



## DCO Rules

### UNITED STATES COMMODITY FUTURES TRADING COMMISSION

<b>Submitter Information</b>	
<b>Organization Name</b> Options Clearing Corporation	
<b>Organization Type</b> DCO	<b>Organization Acronym</b> OCC
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<b>Cover Sheet</b>	
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<b>Submission Type</b> 40.6(a) Rule Certification	
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<b>Registered Entity Identifier Code</b>	
<b>Rule Numbers</b> Rule 101.M.; Rule 1006(b), (e)	
<b>Date of Intended Implementation</b> 4/9/2021	
<b>Documents</b>	
SITG CFTC Letter (3.18.2021).pdf SITG Confidential Exhibits (3.18.2021).pdf (Confidential Treatment Requested)	
<b>Request For Confidential Treatment - Detailed Written Justification</b>	
CFTC Confidentiality Request 3.18.2021.pdf	

March 18, 2021

**VIA CFTC PORTAL**

Christopher J. Kirkpatrick  
Office of the Secretariat  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21<sup>st</sup> Street, N.W.  
Washington, DC 20581

**Re: OCC Rule Certification to Establish A Persistent Minimum Level of  
Skin-In-The-Game**

Dear Secretary Kirkpatrick:

Pursuant to Section 5c(c)(1) of the Commodity Exchange Act, as amended (“Act”), and Commodity Futures Trading Commission (“CFTC”) Regulation 40.6, The Options Clearing Corporation (“OCC”) submits this rule certification to establish a persistent minimum level of OCC’s own financial resources (commonly referred to as “skin-in-the-game”) that OCC would contribute to cover default losses or liquidity shortfalls. The date of implementation of the rule is at least 10 business days following receipt of the rule filing by the CFTC or the date the proposed rule is approved by the Securities and Exchange Commission (“SEC”) or otherwise becomes effective under the Securities Exchange Act of 1934 (the “Exchange Act”). This proposed rule has been submitted to the SEC under the Exchange Act.<sup>1</sup>

Amendments to OCC’s Rules are included in Exhibit A. Amendments to OCC’s Capital Management Policy are included in confidential Exhibit B. OCC would also make conforming changes to its Default Management Policy and Clearing Fund Methodology Policy, which can be found in confidential Exhibits C and D, respectively, to reflect the amended default waterfall (i.e., the financial resources OCC would use to address default losses and liquidity shortfalls, listed in the order OCC would utilize them).<sup>2</sup> OCC has requested confidential treatment for Exhibits B, C and D. Material proposed to be added is marked by underlining, and material proposed to be deleted is

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<sup>1</sup> See Exchange Act Release No. 91199 (Feb. 24, 2021), 86 FR 12237 (Mar. 2 2021); (File No. SR-OCC-2021-003); Exchange Act Release No. 91184 (Feb. 23, 2021), 86 FR 12057 (Mar. 1, 2021) (File No. SR-OCC-2021-801).

<sup>2</sup> As discussed in the submissions to the SEC, OCC would also apply conforming changes to OCC’s Recovery and Orderly Wind-Down Plan (“RWD Plan”). See, e.g., Exchange Act Release No. 91199, 86 FR at 12242. Upon SEC approval of those changes, OCC will submit the revised RWD Plan to the CFTC in accordance with CFTC Regulation 39.19(c)(4)(xxiv).

marked with strikethrough text. All terms with initial capitalization that are not otherwise defined herein have the same meaning as set forth in the OCC By-Laws and Rules.<sup>3</sup>

In conformity with the requirements of Regulation 40.6(a)(7), OCC states the following:

#### Explanation and Analysis

This proposed rule change by OCC would amend OCC's Rules, Capital Management Policy, and certain other OCC policies to establish a persistent minimum level of skin-in-the-game that OCC would contribute to cover default losses or liquidity shortfalls. The persistent minimum would consist of a minimum amount of OCC's own pre-funded resources that OCC would charge prior to charging a loss to the Clearing Fund (as defined below, the "Minimum Corporate Contribution") and, as OCC's Rules currently provide, applicable funds held in trust in respect to OCC's Executive Deferred Compensation Plan ("EDCP") (such funds, as defined in OCC's Rules, being the "EDCP Unvested Balance") that would be charged pari passu with the Clearing Fund deposits of non-defaulting Clearing Members. This persistent minimum level of skin-in-the-game would establish a floor for the pre-funded resources OCC would contribute to cover default losses and liquidity shortfalls. In addition to this minimum, OCC would continue to commit its liquid net assets funded by equity ("LNAFBE")<sup>4</sup> greater than 110% of its Target Capital Requirement prior to charging a loss to the Clearing Fund.

#### **Background**

In January 2020, OCC implemented its Capital Management Policy, by which OCC (a) determines the amount of Equity<sup>5</sup> sufficient for OCC to meet its regulatory obligations and to serve market participants and the public interest (as defined in OCC's Rules, the "Target Capital Requirement"), (b) monitors Equity and LNAFBE levels to help ensure adequate financial resources are available to meet general business obligations; and (c) manages Equity levels, including by (i) adjusting OCC's fee schedule (as appropriate) and (ii) establishing a plan for accessing additional capital should OCC's Equity fall below certain thresholds (the "Replenishment Plan").<sup>6</sup> In addition, OCC's Rules, the Capital Management Policy, and associated policies provide for the use of OCC's

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<sup>3</sup> OCC's By-Laws and Rules can be found on OCC's public website: <https://www.theocc.com/Company-Information/Documents-and-Archives/By-Laws-and-Rules>.

<sup>4</sup> International standards and the SEC's Rules established minimum LNAFBE requirements for financial market infrastructures and covered clearing agencies, respectively. See CPSS-IOSCO, Principles for financial market infrastructures, at Principle 15 (Apr. 16, 2012), available at <http://www.bis.org/publ/cpss101a.pdf>; 17 CFR 240.17Ad-22(e)(15). Similarly, CFTC regulations provide that a subpart C derivatives clearing organization must maintain sufficient "unencumbered liquid financial assets, funded by the equity of its owners," to implement its recovery or orderly wind-down plans. 17 CFR 39.39(d)(2). The Capital Management Policy defines "LNAFBE" as the level of cash and cash equivalents, no greater than Equity, less any approved adjustments (i.e., agency-related liabilities such as Section 31 fees held by OCC).

