www.sec.gov/files/form19b-4.pdf> (last visited February 12, 2019) ("The Commission will not approve a proposed rule change . . . before the self-regulatory organization has completed all action required to be taken under its constitution, articles of incorporation, bylaws, rules, or instruments corresponding thereto (excluding action specified in any such instrument with respect to (i) compliance with the procedures of the Act or (ii) the formal filing of amendments pursuant to state law).").

<sup>88</sup> The Commission has the ability under Section 19(h) of the Exchange Act to initiate proceedings against a clearing agency such as OCC for failure to comply with its own rules. But such proceedings cannot remedy the impact that a failure to comply with OCC's own rules during the process of developing proposals of competitive significance could have on the final result.

<sup>89</sup> OCC September 2018 Path to Re-Approval at 38.

<sup>90</sup> Donohue Declaration at para. 22; OCC October 2017 Post-Remand Submission at 25.

<sup>91</sup> Petitioners November 2017 Post-Remand Submission at 7.

<sup>92</sup> Petitioners November 2017 Post-Remand Submission at 8.

<sup>81</sup> *Id.* at 58094.

<sup>82</sup> See *supra* note 8.

<sup>83</sup> See *id.* at 58094, n.6 (citing Letter from William H. Navin, Executive Vice President, General Counsel, and Secretary, OCC (Jul. 8, 2002)).

<sup>84</sup> *Id.* at 58095.

<sup>85</sup> See *id.* at 58095.

<sup>86</sup> See *id.*



determination of competitive significance to the discretion of the Executive Chairman. But, given the importance of the By-law provisions and the status of such provisions as SRO rules under Section 19(b) of the Exchange Act, the Commission believes that there must be a mechanism for ensuring that this discretion is not abused.

**b. The Commission Lacks Sufficient Information in the Record To Determine Whether OCC Complied With Article VIIB**

We conclude that the information before the Commission is insufficient for us to make the necessary determinations as to whether or how the Executive Chairman exercised his discretion under Article VIIB with respect to the Capital Plan.

Although the record includes comments regarding the potential burden on competition of the Capital Plan, OCC has not provided any contemporaneous records regarding a competitive significance determination. Rather, the only information in the record is contained in an affidavit submitted in connection with OCC's October 2017 Post-Remand Submission. In that affidavit, OCC's Executive Chairman declared: "In the exercise of my business judgment, I never considered the Capital Plan to be of competitive significance to the Non-Equity Exchanges."<sup>98</sup> In addition, OCC's October 2017 Post-Remand Submission included the following statement:

Here, as discussed previously, the Executive Chairman, in the exercise of his business judgment, never determined that he "considers [the Capital Plan] to be of competitive significance to [the] Non-Equity Exchanges." Nor did anyone on OCC's Board ever suggest that the Capital Plan was of competitive significance and its development was required to be disclosed to non-Stockholder Exchanges pursuant to OCC's bylaw, despite the OCC Board's knowledge of the comments submitted on the record by the Petitioners to that effect.<sup>99</sup>

These statements do not establish that the Executive Chairman gave consideration to the question of whether the Capital Plan was competitively significant prior to the adoption of the Capital Plan. Rather, the statement that

the Executive Chairman never determined that he "considers the Capital Plan to be of competitive significance to the Non-Equity Exchanges"<sup>100</sup> could be consistent with either of two things: (i) The Chairman considered the information but did not find that it was of competitive significance; or (ii) the Chairman did not consider the question of whether the information would be of competitive significance. Given the lack of clarity of this statement, and the lack of other contemporaneous records demonstrating that the Executive Chairman actually determined that the Capital Plan is not competitively significant or—if he did—the basis for that determination, we lack sufficient information to conclude that any exercise of the Executive Chairman's discretion complied with Article VIIB.

**3. OCC's Focus on Post-Implementation Evidence of Competitive Effect Is Neither Justified nor Persuasive**

OCC also maintains that, regardless of what the Executive Chairman considered, the Capital Plan has not proven to be competitively significant to the Non-Stockholder Exchanges and, therefore, the Non-Stockholder Exchanges were not in fact required to be notified under Article VIIB. In doing so, OCC focuses on competition between the Stockholder Exchanges and Non-Stockholder Exchanges for listed options order flow, and asserts that there is no evidence suggesting that the payment of dividends has altered such competition in the two years in which they have been paid.<sup>101</sup> OCC states that there is no evidence that prices for execution services have been affected by the Capital Plan, which—in its view—indicates that there has been no competitive effect.<sup>102</sup> Furthermore, OCC maintains that the Stockholder Exchanges' receipt of dividends is in exchange for their capital contributions and Replenishment Capital commitments, which the Non-Stockholder Exchanges did not make.<sup>103</sup> OCC adds that, even if the Dividend Policy subsidizes the Stockholder Exchanges' operations by reducing expenses and improving profit margins—a proposition that OCC disputes—such a subsidy would not

affect inter-exchange competition for order flow given the size of the market.<sup>104</sup>

Petitioners counter that moving away from OCC's historical operating model as an industry utility to a for-profit model that makes dividend payments to the Stockholder Exchanges is of obvious competitive significance.<sup>105</sup> Petitioners assert that the Dividend Policy provides an advantage to the Stockholder Exchanges over the Non-Stockholder Exchanges.<sup>106</sup> Given the fierceness and intensity of the competition between the Stockholder Exchanges and Non-Stockholder Exchanges, in Petitioners' view, such an advantage is necessarily significant. Petitioners point to the size of the dividends paid (two cents or less per contract) as compared to OCC's clearing fees (up to a maximum of five cents per contract) to demonstrate the significance of the advantage.<sup>107</sup> And, because they view participation in the Capital Plan as advantageous, Petitioners assert that the fact that only the Stockholder Exchanges were permitted to participate in the Capital Plan is, in and of itself, competitively significant.<sup>108</sup> Moreover, Petitioners state that the structure of the Dividend Policy is such that the more options trades the Non-Stockholder Exchanges generate, the greater the dividends that the Stockholder Exchanges will receive.<sup>109</sup>

At the outset, we find that OCC's effort to narrow the analysis to evidence related to the effect on competition after the Capital Plan was implemented is neither justified nor appropriate. "Competitive significance" as used in

<sup>104</sup> OCC October 2017 Post-Remand Submission at 20; *see also* TABB September 2018 Report at 3 (stating that the dollar amount of the dividend is very low relative to the annual revenues of the Stockholder Exchanges).

