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SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-91491; File No. SR-OCC-2021-801)

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of No Objection to Advance Notice relating to OCC's Establishment of Persistent Minimum Skin-In-The-Game

April 7, 2021.

## I. INTRODUCTION

On February 10, 2021, the Options Clearing Corporation (“OCC”) filed with the Securities and Exchange Commission (“Commission”) advance notice SR-OCC-2021-801 (“Advance Notice”) pursuant to Section 806(e)(1) of Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, entitled Payment, Clearing and Settlement Supervision Act of 2010 (“Clearing Supervision Act”)<sup>1</sup> and Rule 19b-4(n)(1)(i)<sup>2</sup> under the Securities Exchange Act of 1934 (“Exchange Act”)<sup>3</sup> to establish a persistent minimum level of skin-in-the-game that OCC would contribute to cover default losses or liquidity shortfalls.<sup>4</sup> The Advance Notice was published for public comment in the Federal Register on March 1, 2021,<sup>5</sup> and the Commission has received comments

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<sup>1</sup> 12 U.S.C. 5465(e)(1).

<sup>2</sup> 17 CFR 240.19b-4(n)(1)(i).

<sup>3</sup> 15 U.S.C. 78a et seq.

<sup>4</sup> See Notice of Filing infra note 5, at 86 Fed. Reg. 12057.

<sup>5</sup> Securities Exchange Act Release No. 91184 (Feb. 23, 2021), 86 Fed. Reg. 12057 (Mar. 1, 2021) (File No. SR-OCC-2021-801) (“Notice of Filing”). On February 10, 2021, OCC also filed a related proposed rule change (SR-OCC-2021-003) with the Commission pursuant to Section 19(b)(1) of the Exchange Act and Rule 19b-4 thereunder (“Proposed Rule Change”). 15 U.S.C. 78s(b)(1) and 17 CFR 240.19b-4, respectively. In the Proposed Rule Change, which was published in the Federal Register on March 2, 2021, OCC seeks approval of proposed changes to its rules necessary to implement the Advance Notice. Securities Exchange Act Release No. 91199 (Feb. 24, 2021), 86 Fed. Reg. 12237 (Mar. 2, 2021) (File No. SR-OCC-2021-003). The comment period for the related Proposed Rule Change filing closed on March 23, 2021.

regarding the changes proposed in the Advance Notice.<sup>6</sup> The Commission is hereby providing notice of no objection to the Advance Notice.

## II. BACKGROUND<sup>7</sup>

“Skin-in-the-game,” as a component of financial risk management, entails a covered clearing agency choosing, upon the occurrence of a default or series of defaults and application of all available assets of the defaulting participant(s), to apply its own capital contribution to the relevant clearing or guaranty fund in full to satisfy any remaining losses prior to the application of any (a) contributions by non-defaulting members to the clearing or guaranty fund, or (b) assessments that the covered clearing agency require non-defaulting participants to contribute following the exhaustion of such participant’s funded contributions to the relevant clearing or guaranty fund.<sup>8</sup>

OCC’s skin-in-the-game component of its financial risk management regime is described in its current rules, which provide for the use of OCC’s own capital to mitigate losses arising out of a Clearing Member default.<sup>9</sup> Specifically, OCC’s rules provide for the offsetting of default losses remaining after the application of a defaulted Clearing

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<sup>6</sup> Comments on the Advance Notice are available at <https://www.sec.gov/comments/sr-occ-2021-801/occ2021801.htm>.

Since the proposal contained in the Advance Notice was also filed as a proposed rule change, all public comments received on the proposal are considered regardless of whether the comments are submitted on the Proposed Rule Change or the Advance Notice. Comments on the Proposed Rule Change are available at <https://www.sec.gov/comments/sr-occ-2021-003/srocc2021003.htm>.

<sup>7</sup> Capitalized terms used but not defined herein have the meanings specified in OCC’s Rules and By-Laws, available at <https://www.theocc.com/about/publications/bylaws.jsp>.

<sup>8</sup> See Securities Exchange Act Release No. 78961 (Sep. 28, 2016), 81 Fed. Reg. 70786, 70806 (Oct. 13, 2016) (S7-03-14) (“Covered Clearing Agency Standards”).