<sup>5</sup> The Capital Management Policy defines "Equity" as shareholders' equity as shown on OCC's Statement of Financial Condition.

<sup>6</sup> See Exchange Act Release No. 88029 (Jan. 24, 2020), 85 FR 5500 (Jan. 30, 2020) (File No. SR-OCC-2019-007) ("Order Approving Capital Management Policy").

current and retained earnings in excess of 110% of the Target Capital Requirement (i.e., the “Early Warning” threshold under OCC’s Replenishment Plan) to cover losses arising from a Clearing Member’s default.<sup>7</sup> While OCC’s Rules previously provided for OCC to contribute its own capital to cover default losses at the Board’s discretion, the Capital Management Policy made the contribution of such excess capital obligatory.<sup>8</sup>

In the event of a Clearing Member default, OCC would contribute excess capital to cover losses remaining after applying the margin assets and Clearing Fund contribution of the defaulting Clearing Member and before charging the Clearing Fund contributions of non-defaulting Clearing Members. Should OCC’s excess capital be insufficient to cover the loss, OCC also has another tranche of OCC resources in addition to the Clearing Fund; namely, the EDCP Unvested Balance.<sup>9</sup> In the event of a default loss, the EDCP Unvested Balance is contributed pari passu with the Clearing Fund contributions of non-defaulting Clearing Members.

The implementation of OCC’s Capital Management Policy marked the first time OCC committed OCC’s own pre-funded financial resources into OCC’s approach to capital management and resiliency. In particular, OCC believes that the inclusion of the EDCP Unvested Balance is a powerful alignment of interest between management and Clearing Members. OCC takes seriously the interest of the industry and international regulators in seeing more significant skin-in-the-game commitments at central counterparties.

To that end, OCC has reviewed feedback received in connection with the initial filing of the Capital Management Plan, relevant papers from industry participants and stakeholders concerning skin-in-the-game, and regulatory regimes in jurisdictions outside the United States. For one, a comment submitted in connection with the Capital Management Policy’s filing urged OCC to implement a “minimum amount of skin-in-the-game that ‘scales with risk and is defined and funded upfront’ and . . . ‘to define a level of [skin-in-the-game] ex ante that would always be readily available in case of a default loss.’”<sup>10</sup> OCC has also reviewed the paper, “A Path Forward for CCP Resilience, Recover, and Resolution,” originally released in October 2019 with nine signatories and re-released in March of 2020 with ten additional signatories, representing major buy-side and sell-side firms in the markets OCC serves.<sup>11</sup> One of the paper’s significant recommendations is that

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<sup>7</sup> Id. at 5502.

<sup>8</sup> Use of excess capital to cover losses arising from the default of a bank or other clearing agency that is not otherwise associated with a Clearing Member default remains at the Board’s discretion. See Rule 1006(e)(ii).

<sup>9</sup> As defined in OCC’s Rules, the EDCP Unvested Balance consists of funds (x) deposited on or after January 1, 2020 in respect of its EDCP and (y) in excess of amounts necessary to pay for benefits accrued and vested under the EDCP at such time.

<sup>10</sup> Order Approving Capital Management Policy, 85 FR at 5507 (quoting comments submitted by FIA).

<sup>11</sup> See ABN AMRO Clearing Bank N.V., et al., A Path Forward for CCP Resilience, Recovery, and Resolution (Mar. 10, 2020), available at <https://www.jpmmorgan.com/solutions/cib/markets/a-path-forward-for-ccp-resilience-recovery-and-resolution>.

central counterparties should have skin-in-the-game in a more defined manner.<sup>12</sup> In contrast, OCC's current variable approach to skin-in-the-game does not guarantee a defined amount would be available. Additionally, as OCC seeks recognition in the European Union and the United Kingdom, OCC is cognizant of the European Market Infrastructure Regulation's ("EMIR") expectation that skin-in-the-game be a minimum of 25% of the central counterparty's regulatory capital requirement.<sup>13</sup> Under the current Capital Management Policy, excess capital is not dedicated solely as skin-in-the-game and it is possible that OCC's capital in excess of 110% of its Target Capital Requirement would be less than 25% of OCC's Target Capital Requirement.

To address the concerns raised by these market participants, further strengthen OCC's pre-funded financial resources, further align the interests of OCC's management and Clearing Members, and align OCC's skin-in-the-game with international standards, OCC is filing this proposed rule change, which would establish a persistent minimum amount of skin-in-the-game that would be used to cover default losses and liquidity shortfalls. This skin-in-the-game proposal is part of a broader set of decisions announced by OCC to lower the cost of clearing for its members,<sup>14</sup> including a fee decrease effective September 1, 2020.<sup>15</sup> OCC also discussed these changes on calls with OCC's Non-Equity Exchanges, Clearing Members, and other market participants, including discussions with the SIFMA Options Committee and FIA and open calls with OCC Clearing Members. Members expressed that the proposed addition of a minimum level of skin-in-the-game would be a welcome enhancement by OCC. One market participant expressed its appreciation for OCC's commitment to resiliency, but renewed concerns it had raised in connection with OCC's Capital Management Policy about increases in OCC's capital and, if OCC were sold, a more commercial

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<sup>12</sup> While OCC agrees with the paper's authors that central counterparties should have meaningful skin-in-the-game, OCC does not agree with the level of skin-in-the-game recommended in the paper. See *Optimizing Incentives, Resilience and Stability in Central Counterparty Clearing: Perspectives on CCP Issues from a Utility Model Clearinghouse* (Sept. 22, 2020), available at <https://www.theocc.com/Newsroom/Insights/2020/09-22-Optimizing-Incentives.-Resilience-and-Stabil>.