<sup>105</sup> Petitioners November 2017 Post-Remand Submission at 8–9.

<sup>106</sup> *Id.* Petitioners find support for this contention in OCC's assertion elsewhere in its submissions that the Dividend Policy may benefit end-user customers by causing the Stockholder Exchanges to lower prices. *Id.* at 17.

<sup>107</sup> Petitioners September 2018 Expert Rebuttal at 11 (citing OCC September 2018 Path to Re-Approval at 33); *see also* OCC September 2018 Path to Re-Approval at 33 (stating that a dividend of \$30 million used entirely to subsidize Stockholder Exchanges' equity options products would result in fee decreases between 0.939 cents and 2.04 cents at each Exchange). Petitioners argue that such a subsidy would be non-trivial and cite a prior statement by OCC in support of a 2016 fee reduction. Petitioners September 2018 Expert Rebuttal at 11 (citation omitted).

<sup>108</sup> Petitioners November 2017 Post-Remand Submission at 9.

<sup>109</sup> *Id.* at 10; *see also* TABB October 2018 Follow-Up Report at 2 (stating that the Capital Plan seems to foster incentives for OCC to manage its costs in a way that takes into account the related impacts on profits flowing back to OCC's investors).

<sup>98</sup> Donohue Declaration, para. 22.

<sup>99</sup> OCC October 2017 Post-Remand Submission at 25–26 (internal citations omitted). We note that the Confidential Materials include documentation demonstrating that at least some Board members did raise concerns that the Capital Plan would move OCC away from its original industry utility model, would provide a dividend that was too high given the size of the investment, and/or could put upward pressure on fees going forward.

<sup>100</sup> *Id.* at 25 (internal punctuation omitted).

<sup>101</sup> OCC October 2017 Post-Remand Submission at 19, 26.

<sup>102</sup> *Id.* at 20.

<sup>103</sup> *Id.* at 26; *see also* TABB September 2018 Report at 3 (noting the existence of the ability to request payment of Replenishment Capital and further stating that such a request would likely occur "as the result of an operational loss at OCC or a period of industry stress").

Article VIIB must be analyzed in the context of both the Commission's approval of Article VIIB, which was put in place to mitigate governance concerns stemming from the exclusion of the Non-Stockholder Exchanges from OCC's governance framework, as well as OCC's obligations under Section 17A of the Exchange Act and Rule 17Ad-22(d)—and now Rule 17Ad-22(e)—thereunder.<sup>110</sup>

Article VIIB was designed to ensure that the Non-Stockholder Exchanges would receive information that was of competitive significance and be provided an opportunity to present their views to the Board (and potentially influence the Board's decision with respect to such information), thereby ensuring that the 2002 By-law Amendment was consistent with Section 17A(b)(3)(C) of the Exchange Act. For Article VIIB to serve this purpose, the Non-Stockholder Exchanges must be afforded the opportunity to present their views to the Board, and potentially influence the Board's decision, *before* any relevant action is taken. A failure to provide that opportunity, if it was required, cannot be rendered meaningless by the later effects of a policy adopted without their *ex ante* participation. It is important to acknowledge, however, that the 2002 By-law Amendment does not place any substantive restrictions on the OCC Board's exercise of its business judgment. The Board is still free to adopt any proposal it believes is consistent with its By-laws, the Exchange Act, and any rules and regulations promulgated thereunder; it, however, must comply with OCC's own rules in doing so.<sup>111</sup>

<sup>110</sup> Appropriate and clear governance arrangements are a key component of a registered clearing agency's regulatory obligations. *See, e.g.*, 17 CFR 240.17Ad-22(d)(8) and (e)(2); *see also* Release No. 34-68080 (Oct. 22, 2012), 77 FR 66219, 66252 (Nov. 2, 2012) ("Governance arrangements . . . play an important role in making sure that clearing agencies fulfill the Exchange Act requirements that the rules of a clearing agency be designed to protect investors and the public interest and to support the objectives of owners and participants. Similarly, governance arrangements . . . [help] creat[e] an oversight framework that fosters a focus on the critical role that risk management plays in promoting prompt and accurate clearance and settlement.").

<sup>111</sup> Release No. 34-46257 (Jul. 25, 2002), 67 FR 49729, 49730 (Jul. 31, 2002) (stating that the non-equity exchanges would become parties to OCC's "existing Restated Participant Exchange Agreement" in the same way new participant exchanges have done in the past). Although OCC provides for direct Board membership only by those exchanges that are stockholders, it represented to the Commission that it would provide non-equity exchanges with information of competitive significance and opportunities for the presentation of information to OCC's Board. *Id.* at n. 6.

Moreover, even if such after-the-fact evidence could be relevant to our assessment of compliance with Article VIIB, as we explain in greater detail below, we do not believe that competition among exchanges for order flow is as narrow as OCC contends.<sup>112</sup> Exchanges can compete for order flow through a variety of activities, for example, by offering technological services.<sup>113</sup>

Additionally, we note that the Capital Plan changes the way in which OCC determines, collects, and distributes fees, refunds, and dividends among its participants, the Non-Stockholder Exchanges, and the Stockholder Exchanges. Prior to the Capital Plan, as previously described, OCC returned close to 100% of excess fees collected over annual expenses to its participants, including the Non-Stockholder Exchanges, and no dividends were paid to the Stockholder Exchanges.<sup>114</sup> The Capital Plan altered this model by introducing the concept of annual dividend obligations to the Stockholder Exchanges, which are obtained by reducing the amount of refunds previously afforded to OCC's participants.<sup>115</sup> We believe that this material change in the use of any excess fees that OCC collects could well have been considered competitively significant for OCC, its owners, and its participants (including the Non-Stockholder Exchanges) because those parties now have divergent interests in the generation, collection, and allocation of the excess fees.<sup>116</sup> In particular, the change in the allocation of such funds among the parties could have the potential to alter their competitive positions, especially if—as Petitioners allege—the rate of return provided by the dividend is disproportionate to the investments made by the Stockholder Exchanges.

At this time, we do not take a conclusive position regarding the

<sup>112</sup> OCC October 2017 Post-Remand Submission at 19–20 and OCC October 2015 Support Statement at 19–20 (focusing on the price of execution services).

<sup>113</sup> *See* discussion *infra* Section V.B.1.