<sup>9</sup> See Securities Exchange Release No. 88029 (Jan. 24, 2020), 85 Fed. Reg. 5500, 5502 (Jan. 30, 2020) (File No. SR-OCC-2019-007) (“CMP Approval Order”).

Member's margin deposits and Clearing Fund contributions with OCC's capital in excess of 110 percent of the Target Capital Requirement at the time of the default.<sup>10</sup> OCC's rules also provide for charging losses remaining after the application of OCC's excess capital to OCC senior management's deferred compensation<sup>11</sup> as well as non-defaulting Clearing Members.<sup>12</sup>

OCC reviewed feedback received in connection with the initial filing of its current rules, relevant papers from industry participants and stakeholders concerning skin-in-the-game, and regulatory regimes in jurisdictions outside the United States.<sup>13</sup> OCC's current rules do not, however, dedicate OCC's excess capital for use solely as skin-in-the-game, or guaranty that OCC maintain a minimum amount of skin-in-the-game.<sup>14</sup>

*Establishing the Minimum Corporate Contribution.* OCC proposes to establish a persistent minimum level of skin-in-the-game that OCC would contribute to cover default losses or liquidity shortfalls. Such skin-in-the-game would consist of a minimum

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<sup>10</sup> See OCC Rule 1006(e), available at [https://www.theocc.com/getmedia/9d3854cd-b782-450f-bcf7-33169b0576ce/occ\\_rules.pdf](https://www.theocc.com/getmedia/9d3854cd-b782-450f-bcf7-33169b0576ce/occ_rules.pdf) (last visited Mar. 16, 2021). See also CMP Approval Order at 5502.

<sup>11</sup> Such deferred compensation is in trust with respect to OCC's Executive Deferred Compensation Plan ("EDCP"). See OCC Rule 101(e)(1), available at [https://www.theocc.com/getmedia/9d3854cd-b782-450f-bcf7-33169b0576ce/occ\\_rules.pdf](https://www.theocc.com/getmedia/9d3854cd-b782-450f-bcf7-33169b0576ce/occ_rules.pdf) (last visited Mar. 16, 2021). The specific EDCP funds that comprise a portion of OCC's skin-in-the-game are referred to in OCC's rules as the "EDCP Unvested Balance." See *id.*

<sup>12</sup> See OCC Rule 1006(b), available at [https://www.theocc.com/getmedia/9d3854cd-b782-450f-bcf7-33169b0576ce/occ\\_rules.pdf](https://www.theocc.com/getmedia/9d3854cd-b782-450f-bcf7-33169b0576ce/occ_rules.pdf) (last visited Mar. 16, 2021). See also CMP Approval Order at 5502. The application the EDCP Unvested Balance in parallel with non-defaulting Clearing Members' Clearing Fund contributions would necessarily occur before assessments related to the exhaustion of OCC's Clearing Fund.

<sup>13</sup> See Notice of Filing, 86 Fed. Reg. at 12058-59. For example, OCC is cognizant of the European Market Infrastructure Regulation's expectation that skin-in-the-game be a minimum of 25 percent of the central counterparty's regulatory capital requirement. See Notice of Filing, 86 Fed. Reg. at 12059.

<sup>14</sup> See Notice of Filing, 86 Fed. Reg. at 12060.

amount of OCC's own pre-funded resources that OCC would contribute prior to charging a loss to the Clearing Fund (the "Minimum Corporate Contribution") and the EDCP Unvested Balance.<sup>15</sup> As proposed, funds comprising the Minimum Corporate Contribution would be excluded from OCC's liquid net assets funded by equity ("LNAFBE") for purposes of meeting OCC's Target Capital Requirement to ensure that OCC may maintain the Minimum Corporate Contribution exclusively for default management.<sup>16</sup>

OCC proposes to define the Minimum Corporate Contribution to mean the minimum level of OCC's own funds maintained exclusively to cover credit losses or liquidity shortfalls, the level of which OCC's Board of Directors (the "Board") shall determine from time to time. To facilitate implementation of OCC's proposal, the Board approved an initial Minimum Corporate Contribution at such a level that OCC's total skin-in-the-game (i.e., the sum of the Minimum Corporate Contribution and OCC's current EDCP Unvested Balance) would equal 25 percent of OCC's Target Capital Requirement. OCC stated that, in setting the initial Minimum Corporate Contribution, the Board considered factors including, but not limited to, the regulatory requirements in each jurisdiction in which OCC is registered or in which OCC is actively seeking recognition, the amount similarly situated central counterparties commit of their own resources to address participant defaults, the EDCP Unvested Balance, OCC's LNAFBE greater than 110 percent of its Target Capital Requirement, projected revenue and

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<sup>15</sup> OCC does not propose altering its rules regarding the use or sizing of the EDCP Unvested Balance.