<sup>13</sup> Though OCC, as a non-EU central counterparty, would not be subject directly to the EMIR standards or the supervision of the European Securities and Markets Authority ("ESMA"), OCC has considered the EMIR standards as part of its bid to seek third-country recognition in Europe and the United Kingdom. OCC is seeking recognition to address European bank capital requirements set to go into effect next year that would require European banks to set aside additional capital for exposure to central counterparties that are not "qualified CCPs" in Europe. In order to become a qualified CCP, ESMA and the regulatory authority in a non-EU jurisdiction must reach an agreement that their regulatory regimes for central counterparties are equivalent. As of the date of this filing, the Commodity Futures Trading Commission ("CFTC") has reached an agreement with ESMA on the equivalence of their regulatory regimes.

<sup>14</sup> OCC announced these decisions in a press release and letter to Clearing Members. See *Press Release, OCC To Lower Costs for Users of U.S. Equity Derivatives Markets* (Aug. 3, 2020), available at <https://www.theocc.com/Newsroom/Press-Releases/2020/08-03-OCC-To-Lower-Costs-for-Users-of-US-Equity-De>; "Letter to Clearing Member Firms – OCC to Lower Costs for Users of U.S. Equity Derivative Markets" (Aug. 3, 2020), available at <https://www.theocc.com/Newsroom/Views/2020/08-03-Letter-to-Clearing-Member-Firms>.

<sup>15</sup> See Exchange Act Release No. 89534 (Aug. 12, 2020), 85 FR 50858 (Aug. 18, 2020) (File No. SR-OCC-2020-009).

orientation monetized with higher fees. OCC believes that this view is well outside the scope of the Capital Management Policy and this proposed rule change, but will continue to engage with Clearing Members and other market participants to address any concerns. While questions were raised in these conversations, no specific suggestions were made.

### **Proposed Changes**

In order to establish a persistent minimum amount of skin-in-the-game, OCC is proposing to: (a) amend OCC's Rules to define the Minimum Corporate Contribution, insert the Minimum Corporate Contribution in OCC's default waterfall as provided in Rule 1006, provide for how OCC would calculate any LNAFBE greater than 110% of its Target Capital Requirement that OCC would contribute in addition to the Minimum Corporate Contribution, and provide a time by which OCC would reestablish the Minimum Corporate Contribution if and when OCC uses it to cover default losses; (b) amend the Capital Management Policy to exclude the Minimum Corporate Contribution from OCC's measurement of its LNAFBE against its Target Capital Requirement and from OCC's calculation of the Early Warning and Trigger Event, to ensure that OCC may maintain the Minimum Corporate Contribution exclusively for default losses while retaining access to replenishment capital in the event OCC suffers an operational loss that reduces its Equity below those thresholds; and (c) apply conforming changes to the Default Management Policy and Clearing Fund Methodology Policy to reflect that in the event of a default loss or liquidity shortfall, the Minimum Corporate Contribution would be charged after contributing the margin and Clearing Fund deposit of a default member and before the contribution of OCC's LNAFBE in excess of 110% of OCC's Target Capital Requirement, both of which OCC would exhaust before charging the Clearing Fund deposits of non-default Clearing Members and the EDCP Unvested Balance on a pro rata basis.

#### **(a) Amendments to OCC's Rules**

To establish and maintain a persistent minimum level of skin-in-the-game, OCC proposes to amend its Rules to (1) define the Minimum Corporate Contribution; (2) revise OCC's default waterfall to more clearly define the skin-in-the-game resources OCC would contribute to a default loss; (3) provide for how OCC would calculate any LNAFBE greater than 110% of the Target Capital Requirement it would contribute after exhausting the Minimum Corporate Contribution; and (4) provide for how OCC would replenish the Minimum Corporate Contribution after each chargeable default loss.

#### **(1) *Defining the Minimum Corporate Contribution***

OCC would establish a persistent minimum level of skin-in-the-game by first amending OCC's Rules to define the Minimum Corporate Contribution in Chapter I of the Rules 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 shall determine from time to time. As OCC's own funds, OCC would hold the Minimum Corporate Contribution in accordance with OCC's By-Laws governing the investment of OCC's funds<sup>16</sup> and OCC's policies and procedures governing cash and investment management. Specifically, OCC maintains uninvested OCC cash in demand deposits

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<sup>16</sup> See OCC By-Laws Art. IX, Sec. 1.

and any investments of funds maintained to satisfy the Minimum Corporate Contribution would be limited to overnight reverse repurchase agreements involving U.S. Government Treasury Securities, consistent with OCC's same-day liquidity needs for such funds.

While the proposed definition would give OCC's Board discretion in setting the Minimum Corporate Contribution, the Board has approved an initial Minimum Corporate Contribution that sets OCC's total persistent skin-in-the-game (*i.e.*, the sum of the Minimum Corporate Contribution and OCC's current EDCP Unvested Balance) at 25% of OCC's Target Capital Requirement. In setting the initial Minimum Corporate Contribution, OCC's 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% of its Target Capital Requirement, projected revenue and expenses, and other projected capital needs.

(2) *Revising OCC's Default Waterfall*

OCC would also amend OCC Rule 1006 to insert the Minimum Corporate Contribution in OCC's default waterfall after contributing a defaulting Clearing Member's margin and Clearing Fund deposit, and before contributing OCC's LNAFBE greater than 110% of OCC's Target Capital Requirement, both of which OCC would exhaust before charging a loss to the Clearing Fund and the EDCP Unvested Balance, *pari passu* with the Clearing Fund deposits of non-defaulting Clearing Members. So placed, OCC believes that the Minimum Corporate Contribution would demonstrate OCC's institutional commitment to its ongoing financial surveillance of Clearing Members and the establishment and maintenance of a prudent and effective margin methodology. A draw against the Minimum Corporate Contribution and the associated requirement to replenish, as discussed below, would provide fewer resources to meet other corporate commitments. Accordingly, the proposal would further align OCC's and its management's interests with those of non-defaulting Clearing Members.

OCC would also remove references to "retained earnings" or "current or retained earnings" in OCC Rule 1006(b), Rule 1006(e)(i), Rule 1006(e)(ii), and the second sentence of Rule 1006(e)(iii), and replace them with references to the contribution of the "Minimum Corporate Contribution" and "the Corporation's liquid net assets funded by equity that are greater than 110% of its Target Capital Requirement." The references to "retained earnings" or "current or retained earnings" are legacy terms used prior to OCC's implementation of the Capital Management Policy.<sup>17</sup> OCC is proposing to replace these references in OCC's Rules to better identify the funds OCC would contribute in terms that align with OCC's Capital Management Policy.