<sup>114</sup> *See* OCC 2012 Annual Report at 18 (noting that net income before taxes and refunds for fiscal year 2012 was \$55,264,907, and the Board determined to return \$50.1 million to its members); Petitioners November 2017 Post-Remand Submission at 8–9 (citing to materials that characterize OCC as operating under a "zero profit" operating model).

<sup>115</sup> *See* description of Dividend Policy, *supra* Section IV.C.3.

<sup>116</sup> The TABB October 2018 Follow-Up Report concludes that the structure of the Capital Plan affects how OCC considers the generation, collection, and allocation of excess fees, particularly in terms of how profits flow back to the Stockholder Exchanges. *See* TABB October 2018 Follow-Up Report at 2.

ultimate competitive impact that this change could have, or has had, on competition among the Stockholder Exchanges and Non-Stockholder Exchanges. But, at a minimum, we believe that the potential for such an effect at the time the Capital Plan was under consideration was relevant to determining whether the Capital Plan was competitively significant. As a result, we cannot conclude that the lack of competitive significance is so obvious as to render a review of the Executive Chairman's determination unnecessary. And, as explained above, because we cannot determine whether the Executive Chairman considered these factors and, if so, what conclusions he drew at the time, we cannot determine whether he abused the discretion afforded him in the By-laws.

#### 4. A Violation of Article VIIB of OCC's By-Laws Would Not Be Harmless

Finally, OCC states that any violation of the By-laws in question would be harmless because Petitioners were given a full and fair opportunity to be heard through the notice and comment process before the Commission and have had ample opportunity to review and share their suggestions on the Capital Plan, including offering suggestions as recently as August 2017.<sup>117</sup>

The Petitioners state that the By-laws mandate that the Non-Stockholder Exchanges have an opportunity to participate in, and potentially shape and influence, matters of competitive significance to OCC's Board before they are decided upon. In their view, the ability to participate in an administrative review process where the outcome is either an approval or disapproval is not an adequate substitute.<sup>118</sup>

For the reasons discussed more fully in Section V.A.1. above setting forth the important substantive protections provided to the Non-Stockholder Exchanges by the By-laws, we do not consider the failure to follow the By-laws in these circumstances to be harmless error. Rather, we recognize that the development process for a proposal such as the Capital Plan can have a significant impact on the final proposal presented to the Board. Thus, it is not sufficient for Petitioners to have been able to raise their concerns as part of the Commission review process only *after* OCC had settled on a final Capital Plan proposal.

<sup>117</sup> OCC October 2017 Post-Remand Submission at 27.

<sup>118</sup> Petitioners November 2017 Post-Remand Submission at 9.

Accordingly, for all of the reasons discussed above, the Commission finds that OCC has failed to meet its burden to show that it followed its own rules in considering and adopting the Capital Plan, as required by Exchange Act Section 19(g)(1).<sup>119</sup> On this basis, we are therefore unable to approve the proposed rule change.

*B. The Commission Lacks Sufficient Information To Assess the Impact of the Dividend Policy on the Capital Plan's Consistency With the Exchange Act*

We also conclude that OCC failed to meet its burden of establishing that the Capital Plan is consistent with Section 17A(b)(3)(I) of the Exchange Act.<sup>120</sup> Petitioners contend that the Capital Plan's Dividend Policy creates a "subsidy" that unfairly advantages the Stockholder Exchanges and therefore burdens competition in a manner neither necessary nor appropriate in furtherance of the purposes of the Act.<sup>121</sup> In the Approval Order, we concluded to the contrary, finding that the dividends under the Plan provided reasonable compensation for the capital commitments made by the Stockholder Exchanges and, as a result, the Plan did not impose "any costs that could be viewed as imposing a burden on competition not necessary or appropriate under the Exchange Act."<sup>122</sup> Our finding that the rate of return the dividend provides to the Stockholder Exchanges was reasonable, however, was based on our reliance on the process used by OCC to arrive at that rate of return.<sup>123</sup> In light of the D.C. Circuit's instruction that such reliance was insufficient and that the Commission may not rely on OCC's process divorced from an examination of the substance of the Plan,<sup>124</sup> we have reexamined our original conclusions.

Upon reconsideration, we conclude that we lack sufficient information to make the necessary findings regarding the Plan's consistency with this provision of the Exchange Act. In particular, we cannot find—as OCC urges—that there has, in fact, been no impact on competition since the Plan has been implemented. Nor do we have sufficient information to find that the dividends under the Plan provide a reasonable rate of return such that they do not unfairly advantage the Stockholder Exchanges.

1. OCC Asserts, but Has Not Established, That There Has Been No Impact on Competition Since Implementation of the Capital Plan

OCC contends that the rate of return provided by the Dividend Policy is only relevant to the extent that the Dividend Policy imposes a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. And because, in OCC's view, there is no evidence that competition has been burdened or diminished as a result of the Dividend Policy, OCC contends that there is no need to analyze the rate of return.<sup>125</sup> In particular, OCC states that there is no evidence of any change in prices for execution or exchange services, the introduction of new services by the Stockholder Exchanges as a result of the dividends they receive, or an alteration to the competitive behavior of the options exchanges, and therefore there is no need for a more detailed examination of whether the rate of return is reasonable.<sup>126</sup> OCC also again states that as between the Stockholder Exchanges and Non-Stockholder Exchanges, the primary competition is with respect to order flow through options execution services, and that the dividends are insignificant when compared to the multi-billion-dollar market for options execution services.<sup>127</sup>

Petitioners, in contrast, state that the D.C. Circuit found that the reasonableness of the dividend rate is a central issue, and that to the extent the dividend rate is unreasonable, it creates a windfall to the Stockholder Exchanges that may inappropriately or unnecessarily burden competition.<sup>128</sup> Petitioners further state that their submissions demonstrate that the dividends are, in fact, a burden on competition.<sup>129</sup>

The Commission agrees with OCC that the reasonableness of the rate of return provided by the Dividend Policy is relevant only insofar as it affects the analysis of the consistency of the Plan with the Exchange Act. But we do not believe that this obviates the need to assess the reasonableness of the rate of return. As explained further below, OCC has asserted, but not established, that implementation of the Dividend Policy has had no effect on competition. Nor do we have sufficient information to independently determine whether or to

what extent competition has, in fact, been affected. We therefore believe that examination of the reasonableness of the rate of return is appropriate.