<sup>16</sup> In addition to the Minimum Corporate Contribution, OCC would continue to commit its LNAFBE greater than 110 percent of its Target Capital Requirement prior to charging a loss to the Clearing Fund. As proposed, OCC would apply the Minimum Corporate Contribution to address default losses before applying its excess LNAFBE.

expenses, and other projected capital needs.<sup>17</sup>

*Replenishing the Minimum Corporate Contribution.* OCC proposes that, in the event it were to apply a portion of the Minimum Corporate Contribution to address losses or shortfalls arising out of a Clearing Member default, the size of the Minimum Corporate Contribution would be temporarily reduced, for a period of 270 days, to the amount remaining after its application.<sup>18</sup> Each application of the Minimum Corporate Contribution would trigger a new 270-day period.<sup>19</sup> Under the proposal, OCC would be obligated to notify Clearing Members of any such reduction of the Minimum Corporate Contribution. OCC believes that 270 calendar days, or approximately nine months, is sufficient time for OCC to accumulate the funds necessary to reestablish the Minimum Corporate Contribution.<sup>20</sup>

OCC proposes change to its Rules, Capital Management Policy, Default Management Policy, Clearing Fund Methodology Policy, and Recovery and Orderly Wind-Down Plan to effectuate the changes described above.

### **III. DISCUSSION AND NOTICE OF NO OBJECTION**

Although the Clearing Supervision Act does not specify a standard of review for an advance notice, the stated purpose of the Clearing Supervision Act is instructive: to mitigate systemic risk in the financial system and promote financial stability by, among

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<sup>17</sup> See Notice of Filing, 86 Fed. Reg. at 12060.

<sup>18</sup> For example, if the Minimum Corporate Contribution were \$100 million and OCC applied \$25 million to address default losses, then the Minimum Corporate Contribution would be temporarily set at \$75 million.

<sup>19</sup> For example, if OCC were to contribute a portion of the Minimum Corporate Contribution on day 1 and another portion 100 days later, the Minimum Corporate Contribution would remain temporarily reduced until day 370.

<sup>20</sup> See Notice of Filing, 86 Fed. Reg. at 12060. OCC stated that the analysis on which its belief is based is the same analysis on which OCC relied to set various thresholds related to OCC's plan for replenishing its regulatory capital. See id.

other things, promoting uniform risk management standards for SIFMUs and strengthening the liquidity of SIFMUs.<sup>21</sup>

Section 805(a)(2) of the Clearing Supervision Act authorizes the Commission to prescribe regulations containing risk management standards for the payment, clearing, and settlement activities of designated clearing entities engaged in designated activities for which the Commission is the supervisory agency.<sup>22</sup> Section 805(b) of the Clearing Supervision Act provides the following objectives and principles for the Commission’s risk management standards prescribed under Section 805(a):<sup>23</sup>

- to promote robust risk management;
- to promote safety and soundness;
- to reduce systemic risks; and
- to support the stability of the broader financial system.

Section 805(c) provides, in addition, that the Commission’s risk management standards may address such areas as risk management and default policies and procedures, among other areas.<sup>24</sup>

The Commission has adopted risk management standards under Section 805(a)(2) of the Clearing Supervision Act and Section 17A of the Exchange Act (the “Clearing Agency Rules”).<sup>25</sup> The Clearing Agency Rules require, among other things, each covered clearing agency to establish, implement, maintain, and enforce written policies

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<sup>21</sup> See 12 U.S.C. 5461(b).

<sup>22</sup> 12 U.S.C. 5464(a)(2).

<sup>23</sup> 12 U.S.C. 5464(b).