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<sup>17</sup> OCC first established discretionary use of OCC's current or retained earnings to cover default losses in Article VIII (Clearing Fund) of OCC's By-Laws. *See* Exchange Act Release No. 15493 (Jan. 4, 1979), 44 FR 3802 (Jan. 18, 1979) (File No. SR-OCC-79-01). When OCC moved the provisions governing the Clearing Fund from OCC's By-Laws to the Rules in 2018, the provisions governing the usage of the Clearing Fund became Rule 1006(e). *See* Exchange Act Release No. 83735 (Jul. 27, 2018), 83 FR 37855 (Aug. 2, 2018) (File No. SR-OCC-2018-008).

(3) *Calculating LNAFBE Available as Skin-In-The-Game*

Because OCC proposes to replace references to “current or retained earnings,” OCC would also delete the first sentence of Rule 1006(e)(iii), which currently provides for how OCC determines its “current earnings” for purposes of the amount available to cover losses under Rule 1006(e)(i) and Rule 1006(e)(ii). In its place, the first sentence of Rule 1006(e)(iii) would set out how OCC would determine its LNAFBE for purposes of contributing LNAFBE greater than 110% of the Target Capital Requirement to cover default losses and liquidity shortfalls. Specifically, similar to how the Rules currently provide for the calculation of “current earnings,” OCC would determine its LNAFBE based on OCC’s unaudited financial statements at the close of the calendar month immediately preceding the occurrence of the loss or deficiency under paragraphs (e)(i) or (e)(ii), less an amount equal to the aggregate of all refunds made or authorized to be made or deemed to have been made during the fiscal year in which such loss or deficiency occurs if the refund is not reflected on such unaudited financial statements. Accordingly, OCC would retain the priority given to the payment of refunds that OCC has declared, but not yet issued, as currently provided by OCC Rule 1106(e)(iii), when calculating the amount of LNAFBE available to cover a default loss after contributing the Minimum Corporate Contribution.

OCC would further amend Rule 1006(e)(iii) to provide that in no event shall OCC be required to contribute an amount that would cause OCC’s LNAFBE to fall below 110% of the Target Capital Requirement at the time changed. The Capital Management Policy, in accordance with SEC Rule 17Ad-22(e)(15)(ii)(A),<sup>18</sup> currently requires that the funds OCC maintains to satisfy its Target Capital Requirement be separate from OCC’s resources to cover participant defaults and liquidity shortfalls. Accordingly, should a default occur in a month during which OCC suffers an operational loss that decreases the value of its excess capital available as skin-in-the-game below what is reflected on the unaudited financial statement at the close of the previous month,<sup>19</sup> OCC would be able to take into account the decrease in its excess capital when calculating its available LNAFBE above 110% of the Target Capital Requirement. In addition, OCC would renumber as Rule 1006(e)(iv) the last sentence of Rule 1006(e)(iii). That sentence, which concerns a defaulting Clearing Member’s continuing obligation for losses OCC charges to OCC’s own capital, is conceptually distinct from the rest of Rule 1006(e)(iii) and, accordingly, deserves to be addressed separately.

(4) *Replenishing the Minimum Corporate Contribution*

Finally, OCC would add a new paragraph to Rule 1006(e)—Rule 1006(e)(v)—to provide for a 270 calendar-day period during which the Minimum Corporate Contribution, once charged, would be reduced to the remaining unused portion. OCC believes that 270 calendar days, or approximately nine months, is sufficient time for OCC to accumulate the funds necessary to reestablish the

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<sup>18</sup> 17 CFR 240.17Ad-22(e)(15)(ii)(A).

<sup>19</sup> Under OCC’s current rules, LNAFBE greater than 110% of the Target Capital Requirement and the EDCP Unvested Balance are committed to cover both operational losses and default losses. In the event OCC experiences operational losses and default losses in short succession, OCC would contribute these resources in the manner specified by OCC’s Rules to the event that occurred first.

Minimum Corporate Contribution. In making this determination, OCC used the same analysis employed to set the Early Warning and Trigger Event under its Replenishment Plan, both of which are based on the time OCC estimates it would take to accumulate 10% of its Target Capital Requirement.<sup>20</sup> Specifically, OCC took into account its typical monthly earnings and the amount of earnings that would be needed to replenish the Minimum Corporate Contribution on an after-tax basis. Proposed Rule 1006(e)(v) would also provide that OCC shall notify Clearing Members of any such reduction to the Minimum Corporate Contribution.

Each chargeable loss would trigger a new 270-day period. As such, proposed Rule 1006(e)(v) is designed to allow OCC to manage multiple defaults within a 270-day period by eliminating the risk that a successive default would exhaust the resources needed to reestablish the Minimum Corporate Contribution by the end of the initial 270-day period. And while a successive default loss that does not impact excess LNAFBE<sup>21</sup> available to replenish the Minimum Corporation Contribution would nevertheless trigger another 270-day period during which the Minimum Corporate Contribution would be reduced to the remaining unused portion after the first two defaults, any LNAFBE greater than 110% of the Target Capital Requirement would continue to be available to cover successive default losses. In the very unlikely event that OCC experiences an operational loss or a drop in revenue from clearing fees that threatens its ability to reestablish the Minimum Corporate Contribution at the end of the 270-day period, OCC would likely file a rule change to extend the period rather than act to lower the Minimum Corporate Contribution, dependent on the Board's consideration of the same non-exclusive list of factors that the Board would consider when determining whether to adjust the Minimum Corporate Contribution, discussed below.