In arguing that there is no evidence of an effect on competition, OCC asserts that (i) the only conceivably affected competition here is among exchanges; (ii) the competition among exchanges is principally for order flow; and (iii) there is no basis to expect that competition among exchanges for order flow has been or could be diminished because of the Capital Plan.<sup>130</sup>

Even accepting OCC's arguments that the only conceivably affected competition here is among exchanges and that the competition among exchanges is principally for order flow, we do not agree with OCC's assertion that it has conclusively shown that such competition has not been affected by the Capital Plan.<sup>131</sup> We therefore find that OCC has not established that competition has not been burdened. OCC itself concedes that the competitive balance among the options exchanges is dependent upon a multitude of sources, and that both Stockholder and Non-Stockholder Exchanges compete for order flow through a variety of activities.<sup>132</sup> For example, exchanges can compete on the quality of their trade execution services by offering technological services to their market participants to enhance the trading process. Further, there are numerous ways that competition among the exchanges could be affected that would not necessarily manifest directly as immediately observable competitive behavior. For example, the Dividend Policy could allow the Stockholder Exchanges to lower the cost of executing options transactions on their exchanges (for example, by investing the dividend payments in more efficient order matching systems and trade processing systems), potentially gaining a competitive advantage over, and attracting options order flow from, the Non-Stockholder Exchanges. The Stockholder Exchanges also could use the dividends to defray the costs of new product listings, which, if successful, could attract options order flow from the Non-Stockholder Exchanges. And, while these forms of competition could be affected by any subsidy provided to the Stockholder Exchanges through the

<sup>119</sup> 15 U.S.C. 78s(g)(1).

<sup>120</sup> 15 U.S.C. 78q-1(b)(3)(I).

<sup>121</sup> See, e.g., Petitioners September 2018 Expert Rebuttal at 11.

<sup>122</sup> Approval Order at 8301.

<sup>123</sup> See, e.g., *id.* at 8300–8301.

<sup>124</sup> *Susquehanna*, 866 F.3d at 447–448.

<sup>125</sup> OCC December 2017 Reply at 5.

<sup>126</sup> *Id.* at 6–7.

<sup>127</sup> OCC October 2017 Post-Remand Submission

at 12.

<sup>128</sup> Petitioners January 2018 Surreply at 4.

<sup>129</sup> *Id.* at 5.

<sup>130</sup> OCC October 2017 Post-Remand Submission at 19. In its Reply, OCC offered additional details that it believes support a conclusion that

"competition for order flow has not been affected in the slightest." OCC December 2017 Reply at 6–7.

<sup>131</sup> OCC December 2017 Reply at 6–7.

<sup>132</sup> OCC October 2015 Support Statement at 19–20.

Dividend Policy, we lack sufficient information to determine if there has been a change in these markets attributable to the Capital Plan.

Because we cannot determine whether the Plan has had an effect on these aspects of competition, we cannot agree with OCC that it has shown an absence of a burden on competition that would obviate the need to assess the reasonableness of the rate of return generated by the Plan's Dividend Policy and its effect on competition.

## 2. We Do Not Have Sufficient Information To Assess the Reasonableness of the Rate of Return Provided by the Dividend Policy

In asserting that the rate of return is reasonable, OCC states that an Ad Hoc Strategic Advisory Group ("Advisory Group") of OCC directors "negotiated an after-tax dividend that it concluded was fair and reasonable consideration for the Stockholder Exchanges' capital outlays and commitments for additional capital outlays."<sup>133</sup> Specifically, in an affidavit submitted with its post-remand submission, OCC's Executive Chairman declared: OCC planned "to calculate the dividend each year by first providing clearing members with a refund of 50% of OCC's earnings before tax and then issuing the after-tax amount of the remainder as a dividend to the Stockholder Exchanges" and the "Stockholder Exchanges represented to OCC that they required payment of the dividend . . . as an incentive to participate in the Plan."<sup>134</sup> OCC states that the amount of dividends is reasonable because the dividends are necessary to compensate the Stockholder Exchanges for the Capital Contribution and Replenishment Capital Agreement.<sup>135</sup> OCC also states that its Board, with the assistance of Oliver Wyman, Inc. and Barclays Capital, Inc. ("Barclays"), reviewed the risks to the Stockholder Exchanges' Capital Contribution and Replenishment Capital Agreement and concluded that the

dividends were reasonable compensation for those risks.<sup>136</sup>

Petitioners state that the OCC October 2017 Post-Remand Submission fails to address the substantive reasonableness of the rate of return provided by the Plan's dividend provisions and instead relies on the process that produced the Dividend Policy.<sup>137</sup> Petitioners suggest that this process was flawed because OCC kept the Non-Stockholder Exchanges out of the deliberations and because the Stockholder Exchanges appear to have used their veto power to obtain unreasonable concessions from OCC.<sup>138</sup>

Petitioners also state that OCC has failed to demonstrate why it is reasonable to allocate roughly half of unused fees to dividends, as opposed to using a set percentage or a formula other than a fixed proportion of unused fees.<sup>139</sup> Petitioners state that the resulting rate of dividends is unreasonably high, comparing OCC's recent dividends rates of 13.3% and 17.1% to the recent yield on Ten Year United States Treasuries (which has the same debt rating as OCC), of approximately 2.37%.<sup>140</sup> Petitioners suggest that Barclays, in a presentation dated December 5, 2014, found that other capital raising transactions had lower rates of return that averaged 5.98%, and, further, that Barclays' analysis of an internal rate of return to the Stockholder Exchanges was flawed.<sup>141</sup>

Finally, Petitioners state that OCC failed to consider cheaper alternatives, such as an offer by one of the Stockholder Exchanges to provide OCC with capital at an 8% to 9% annual rate of return, setting the dividend at a predefined percentage rather than half of all excess fees,<sup>142</sup> or obtaining the

required amount of capital by retaining earnings.<sup>143</sup> In its response to Petitioners, OCC relies on statements by Barclays that the terms of the Capital Plan "provide a 'reasonable IRR on contributed capital' and that returns would be 'effectively capped.'" <sup>144</sup>

In our view, although OCC states that the dividend rate is reasonable, OCC failed to provide sufficient information to support this conclusion. Rather, OCC submitted, pursuant to a request for confidential treatment, a variety of materials prepared by third-party consultants that OCC's Board considered in crafting and ultimately approving the Capital Plan.<sup>145</sup> These materials largely consist of PowerPoint presentations prepared by these third-party consultants without narratives or explanations of key assumptions. OCC does not address all of the potential errors in these calculations alleged by Petitioners, or itself explain any of the assumptions used by the consultants in deriving their estimates.