<sup>24</sup> 12 U.S.C. 5464(c).

<sup>25</sup> 17 CFR 240.17Ad-22. See Securities Exchange Act Release No. 68080 (Oct. 22, 2012), 77 Fed. Reg. 66220 (Nov. 2, 2012) (S7-08-11). See also Covered Clearing Agency Standards, 81 Fed. Reg. 70786. OCC is a “covered clearing agency” as defined in Rule 17Ad-22(a)(5).

and procedures that are reasonably designed to meet certain minimum requirements for its operations and risk management practices on an ongoing basis.<sup>26</sup> As such, it is appropriate for the Commission to review advance notices against the Clearing Agency Rules and the objectives and principles of these risk management standards as described in Section 805(b) of the Clearing Supervision Act. As discussed below, the Commission believes the changes proposed in the Advance Notice are consistent with the objectives and principles described in Section 805(b) of the Clearing Supervision Act,<sup>27</sup> and in the Clearing Agency Rules, in particular Rule 17Ad-22(e)(2).<sup>28</sup>

**A. Consistency with Section 805(b) of the Clearing Supervision Act**

The Commission believes that the proposal contained in OCC’s Advance Notice is consistent with the stated objectives and principles of Section 805(b) of the Clearing Supervision Act.<sup>29</sup> Specifically, as discussed below, the Commission believes that the

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<sup>26</sup> 17 CFR 240.17Ad-22.

<sup>27</sup> 12 U.S.C. 5464(b).

<sup>28</sup> 17 CFR 240.17Ad-22(e)(2).

<sup>29</sup> As noted above, the Commission considers all public comments received on the proposal regardless of whether the comments are submitted on the Proposed Rule Change or the Advance Notice. One commenter raised issues related solely to the consistency of the proposal with the requirements of Section 17A of the Exchange Act. See letter from Richard J. McDonald, Susquehanna International Group (“SIG”), dated March 30, 2021, to Vanessa Countryman, Secretary, Commission (“SIG Letter”), available at <https://www.sec.gov/comments/sr-occ-2021-003/srocc2021003.htm>.

Specifically, SIG expressed concern regarding (i) the extent to which OCC fees, dues, and other charges would be used to finance the equity windfall of OCC shareholders and their commercial interests and (ii) the effect of the proposal on the protection of investors and the public interest. The Commission’s evaluation of the Advance Notice is conducted under the Clearing Supervision Act and, as noted above, generally considers whether the proposal will mitigate systemic risk and promote financial stability. The Commission notes that SIG has not explained or demonstrated how the retention of capital, derived from clearing fees, for use as skin-in-the-game would cause the proposal to be inconsistent with the Clearing Supervision Act. The SIG Letter is directed at the Proposed Rule Change and will be addressed in that context.

changes proposed in the Advance Notice are consistent with promoting robust risk management, promoting safety and soundness, reducing systemic risks, and supporting the stability of the broader financial system.<sup>30</sup>

The Commission continues to regard skin-in-the-game as a potential tool to align the various incentives of a covered clearing agency's stakeholders, including management and clearing members.<sup>31</sup> OCC's current rules provide for the application of excess capital as skin-in-the-game. The Commission believes that OCC's proposal to set aside capital to maintain a minimum amount of skin-in-the-game strengthens OCC's existing skin-in-the-game rules. OCC's current rules align senior management's personal economic incentives with OCC's overall risk management incentives,<sup>32</sup> but do not guaranty that an amount of OCC capital would be set aside to ensure a pre-determined minimum level of skin-in-the-game. The Commission believes that holding a Minimum Corporate Contribution, in addition to the EDCP unvested balance, to ensure such a minimum level of skin-in-the-game would help to align OCC's economic incentives as a corporation with risk management more broadly, thereby promoting robust risk management at OCC.

Holding a defined Minimum Corporate Contribution, as opposed to an undefined amount of excess capital, may help to incentivize OCC further to maintain the appropriate amount of resources to manage a Clearing Member default, consistent with the promotion of safety and soundness at OCC. Further, the Commission believes that, to the extent the proposed changes are consistent with promoting OCC's safety and soundness, they are also consistent with supporting the stability of the broader financial

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<sup>30</sup> 12 U.S.C. 5464(b).