(b) Amendments to the Capital Management Policy

Consistent with the proposed changes to OCC's Rules, OCC would amend the portions of the Capital Management Policy that concern OCC's usage of excess capital to cover default losses to more specifically identify the resources OCC would contribute to default losses; namely, the Minimum Corporate Contribution and LNAFBE above 110% of the Target Capital Requirement. OCC would clarify that after exhausting the Minimum Corporate Contribution, OCC would continue to offset default losses with LNAFBE, rather than "Equity," above 110% of the Target Capital requirement. This change is not intended to change OCC's current obligations. Rather, OCC intends to conform the Capital Management Policy so that the terms are consistent with those used in the proposed Rules, other requirements in the Capital Management Policy, and OCC's regulatory obligations. Specifically, the Capital Management Policy provides that the resources held to meet the Target Capital Requirement must be liquid assets separate from OCC's resources to cover participant defaults and liquidity shortfalls, consistent with SEC Rule 17Ad-22(e)(15)(ii)(A).<sup>22</sup>

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<sup>20</sup> See Order Approving Capital Management Policy, 85 FR at 5510-11.

<sup>21</sup> As described below, OCC is proposing to amend the Capital Management Policy to exclude the Minimum Corporate Contribution from the definition of LNAFBE. As a result, a second default loss covered exclusively by the Minimum Corporate Contribution would not impact OCC's level of LNAFBE.

<sup>22</sup> See 17 CFR 240.17Ad-22(e)(15)(ii)(A).

Because Equity typically exceeds LNAFBE and because any funds OCC would contribute to cover a default loss would need to be liquid assets, contributing liquid assets in excess of LNAFBE greater than 110% of the Target Capital Requirement would be inconsistent with the Capital Management Policy.

In addition, OCC would amend the Capital Management Policy's list of capital management actions with a material impact on current or future levels of Equity, replacing "use of current and retained earnings greater than 100% of the Target Capital Requirement" with "use of excess capital," to align with the title of the Capital Management Policy's "Excess Capital Usage" section. That section would also be updated to include a discussion of the factors that the Board would consider in establishing and adjusting the Minimum Corporate Contribution. Factors the Board would consider include, but are 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 current and projected level of the EDCP Unvested Balance, OCC's LNAFBE greater than 110% of its Target Capital Requirement, projected revenue and expenses, and other projected capital needs. While the Capital Management Policy would provide that the Board would review Minimum Corporate Contribution annually, the Board would retain authority to change the Minimum Corporate at its discretion. In addition, the Capital Management Policy would be updated to include the substance of and references to proposed Rule 1006(e)(v), which, as discussed above, provides for a 270-day period following a chargeable loss during which the Minimum Corporate Contribution is reduced to its remaining unused portion.

OCC would also amend the definition of LNAFBE in the Capital Management Policy to specifically exclude the Minimum Corporate Contribution, which would be dedicated to cover default losses. The Capital Management Policy defines LNAFBE as the level of cash and cash equivalents, no greater than Equity, less any approved adjustments. The definition currently specifies the exclusion of "agency-related liabilities, such as Section 31 fees" as the only approved adjustment. OCC would amend the definition to add the Minimum Corporate Contribution as another example of an approved exemption to the calculation of LNAFBE. As discussed in more detail in the discussion of the statutory basis for these proposed changes below, this proposed amendment to the definition of LNAFBE is intended to ensure that OCC does not double count resources committed to cover default losses as resources available to satisfy regulatory requirements concerning the amount of LNAFBE or other financial resources OCC must maintain to cover operational costs and potential business losses. For similar reasons, OCC would amend the Capital Management Policy's discussion of OCC's Replenishment Plan to add that in the event of an operational loss, OCC shall first use Equity, "less the Minimum Corporate Contribution," above 110% of Target Capital. This amendment reflects that the funds maintained for the Minimum Corporate Contribution are not funds available to cover operational losses.

With respect to OCC's Replenishment Plan, OCC would also amend the definitions of the Early Warning and Trigger Event to exclude the Minimum Corporate Contribution from the calculation of those thresholds so that OCC maintains access to replenishment capital in the event operational losses materialize while still maintaining the Minimum Corporate Contribution exclusively to cover default losses. As described above, the Early Warning and Trigger Event are

the thresholds for actions under OCC's Replenishment Plan. Currently, the Early Warning and Trigger Event thresholds are defined with respect to OCC's Equity falling below certain thresholds. OCC is proposing to amend those definitions so that the Early Warning and Trigger Event occur when Equity "less the Minimum Corporate Contribution" falls below those same thresholds. These changes would ensure that OCC may maintain the Minimum Corporate Contribution exclusively to address default losses—the effect of which would be to increase Equity relative to LNAFBE—while still maintaining access to its Replenishment Plan should OCC's Equity, less the Minimum Corporate Contribution, fall close to or below the Target Capital Requirement.

(c) Amendments to the Default Management Policy and Clearing Fund Methodology Policy

To accommodate the proposed establishment of the Minimum Corporate Contribution, OCC proposes conforming changes to other rule-filed policies that describe OCC's default waterfall, as set forth in OCC Rule 1006. In the Default Management Policy, OCC would delete the passage concerning "Current and Retained Earnings" in the current discussion of OCC's default waterfall and replace it with the Minimum Corporate Contribution and LNAFBE greater than 110% of the Target Capital Requirement, as provided in the proposed amendments to Rule 1006 above. OCC would also amend the Default Management Policy's definition of "financial resources" to include the Minimum Corporate Contribution as among those available to address Clearing Member defaults and suspensions. In the Clearing Fund Methodology Policy, OCC would similarly revise the discussion of the default waterfall in that policy's section covering Clearing Fund charges and assessments to incorporate the Minimum Corporate Contribution, consistent with the proposed amendments to Rule 1006 above. OCC would also amend the Clearing Fund Methodology Policy's definitions of OCC's "Pre-Funded Financial Resources" for the purposes of sizing or measuring the sufficiency of the Clearing Fund to include the Minimum Corporate Contribution.