For example, OCC does not explain anywhere why a pretax 50% division between refunds and dividends is appropriate.<sup>146</sup> While OCC indicates that the 50% split between fees (before taxes) and dividends (after taxes), was arrived at through a negotiation process by the Advisory Group,<sup>147</sup> it fails to provide any relevant substantive details regarding that negotiation process, nor does OCC provide any information or explanation as to why that particular split was chosen or why this division is consistent with the Exchange Act. Nor does OCC provide support for the disparity in treatment between dividends and refunds when replenishment capital has been outstanding for twenty-four months.<sup>148</sup>

of LIBOR + 3%. Petitioners November 2017 Post-Remand Submission at 15; Letter from David M. Pollard, Head of Strategic Planning and Special Counsel, Susquehanna Int'l Grp. to OCC Board of Directors (Aug. 25, 2017). On August 24, 2018, Petitioner SIG notified the Commission that it had amended this offer to \$150 million at the Federal Funds Rate. SIG August 2018 Post-Remand Letter at 1.

<sup>143</sup> Petitioners November 2017 Post-Remand Submission at 14–15. See also TABB October 2018 Follow-Up Report at 2–3 (discussing potential alternatives not pursued by OCC).

<sup>144</sup> OCC December 2017 Reply at 4.

<sup>145</sup> See *supra* note 26.

<sup>146</sup> *Susquehanna*, 866 F.3d at 447–48.

<sup>147</sup> See OCC October 2017 Post-Remand Submission at 8.

<sup>148</sup> As noted above in Section IV(C)(2) and (3), the Refund Policy under the Capital Plan specifies that OCC will not resume paying refunds and will recalculate how refunds are made if, for more than twenty-four months: (i) Replenishment Capital remains outstanding, or (ii) the Target Capital Requirement is not restored; however OCC would resume dividends after the Replenishment Capital is repaid in full and the Target Capital Requirement

<sup>133</sup> OCC October 2017 Post-Remand Submission at 8. The members of the Advisory Group were all directors of OCC: Three clearing member directors, two management directors, two exchange directors, and two public directors. Donohue Declaration at par. 5. Craig S. Donohue, Executive Chairman and Chief Executive Officer of OCC, was one of the management directors. *Id.*, para. 3.

<sup>134</sup> *Id.*, paras. 17, 18.

<sup>135</sup> OCC October 2017 Post-Remand Submission at 18. See also TABB September 2018 Report at 3 (noting the existence of the ability to request payment of Replenishment Capital and further stating that such a request would likely occur "as the result of an operational loss at OCC or a period of industry stress").

<sup>136</sup> OCC October 2017 Post-Remand Submission at 20–21. OCC, however, does not explain what factors made the dividend rates reasonable, nor does it address the potential errors in the calculations that Petitioners describe. See *infra* note 141 and accompanying text.

<sup>137</sup> Petitioners November 2017 Post-Remand Submission at 11–12.

<sup>138</sup> *Id.* at 1.

<sup>139</sup> *Id.* at 3.

<sup>140</sup> *Id.* at 4.

<sup>141</sup> *Id.* at 14. According to Petitioners, the analysis was incorrect because it assumed that the Stockholder Exchanges would contribute \$222 million, instead of the \$150 million that they actually contributed, and deducted the taxes that the Stockholder Exchanges were expected to pay on the dividends. Petitioners state that applying the yearly dividends Barclays assumed OCC would pay to the \$150 million Capital Contribution yields a dividend rate ranging from 16.67% to 19.93%, which is significantly higher than the internal rates of return estimated in Barclays' presentation for the Stockholder Exchanges, which were 11.7% to 13.7%. *Id.* at 12–14.

<sup>142</sup> Petitioners note that Petitioner SIG has offered to provide OCC \$150 million in capital at the rate

As the D.C. Circuit made clear, trusting the process is insufficient.<sup>149</sup> Without information sufficient to determine why a pretax 50% division between refunds and dividends and disparate treatment of refunds and dividends in the event replenishment capital has been outstanding for twenty-four months is appropriate, the Commission is unable to make determinations as to the reasonableness of the dividend rate and its consistency with the Act.<sup>150</sup>

Nor does the AlixPartners August 2018 Report, submitted by OCC, provide sufficient information to justify the expected rate of return. That report assesses the expected rate of return at the time the Capital Plan was being considered, concluding that the “expected returns to the Stockholder Exchanges for their investment in OCC and the Replenishment Capital Commitment under the Capital Plan fall within a range of returns that is reasonable for this investment and commitment.”<sup>151</sup> More specifically, it concludes that the present value of the Stockholder Exchanges’ expected returns at the time they agreed to make their \$150 million investment in OCC were between \$128.6 million and \$137.8 million. The report therefore concludes that the Stockholder Exchanges were not expected to receive outsized compensation given the risk of their investment in OCC, and thus the expected rate of return was not unreasonable.<sup>152</sup>

The AlixPartners August 2018 Report, however, has a number of deficiencies that preclude the Commission from relying on it as a basis to conclude that the dividend rate is reasonable and therefore that the Dividend Policy is consistent with the Exchange Act. As an initial matter, the report relies on a report<sup>153</sup> produced by Barclays—

is restored through the accumulation of retained earnings, even if the time of repayment exceeds twenty-four months.

<sup>149</sup> See *Susquehanna*, 866 F.3d at 447–48 (“‘Trust the process’ may be a reasonable slogan for the hometown basketball team of lead petitioner Susquehanna International Group. But the process alone cannot justify the dividend rate in this case.”) (internal citation omitted); see also *id.* at 448 (“‘More fundamentally, the SEC cannot rely on OCC’s process totally divorced from any examination of the substance of the Plan . . . .’”).

<sup>150</sup> In addition, while we do not reach the issue of the effect of the Capital Plan on fees in this order, we note that such further information regarding the reasonableness of the split and the disparity in treatment between dividends and refunds when replenishment capital has been outstanding for twenty-four months would be necessary to assess the reasonableness of the Capital Plan’s effect on fees as well. 17 CFR 240.17Ad–22(e)(15).

<sup>151</sup> AlixPartners August 2018 Report at 5, 7, 18.

<sup>152</sup> *Id.* at 18.