<sup>31</sup> Covered Clearing Agency Standards, 81 FR at 70805–06.

<sup>32</sup> See Securities Exchange Act Release No. 87257 (Oct. 8, 2019), 84 Fed. Reg. 55194, 55199 (Oct. 15, 2019) (File No. SR-OCC-2019-805).



system. OCC has been designated as a SIFMU, in part, because its failure or disruption could increase the risk of significant liquidity or credit problems spreading among financial institutions or markets.<sup>33</sup> The Commission believes that the proposed changes would help support the maintenance of OCC as a going concern following a Clearing Member default, which in turn would help support the stability of the financial system by reducing the risk of significant liquidity or credit problems spreading among market participants that rely on OCC's central role in the options market. Finally, the Commission believes that the proposed changes to increase OCC's pre-determined default management resources are consistent with the reduction of systemic risk because such increase enhances the ability of OCC to absorb and contain the spread of any losses that might arise from a member default.

Accordingly, and for the reasons stated above, the Commission believes the changes proposed in the Advance Notice are consistent with Section 805(b) of the Clearing Supervision Act.<sup>34</sup>

**B. Consistency with Rule 17Ad-22(e)(2) under the Exchange Act**

Rule 17Ad-22(e)(2) under the Exchange Act requires that a covered clearing agency establish, implement, maintain, and enforce written policies and procedures reasonably designed to provide for governance arrangements that, among other things, are clear and transparent; clearly prioritize the safety and efficiency of the covered clearing agency; and support the public interest requirements of the Exchange Act.<sup>35</sup> In adopting Rule 17Ad-22(e)(2), the Commission discussed comments it received regarding

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<sup>33</sup> See Financial Stability Oversight Council ("FSOC") 2012 Annual Report, Appendix A, <https://home.treasury.gov/system/files/261/here.pdf> (last visited Mar. 17, 2021).

<sup>34</sup> 12 U.S.C. 5464(b).

<sup>35</sup> 17 CFR 240.17Ad-22(e)(2).

the concept of skin-in-the-game as a potential tool to align the various incentives of a covered clearing agency's stakeholders, including management and clearing members.<sup>36</sup> And, while the Commission declined to include a specific skin-in-the-game requirement in the rule, it stated its belief that "the proper alignment of incentives is an important element of a covered clearing agency's risk management practices," and noted that skin-in-the-game "may play a role in those risk management practices in many instances."<sup>37</sup> OCC's current rules require the application management compensation and excess capital as skin-in-the-game, which in turn should help further align the interests of OCC's stakeholders, including OCC management and Clearing Members.<sup>38</sup>

As described above, OCC's proposal would not reduce the resources OCC would apply to address default losses or remove the current skin-in-the-game component of OCC's rules. Rather, OCC proposes to set aside a defined amount of capital for the sole purpose of absorbing losses and shortfalls arising out of a Clearing Member default. OCC has clearly stated the factors that the Board would consider when determining the amount of resources to hold as skin-in-the-game, a portion of which would comprise the Minimum Corporate Contribution. OCC also proposes to establish a clear process for addressing reductions in the Minimum Corporate Contribution arising out of a Clearing Member's default. Accordingly, the Commission believes that the proposed changes to establish a persistent minimum level of skin-in-the-game are consistent with Rule 17Ad-22(e)(2) under the Exchange Act.<sup>39</sup>

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<sup>36</sup> Covered Clearing Agency Standards, 81 FR at 70805–06.

<sup>37</sup> Covered Clearing Agency Standards, 81 FR at 70806.

<sup>38</sup> See CMP Approval Order at 5507.

<sup>39</sup> 17 CFR 240.17Ad-22(e)(2).

#### **IV. CONCLUSION**

IT IS THEREFORE NOTICED, pursuant to Section 806(e)(1)(I) of the Clearing Supervision Act, that the Commission DOES NOT OBJECT to Advance Notice (SR-OCC-2021-801) and that OCC is AUTHORIZED to implement the proposed change as of the date of this notice or the date of an order by the Commission approving proposed rule change SR-OCC-2021-003, whichever is later.

By the Commission.

J. Matthew DeLesDernier,  
Assistant Secretary.

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