### **Compliance with the Act and Regulations Thereunder**

OCC reviewed the DCO core principles ("Core Principles") as set forth in the Act, regulations thereunder, and the provisions applicable to a DCO that elects to be subject to the provisions of 17 CFR Subpart C ("Subpart C DCO"). During this review, OCC identified the following Core Principles, regulations and provisions applicable to subpart C DCOs as potentially being impacted:

**Financial Resources.** Core Principle B and CFTC Rule 39.11(a) require, in part, that a DCO possess financial resources that, at a minimum, exceed the total amount that would (1) enable the DCO to meet its financial obligations to its clearing members notwithstanding a default by the Clearing Member creating the largest financial exposure,<sup>23</sup> or, in the case of a Subpart C DCO, a default by the two clearing members creating the largest combined financial exposure in extreme but plausible market conditions,<sup>24</sup> and (2) enable the DCO to cover its operating costs for a period of at least one year, calculated on a rolling basis. In addition, CFTC Rule 39.11(d)(3) requires, in part, that a DCO may allocate financial resources, in whole or in part, to satisfy either CFTC Rule

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<sup>23</sup> 17 CFR 39.11(a)(1).

<sup>24</sup> 17 CFR 39.33(a)(1).

39.11(a)(1) or (a)(2), but not both.<sup>25</sup> Similarly, with respect to a DCO's financial resources to support recovery or orderly wind-down necessitated by general business risk, operational risk, or any other risk that threatens the DCO's viability as a going concern, CFTC Rule 39.39(d)(3) provides that the financial resources a Subpart C DCO allocates to implement its plan must not be resources the DCO allocates to meet its requirements concerning participant defaults or liquidity shortfalls under CFTC Rule 39.11(a)(1) or Rule 39.33.<sup>26</sup> Subpart C DCOs are also required to maintain viable plans for raising additional financial resources, including, where appropriate, capital, in a scenario in which the Subpart C DCO is unable, or virtually unable, to comply with any financial resources requirement to support its recovery and wind-down plan.<sup>27</sup>

The proposed revisions to the Capital Management Policy's definitions of LNAFBE, Early Warning and Trigger Event are designed to ensure that OCC may establish the Minimum Corporate Contribution exclusively to cover default losses while continuing to maintain sufficient LNAFBE for operational expenses such that OCC could continue as a going concern even if it suffered significant operational losses, including by continuing to maintain access to its Replenishment Plan should an operational loss cause OCC's Equity, less the Minimum Corporate Contribution, to fall close to or below OCC's Target Capital Requirement. Specifically, the proposed revision to OCC's definition of LNAFBE is designed to satisfy Rule 39.11(d)(3) and Rule 39.39(d)(3) by providing that the proposed Minimum Corporate Contribution would be in addition to the financial resources that OCC holds to meet or exceed its regulatory capital requirements. In addition, the proposed revisions to OCC Rule 1006(e)(iii) and the Capital Management Policy—which would specify that OCC's committed skin-in-the-game shall include the Minimum Corporate Contribution and LNAFBE greater than 110% of the Target Capital Requirements—are reasonably designed to ensure that OCC would not be obligated to contribute an amount of skin-in-the-game that would cause its LNAFBE to fall below the Early Warning threshold intended to ensure OCC maintains sufficient LNAFBE to meet its regulatory obligations.

For the above reasons, OCC believes that the proposed amendments to the definitions of LNAFBE, Early Warning and Trigger Event under its Capital Management Policy promote compliance with Core Principle B under the Act and the CFTC regulations thereunder.

**Default Rules and Procedures.** OCC also believes that implementing the proposed rule change will be aligned with the requirements of Core Principle G, which requires, in part, that a DCO have rules and procedures designed to allow for the efficient, fair, and safe management of clearing member defaults.<sup>28</sup> The Act further provides that a DCO shall clearly state its default procedures, make publicly available its default rules, and ensure that the DCO may take timely action to contain losses and liquidity pressures and to continue meeting each of its obligations.<sup>29</sup>

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<sup>25</sup> 17 CFR 39.11(d)(3).

<sup>26</sup> 17 CFR 39.39(d)(3).

<sup>27</sup> 17 CFR 39.39(e).

<sup>28</sup> 7 U.S.C. 7a-1(c)(2)(G)(i).

<sup>29</sup> 7 U.S.C. 7a-1(c)(2)(G)(ii).

CFTC Rule 39.16(c)(2)(iv) provides that a DCO shall adopt rules that set forth the sequence in which the funds and assets of the defaulting clearing member and its customers and the financial resources maintained by the derivatives clearing organization would be applied in the event of a default.<sup>30</sup>

By providing that OCC shall maintain a minimum level of skin-in-the-game—in addition to OCC's LNAFBE greater than 110% of its Target Capital Requirement, contributed prior to charging the Clearing Fund, as OCC's Rules currently provide—OCC is providing for a minimum level of pre-funded financial resources available to cover losses in the event of a Clearing Member default, and reducing the amount OCC would charge the Clearing Fund contributions of non-defaulting Clearing Members. Therefore, OCC believes the amendments to its Rules, the Capital Management Policy, and other related policies to establish the Minimum Corporate Contribution are designed to allow for the efficient, fair and safe management of participant defaults consistent, with Core Principle G and the regulations thereunder.

The proposed changes would also align the terminology used in OCC's Rules and other rule-filed policies with the terminology of the Capital Management Policy, providing better clarity and consistency between OCC's governing documents. Specifically, OCC would amend its Rules, Capital Management Policy, Default Management Policy and Clearing Fund Methodology Policy to identify OCC's sources of skin-in-the-game (the Minimum Corporation Contribution, LNAFBE greater than 110% of the Target Capital Requirement, and the EDCP Unvested Balance). The proposed amendments to the Capital Management Policy would also identify factors the Board would consider in setting and adjusting the Minimum Corporate Contribution. Accordingly, OCC believes these proposed changes help ensure OCC's default management rules and procedures are designed to allow for the efficient, fair and safe management of participant defaults, consistent with Core Principle G and the regulations thereunder.

The proposed changes would also disclose the Minimum Corporate Contribution's place in the default waterfall and provide greater clarity about how OCC would calculate the amount of LNAFBE greater than 110% of the Target Capital Requirement available as skin-in-the-game in the event of a default based upon the unaudited financial statements from the close of the prior month; provided, however, that OCC would not be required to contribute an amount that would cause its LNAFBE to fall below 110% of the Target Capital Requirement at the time charged. The proposed changes to OCC Rules would, in turn, be made available on OCC's website. Accordingly, OCC believes the proposed changes would disclose relevant default rules and procedures to the public and to Clearing Members, as required by Core Principle G and the regulations thereunder.