<sup>153</sup> *Id.* at 8 (“Barclays prepared several presentations for the Advisory Group, which

including that report’s estimate of dividends—as a basis of its analysis.<sup>154</sup> It does not, however, provide any additional information as to the basis of those assumptions.<sup>155</sup>

Moreover, the AlixPartners August 2018 Report focuses on assessing the estimated rate of return at the time OCC’s Board voted to adopt the Capital Plan. But, as the report itself acknowledges, the dividends actually paid by OCC in 2016 and 2017 exceed those estimates.<sup>156</sup> Other than noting the higher-than-estimated payments, the report does not provide any analysis of, or information regarding, the rate of return provided by the dividends actually paid. And, regardless of the reasonableness of OCC’s past predictions, without such analysis or information of the rate of return provided by the dividends actually paid, we cannot assess whether the Capital Plan has proven to inappropriately or unnecessarily burden competition.<sup>157</sup> In justifying its focus on what it terms this “*ex ante*” analysis, the second report provided by AlixPartners in October notes that the Board’s approval of the Plan was based on these same predictive judgments.<sup>158</sup> But in determining whether the Plan is consistent with Section 17A(b)(3)(I), we are not assessing the reasonableness of the Board’s judgment at the time;<sup>159</sup> rather, that provision requires us to ensure that OCC’s rules themselves—including the Capital Plan—“do not

ultimately resulted in a presentation to the OCC Board entitled “Project Optimal: Capital Plan Discussion Materials,” dated December 18, 2014 (the “Barclays Final Presentation”).”

<sup>154</sup> *Id.* at 8, n.27.

<sup>155</sup> Petitioners also noted the lack of any such information. See Petitioners September 2018 Expert Rebuttal at 9. Petitioners also stated that they did not have access to the specific Barclays report upon which the AlixPartners August 2018 Report was based. *Id.*

<sup>156</sup> AlixPartners August 2018 Report at 15, n.46. See also AlixPartners October 2018 Reply at 6, n.18 (“Moreover, I focused on expectations at the time of the adoption of the Capital Plan rather than any *ex post* realization.”).

<sup>157</sup> Barclays estimated (and the AlixPartners August 2018 Report accepted) dividend payments of \$25.5 million, \$25 million, and \$25.6 million in 2015, 2016, and 2017, respectively. The dividends actually paid in those years were \$19.7 million, \$25.6 million, and \$32.5 million, respectively. While the cumulative totals of the estimates and the actual payments are close, the difference between the relatively flat trend predicted and the actual trend of sharp increases is clear, and could be relevant to our analysis.

<sup>158</sup> AlixPartners October 2018 Reply at 9.

<sup>159</sup> In this respect, our analysis under Section 17A(b)(3)(I) differs from that under Section 19(g). As discussed above, by its terms, Section 19(g) requires us to ensure that OCC complies with its own rules, procedural and otherwise. As relevant here, that includes an assessment of whether the Board complied with Article VIII in developing the Capital Plan. See *supra* 22.

impose a burden on competition not necessary or appropriate in furtherance of the purposes of [the Act].”<sup>160</sup> And the effect of that Plan since its implementation in 2015 is relevant to that determination.<sup>161</sup>

The AlixPartners August 2018 Report also argues that the Stockholder Exchanges’ investment in OCC is comparable to a private equity investment and cites an April 2015 paper based on a survey of private equity investors, which reports that private equity investors typically target a 22% internal rate of return on their investments on average (with a vast majority of target rates of return between 20% and 25%).<sup>162</sup> However, the Commission is not persuaded by this comparison because the April 2015 paper also suggests that private equity investors select investments with significant potential for growth,<sup>163</sup> which presumably are risky investments. Indeed, the historical distribution of returns on private equity funds presented in the Easton September 2018 Rebuttal Report indicate that private equity investments are risky investments.<sup>164</sup> These characteristics appear to contradict AlixPartners’ own characterization of OCC as a non-profit-maximizing firm with low growth prospects and presumably low risk.<sup>165</sup>

Further, there are a number of other apparent deficiencies in the AlixPartners August 2018 Report, including areas where the report fails to provide an appropriate analysis or justification for key assumptions. For example, although the AlixPartners August 2018 Report states that it uses the Capital Asset Pricing Model

<sup>160</sup> 15 U.S.C. 78q–1(b)(3)(I).

<sup>161</sup> We also note the tension between OCC’s assertion here that the integrity of the Board’s approval process obviates the need for the Commission to examine the effect of the Plan since implementation and its contention elsewhere (see *supra* Section V.B.1) that the effects of the Plan since implementation obviate the need to examine the Board’s decision making process.

<sup>162</sup> AlixPartners August 2018 Report at 8.

<sup>163</sup> Gompers, Paul, Steven N. Kaplan, Vladimir Mukharlyamov, “What Do Private Equity Firms Say They Do?” *Harvard Business School*, Working Paper 15–081, April 15, 2015, at 27, [https://www.hbs.edu/faculty/Publication%20Files/15-081\\_9baffe73-8ec2-404f-9d62-ee0d825ca5b5.pdf](https://www.hbs.edu/faculty/Publication%20Files/15-081_9baffe73-8ec2-404f-9d62-ee0d825ca5b5.pdf) (last visited February 12, 2019). See also AlixPartners October 2018 Reply at 7 (clarifying that the private equity investments in the sample were primarily buyout and growth equity investors) (citing Gompers, Paul, Steven N. Kaplan, Vladimir Mukharlyamov, “What Do Private Equity Firms Say They Do?” *Harvard Business School*, Working Paper 15–081, April 15, 2015, at 11).

<sup>164</sup> Easton September 2018 Rebuttal Report at 10–11.

<sup>165</sup> AlixPartners August 2018 Report at 13.

(“CAPM”) formula<sup>166</sup> to calculate OCC’s cost of equity, it appears that the report uses a different formula that features elements of the CAPM formula (risk-free rate of return; beta, a measure of an investment’s systematic risk; and market return) as well as elements not in the CAPM formula (a risk premium associated with small stocks and a risk premium associated with an investment’s unsystematic risk).<sup>167</sup> It is therefore unclear what OCC’s cost of equity would have been had the CAPM formula actually been used for the calculation.<sup>168</sup> Further, even if the Commission were to assume that the formula in the AlixPartners August 2018 Report is a reasonable approach to estimate the cost of equity, because the report does not provide a value for the risk premium associated with unsystematic risk, the Commission would not be able to reproduce the cost of equity of 14% stated in the report.<sup>169</sup>

As another example, the Commission has concerns regarding the manner in which the AlixPartners August 2018 Report estimates a beta of 0.85, which the report uses in calculating OCC’s cost of equity. Although the AlixPartners August 2018 Report purports to calculate a beta of 0.85 by averaging the beta of four “guideline companies” that the AlixPartners August 2018 Report contends have similar risk and return profiles as OCC, the report does not actually explain how the average beta of 0.85 was calculated. Specifically, it is

<sup>166</sup> See William F. Sharpe, “Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk,” *The Journal of Finance* 19(3) (1964), pp. 425–442; John Lintner, “The Valuation of Risk Assets and the Selection of Risky Investments in Stock Portfolios and Capital Budgets,” *Review of Economics and Statistics*, 47(1), pp. 13–37; and Eugene F. Fama and Kenneth K. French, “The Capital Asset Pricing Model: Theory and Evidence,” *Journal of Economic Perspectives*, 18(3), pp. 25–46.