### Opposing Views

No opposing views were expressed to OCC before OCC filed the proposed rule change with the SEC. After filing the proposed rule change with the SEC, OCC senior management spoke with one market participant about the participant's concern with increases in the level of OCC's Equity

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<sup>30</sup> 17 CFR 39.16(c)(2)(iv).

and the participant's position that OCC should reduce its clearing fees and issue additional refunds. While OCC believes the participant's views are outside the scope of this proposed rule change, OCC will continue to engage with Clearing Members and other market participants to address any concerns, including the appropriate use of tools under OCC's Capital Management Policy to lower the cost of Clearing Member participation.

For views on the proposed rule change expressed to the SEC after OCC filed the proposed changes, if any, see the SEC's files for File Nos. SR-OCC-2021-003 and SR-OCC-2021-801.<sup>31</sup>

#### Notice of Pending Rule Certification

OCC hereby certifies that notice of this rule filing has been given to Clearing Members of OCC in compliance with Regulation 40.6(a)(2) by posting a copy of the proposed rule change on OCC's website concurrently with the filing of this submission.

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<sup>31</sup> See OCC Rulemaking, <https://www.sec.gov/rules/sro/occ.htm>; OCC Advance Notice Rulemaking, <https://www.sec.gov/rules/sro/occ-an.htm>.

Christopher J. Kirkpatrick  
March 18, 2021  
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Certification

OCC hereby certifies that the rule set forth at Exhibits A through D of the enclosed complies with the Act and the CFTC's regulations thereunder.

Should you have any questions regarding this matter, please do not hesitate to contact me.

Sincerely,

A handwritten signature in black ink, appearing to read "Mark C. Brown". The signature is written in a cursive, slightly slanted style.

Mark C. Brown  
Assistant General Counsel

Enclosure(s)

**Exhibit A**



**OCC Rules**

## **Chapter I - Definitions**

### **RULE 101 - Definitions**

Unless the context otherwise requires, for all purposes of these rules, the terms herein shall have the meanings given them in Article I of the By-Laws of the Corporation or as set forth below:

\* \* \*

#### **M.**

##### ~~Reserved-~~ Minimum Corporate Contribution

(1) The term "Minimum Corporate Contribution" shall mean the minimum level of OCC funds maintained exclusively to cover credit losses or liquidity shortfalls. The Minimum Corporate Contribution is determined by the Board from time to time.

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## **Chapter X - Clearing Fund Contributions**

\* \* \*

### **RULE 1006 - Purpose and Use of Clearing Fund**

(a) *Conditions for Clearing Fund Use.* The Clearing Fund may be used to make good losses or expenses suffered by the Corporation, or losses suffered by the Clearing Fund resulting from borrowings pursuant to the authority in Rule 1006(f), (i) as a result of the failure of any Clearing Member to discharge duly any obligation on or arising from any confirmed trade accepted by the Corporation, (ii) as a result of the failure of any Clearing Member (including any Appointed Clearing Member) or of CDS to perform its obligations (including its obligations to the correspondent clearing corporation) under or arising from any exercised or assigned option contract or matured future or any other contract or obligation issued, undertaken, or guaranteed by the Corporation or in respect of which the Corporation is otherwise liable, (iii) as a result of the failure of any Clearing Member to perform any of its obligations to the Corporation in respect of the stock loan and borrow positions of such Clearing Member, (iv) in connection with any liquidation of a Clearing Member's open positions, (v) in connection with protective transactions effected for the account of the Corporation pursuant to Chapter XI of the Rules, (vi) as a result of the failure of any Clearing Member to make any other required payment or render any other required performance, (vii) as a result of the failure of any bank or securities or commodities clearing organization to perform its obligations to the Corporation for reasons specified in paragraph (c) of this Rule 1006, or (viii) as a result of a borrowing by the Corporation for liquidity needs for same day settlement pursuant to the authority in Rule 1006(f). Notwithstanding the foregoing, in the event that the Corporation performs a Voluntary Tear-Up or a Partial Tear-Up

pursuant to Rule 1111, the Clearing Fund may be used to provide compensation to non-defaulting Clearing Members and their customers as a means of re-allocating the losses, costs and fees imposed upon them as a result of such Voluntary Tear-Up or Partial Tear-Up, but only to the extent that such losses, costs and fees can be reasonably determined by the Corporation.

(b) *Clearing Member Failures.* (i) Upon occurrence of any of the events described in clauses (i) through (vi) of paragraph (a) of this Rule, the Corporation shall (after appropriate application of other funds in the accounts of the Clearing Member) apply the Clearing Member's Clearing Fund contribution to the discharge of the obligation, the reimbursement of such loss or expense, or the making of such payment or the funding of the performance, as applicable. If the sum of all such obligations, losses or expenses, and payments exceeds the sum of the amount of the Clearing Member's total Clearing Fund contribution and the amount of the other funds of the Clearing Member available to the Corporation, and if the Clearing Member fails to pay the Corporation the amount of any such deficiency on demand, the amount of the deficiency shall be first, funded by the ~~Corporation's retained earnings~~ [Minimum Corporate Contribution in accordance with paragraph \(e\) of this Rule; and next funded by the Corporation's liquid net assets funded by equity in excess of 110% of the Target Capital Requirement](#) in accordance with paragraph (e) of this ~~R~~rule; and next, paid out of the Clearing Fund and the EDCP Unvested Balance and charged on a proportionate basis against the sum of the EDCP Unvested Balance and all other Clearing Members' required contributions as calculated at the time, but the Clearing Member who failed to pay the deficiency shall remain liable to the Corporation for the full amount of such deficiency until repayment thereof by such Clearing Member.

(ii) If the Corporation performs a Voluntary Tear-Up or a Partial Tear-Up pursuant to Rule 1111, then, the Corporation may elect to proportionately charge the Clearing Fund and EDCP Unvested Balance in the amount(s) the Corporation reasonably determines necessary to compensate non-defaulting Clearing Members and their customers for the losses, costs or fees imposed upon them as a direct result of such Voluntary Tear-Up or Partial Tear-Up, but only to the extent that such losses, costs and fees can be reasonably determined by the Corporation.