<sup>167</sup> AlixPartners August 2018 Report at 9.

<sup>168</sup> We also note that Petitioners question whether the CAPM is an appropriate approach for calculating a cost of capital for the Shareholder Exchanges’ equity investment in OCC. As a theoretical economic model, the CAPM assumes, among other things, that investors hold diversified portfolios. Petitioners note that this assumption is unlikely to hold in OCC’s case because the Shareholder Exchanges primarily invest in assets and activities associated with the trading of securities, and thus their portfolios are by no means diversified. See Easton September 2018 Rebuttal Report at 11–12. In response, OCC asserts in the AlixPartners August 2018 Report that this argument undermines Petitioners’ “contention about the low-risk nature of the investment” because “if the investor is unable to diversify away the unsystematic risk and is holding both systematic and unsystematic risk, the investment is riskier.” Thus, according to OCC, “by using only the CAPM to calculate the cost of equity for an investor that is undiversified, the cost of equity will be understated.” See AlixPartners October 2018 Reply at 7–8.

<sup>169</sup> AlixPartners August 2018 Report at 11.

unclear whether the AlixPartners August 2018 Report actually makes the necessary adjustments in the calculations to account for differences in financial leverage between OCC and the chosen guideline companies, nor does the AlixPartners August 2018 Report provide the inputs that readers of the report would need to make the adjustments themselves.<sup>170</sup> The Commission therefore does not believe that it can rely on the AlixPartners August 2018 Report in determining the reasonableness of the rate of return provided by the Dividend Policy.

Nor does the Commission believe that it can rely on the alternative assessment of the rate of return provided by Petitioners in the Easton September 2018 Rebuttal Report. Among other things, the Easton September 2018 Rebuttal Report concluded that the Stockholder Exchanges’ investment in OCC is exceptionally low risk. In Professor Easton’s view, the return and expected return on the Stockholder Exchanges’ investment in OCC is not commensurate with the low risk nature of the investment. Rather, based on a number of indicia, he concludes that a reasonable rate of return is near five percent.<sup>171</sup> But the Commission for the reasons discussed below is not persuaded by the argument that the investment made by the Stockholder Exchanges is an exceptionally low risk investment.<sup>172</sup>

<sup>170</sup> One approach to adjusting for differences in financial leverage between the guideline companies and OCC is to remove the effect of financial leverage from each guideline company’s beta by dividing that beta by  $(1 + (1 - t) \times DE)$ , where  $t$  and  $DE$  are respectively, the tax rate and debt-to-equity ratio of the guideline company. The resulting adjusted betas of the guideline companies are then averaged to produce an average beta that does not exhibit financial leverage effects associated with guideline companies. The beta of OCC is calculated by multiplying the average beta by  $(1 + (1 - t_{OCC}) \times DE_{OCC})$ , where  $t_{OCC}$  and  $DE_{OCC}$  are respectively, the tax rate and debt-to-equity ratio of OCC. See Robert S. Hamada, “The Effect of the Firm’s Capital Structure on the Systematic Risk of Common Stocks,” *The Journal of Finance* 27(2) (1972): 435–452; Robert G. Bowman and Susan R. Bush, “Using Comparable Companies to Estimate the Betas of Private Companies,” *Journal of Applied Finance* 16(2) (2006): 71–81.

In addition, in adjusting the present value of the Stockholder Exchanges’ expected dividends for the lack of marketability, the AlixPartners August 2018 Report reviews various studies that quantify the appropriate level of discount to be applied to equity investments that lack marketability. These studies provide different ranges of discounts: 13% to 45%, 13% to 68%, 27% to 68%, and 35% to 50%. The AlixPartners August 2018 Report then uses a lower discount of 25% and an upper discount of 30%, but other than stating that these discounts are conservative, the report does not explain or provide a justification as to why that range is appropriate here. See AlixPartners August 2018 Report at 13–15.

<sup>171</sup> Easton September 2018 Rebuttal Report at 16.

<sup>172</sup> Easton September 2018 Rebuttal Report at 6.

First, the Easton September 2018 Rebuttal Report compares the common stock investment made by the Stockholder Exchanges to the Series C Preferred Stock issued by the Depository Trust and Clearing Corporation. This comparison is problematic because preferred stock has a claim to a firm’s cash flows that is more senior than that of common stock and thus preferred stock is generally less risky than common stock.<sup>173</sup> Second, the Easton September 2018 Rebuttal Report compares the common stock investment made by the Stockholder Exchanges to the debt securities that OCC might issue. This comparison is also problematic because debt securities have a claim to a firm’s cash flows that is more senior than that of either preferred stock or common stock, and thus debt securities are generally less risky than preferred stock or common stock.<sup>174</sup>

The Commission acknowledges the diversity of views presented in the reports, but believes that it cannot rely on the analysis of either report because of the concerns described above. Significantly, as noted above, the AlixPartners August 2018 Report is based on the Barclays report,<sup>175</sup> and the Easton September 2018 Rebuttal Report is limited by the scope of the AlixPartners August 2018 Report.<sup>176</sup> As a consequence, neither report addresses the information that is necessary for the Commission to evaluate the reasonableness of the rate of return, including an analysis of the rate of return provided by the dividends actually paid under the Plan or a justification of a dividend tied to a 50% split between fees and refunds. We therefore cannot determine whether the Dividend Policy, or the Plan as a whole, unnecessarily or inappropriately burdens competition.

Accordingly, for the foregoing reasons, we find that OCC has failed to meet its burden of demonstrating that

<sup>173</sup> The riskiness of a preferred stock can be further reduced if it is cumulative, *i.e.*, any preferred stock dividend payments that have been missed in the past must be paid out to the preferred stockholders before the issuer can pay dividends to its common stockholders. See also AlixPartners October 2018 Reply at 4 (“preferred stock is different from common stock in that it typically has a higher priority in the capital structure”).