(iii) For purposes of this Rule 1006(b), the share of any Clearing Fund loss or deficiency shall be borne pro rata by each Clearing Member (other than the suspended Clearing Member(s)) and the EDCP Unvested Balance. The percentage attributed to each shall be a fraction, the numerator of which shall be the sum of the fixed amount and variable amount calculated pursuant to Rule 1003 for such Clearing Member (or its initial contribution if applicable) or the EDCP Unvested Balance amount, as applicable, and the denominator of which shall be the sum of the EDCP Unvested Balance and fixed amounts, variable amounts and any initial contributions across all Clearing Members (other than suspended Clearing Member(s)).

(c) *Bank or Clearing Organization Failures.* (i) If any bank or securities or commodities clearing organization shall fail to perform any obligation to the Corporation when due because of its bankruptcy, insolvency, receivership, suspension of operations, or any similar event, and the Corporation shall sustain a loss (whether directly or as a trustee, custodian, or secured party) by reason thereof that is not recoverable out of the Clearing Fund pursuant to paragraph (b), the Corporation may, in its discretion, reimburse itself for such loss out of the Clearing Fund pursuant to this paragraph (c), and the amount of any such reimbursement shall be charged proportionately against all Clearing Members' required contributions to the Clearing Fund as calculated at the time.

(ii) With respect to any borrowing by the Corporation for liquidity needs for same day settlement pursuant to the authority in paragraph (e) of this Rule, if such borrowing remains outstanding for a period of less than thirty days, the Corporation may, in its discretion, consider such amount an actual loss to the Clearing Fund and the amount of any such loss shall be charged proportionately against all Clearing Members' required contributions to the Clearing Fund as

calculated at the time, provided however, that if such borrowing remains outstanding on the thirtieth day, the Corporation shall consider such amount an actual loss to the Clearing Fund and the amount of any such loss shall be charged proportionately against all Clearing Members' required contributions to the Clearing Fund as calculated at the time.

(iii) For purposes of this Rule 1006(c), the share of any deficiency to be borne by each Clearing Member (other than the suspended Clearing Member(s)) shall be a fraction, the numerator of which shall be the sum of the fixed amount and variable amount calculated pursuant to Rule 1003 for such Clearing Member (or its initial contribution if applicable) and the denominator of which shall be the sum of the fixed amounts, variable amounts and any initial contributions across all Clearing Members (other than the suspended Clearing Member(s)). To the extent that a loss resulting from any of the events referred to in this paragraph is recoverable out of the Clearing Fund pursuant to paragraph (b), the provisions of paragraph (b) shall control, and this paragraph (c) shall be inapplicable.

(d) *Notice of Charges.* Whenever any proportionate charge is made against Clearing Members' contributions to the Clearing Fund, the Corporation shall promptly notify all Clearing Members of the amount of the charge and the reasons therefor. For the purposes of paragraphs (b) through (d), the amount of any loss sustained by the Corporation shall be determined without reference to the possibility of any subsequent recovery in respect thereof, through insolvency proceedings or otherwise, but the net amount of any such recovery shall be applied in accordance with paragraph (h).

(e) *Use of Earnings.* (i) In advance of charging a loss or deficiency proportionately to the Clearing Fund required contributions of non-defaulting Clearing Members and the EDCP Unvested Balance pursuant to paragraph (b) of this Rule 1006, the Corporation will charge such loss or deficiency first against the ~~Corporation's current and retained earnings~~ Minimum Corporate Contribution, and next against the Corporation's liquid net assets funded by equity that are greater than 110% of its Target Capital Requirement.

(ii) Notwithstanding the provisions of paragraph (c), in lieu of charging a loss or deficiency proportionately to the Clearing Fund required contributions of non-defaulting Clearing Members pursuant thereto, the Corporation may, in its discretion, elect to charge such loss or deficiency in whole or in part against the ~~Corporation's current earnings or retained earnings~~ Minimum Corporate Contribution or the Corporation's liquid net assets funded by equity that are greater than 110% of its Target Capital Requirement. If such charge is made against current earnings, such charge shall be deemed a refund of clearing fees to the non-defaulting Clearing Members to whose Clearing Fund contributions the loss or deficiency would otherwise have been charged, and in that case the Corporation shall notify each such Clearing Member of the aggregate amount of the charge against current earnings, the reasons therefor, and the amount deemed to have been refunded to such Clearing Member.

(iii) ~~As used herein, the term "current earnings" shall mean the Corporation's net income before taxes for the period from the beginning of the fiscal year in which a loss or deficiency occurs to~~ For purposes of determining the amount available to cover a loss or deficiency under paragraphs (e)(i) or (e)(ii), the Corporation's liquid net assets funded by equity shall be determined based on the Corporation's unaudited financial statements at the close of the calendar month immediately preceding the occurrence of such loss or deficiency, less an amount equal to the aggregate of all refunds of clearing fees made or authorized to be made or deemed to have been made ~~for such fiscal year~~ during the fiscal year in which a loss or deficiency occurs if the refund is not reflected on such unaudited financial statements. In no event shall OCC be required to contribute an amount that would cause OCC's liquid net assets funded by equity to fall below 110% of the Target Capital Requirement at the time charged.

(iv) If the Corporation charges a deficiency in a Clearing Member's Clearing Fund contribution against the ~~Corporation's current earnings or retained earnings~~ Minimum Corporate Contribution or the Corporation's liquid net assets funded by equity that are greater than 110% of its Target Capital Requirement, Member shall remain liable to the Corporation for the full amount of such deficiency until repayment thereof by such Clearing Member.

(v) The Minimum Corporate Contribution shall be reduced to the remaining unused portion of the Minimum Corporate Contribution for a period of 270 calendar days after each loss chargeable under paragraph (e)(i). The Corporation shall notify Clearing Members of any such reduction to the Minimum Corporate Contribution.

**Exhibit B**

**[Redacted Under CFTC Regulation 40.8]**

**Exhibit C**

**[Redacted Under CFTC Regulation 40.8]**

**Exhibit D**

**[Redacted Under CFTC Regulation 40.8]**