<sup>174</sup> The riskiness of a debt security can be further reduced by adding provisions to the debt agreement such as the pledging of collateral, provision of third-party credit guarantee, and incorporation of restrictive covenants to ensure that the debt security issuer preserves sufficient cash flows to meet interest payments and principal repayment. See also AlixPartners October 2018 Reply at 2 (“Debt holders have a priority claim (above that of equity holders) to the company’s assets if the company defaults.”).

<sup>175</sup> AlixPartners August 2018 Report at 8, n.27

<sup>176</sup> Easton September 2018 Rebuttal Report at 4.

the Plan is consistent with Section 17A(b)(3)(I) of the Exchange Act.<sup>177</sup> On this independent basis, we are unable to approve the proposed rule change.

#### VI. Consideration of Potential Request for Relief

The Commission recognizes that, in operating under the Capital Plan since 2015, OCC has acted in reliance on the Commission's previous approval of the Plan. But, for the reasons discussed above, the Commission is now unable to find that the Capital Plan is consistent with the Exchange Act, and the proposed rule change is therefore disapproved.

As a result of the Commission's disapproval of the proposed rule change today, OCC is out of compliance with Rule 17Ad-22(e)(15). Accordingly, OCC will be required to submit to the Commission a new or amended version of a capital plan in order to comply with Rule 17Ad-22(e)(15).<sup>178</sup>

While OCC has represented that it is possible to unwind the Capital Plan,<sup>179</sup> the Commission acknowledges that Petitioners argued and the D.C. Circuit recognized that unwinding and replacing the Capital Plan may pose considerable logistical challenges for OCC.<sup>180</sup> The Commission will consider any requests for exemptive or other relief that OCC might seek while OCC establishes a new capital plan and seeks to come into compliance with Rule 17Ad-22(e)(15).<sup>181</sup> The Commission

<sup>177</sup> 15 U.S.C. 78q-1(b)(3)(I).

<sup>178</sup> 17 CFR 240.17Ad-22(e)(15). This order does not preclude OCC from revising the Capital Plan in the form of a new proposed rule change submission or submitting a completely new proposal to set a capital target and raise capital that is in compliance with OCC's own rules and consistent with the Exchange Act and applicable regulations.

Additionally, OCC will need to submit to the Commission some iteration of a capital plan in order to comply with its obligations under Section 19(b) of the Exchange Act and Rule 19b-4 thereunder. 15 U.S.C. 78s; 17 CFR 240.19b-4.

<sup>179</sup> *Susquehanna*, 866 F.3d at 451 ("OCC assure[s] us that it will be possible to unwind the Plan at a later time") (citing Oral Argument Transcript at 33-34, containing OCC statements at oral argument); OCC Opposition to Stay (D.C. Circuit Feb. 22, 2016) at 9 (arguing that Petitioners have failed to show any irreparable harm in the absence of a stay).

<sup>180</sup> *Susquehanna*, 866 F.3d at 451; see also Petitioners September 2018 Expert Rebuttal at 13 (discussing alternatives to the current Capital Plan as well as potential Commission relief to manage consequences). See, e.g., OCC September 2018 Path to Re-Approval at 51-52; TABB September 2018 Report at 4-5; see also Opposition of the Securities and Exchange Commission to Petitioners' Emergency Motion for Stay at 3, *Susquehanna Int'l Grp., LLP v. SEC*, Case No. 16-1061 (D.C. Cir.).

<sup>181</sup> Section 36 of the Exchange Act authorizes the Commission, by rule, regulation, or order, to exempt, either conditionally or unconditionally, any person, security, or transaction, or any class of classes of persons, securities, or transaction, from any provision or provisions of the Exchange Act or

does not currently have sufficient information to understand what, if any, specific challenges OCC may face, and if any regulatory relief may be necessary, or, if so, to appropriately tailor such relief. The Commission would expect any such potential request for relief by OCC to include information sufficient for the Commission to determine whether the requested relief is necessary or appropriate in the public interest, and is consistent with the protection of investors. The Commission expects that any such request from OCC would likely need to include a detailed explanation of (i) the relief being sought, (ii) why the requested relief is necessary, (iii) the time period for which OCC is seeking relief and an explanation of its appropriateness, and (iv) any limitations or conditions that OCC believes would be appropriate to impose in connection with the requested relief.

#### VII. Conclusion

*It is hereby ordered* that SR-OCC-2015-02 is hereby disapproved pursuant to section 19(b)(2) of the Exchange Act;

*It is further ordered* that, in accordance with Section 23(a)(3) of the Exchange Act, the information for which OCC requested confidential treatment will not be kept in a public file because that information is confidential commercial and financial information that could be withheld from the public under FOIA Exemption 4, 5 U.S.C. 552(b)(4).

By the Commission.

**Eduardo A. Aleman,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-85125; File No. SR-Phlx-2019-01]

### Self-Regulatory Organizations; Nasdaq PHLX LLC; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change To Amend the Options Regulatory Fee

February 13, 2019.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup>

any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors. 15 U.S.C. 78mm.

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

notice is hereby given that on February 1, 2019, Nasdaq PHLX LLC ("Phlx" or "Exchange") filed with the Securities and Exchange Commission (the "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

#### I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The Exchange proposes to revise its Pricing Schedule at Options 7, Section 6, Part D to amend the Phlx Options Regulatory Fee or "ORF."

The text of the proposed rule change is available on the Exchange's website at <http://nasdaqphlx.cchwallstreet.com/>, at the principal office of the Exchange, and at the Commission's Public Reference Room.

#### II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

##### A. Self-Regulatory Organization's Statement of the Purpose of, and the Statutory Basis for, the Proposed Rule Change

###### 1. Purpose

Currently, Phlx assesses an ORF of \$0.0045 per contract side. The Exchange proposes to increase this ORF to \$0.0050 per contract side as of February 1, 2019. In light of recent market volumes, the Exchange is proposing to increase the amount of ORF that will be collected by the Exchange. The proposal would allow the Exchange to increase the per contract amount of ORF in order to offset the Exchange anticipated regulatory costs. The Exchange's proposed change to the ORF should balance the Exchange's regulatory revenue against the anticipated regulatory costs. The Exchange also proposes to delete obsolete language in the rule text as described herein.