

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-82901; File Nos. SR-LCH SA-2017-012 and LCH SA-2017-013)

March 19, 2018

Self-Regulatory Organizations; LCH SA; Order Instituting Proceedings to Determine Whether to Approve or Disapprove Proposed Rule Changes Related to LCH SA's Recovery and Wind Down Plans

I. Introduction

On November 30, 2017, Banque Centrale de Compensation, which conducts business under the name LCH SA ("LCH SA"), filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change (LCH SA-2017-012) to adopt a recovery plan (the "RP"). The proposed rule change was published for comment in the Federal Register on December 19, 2017.³ On December 7, 2017, LCH SA filed with the Commission a proposed rule change (LCH SA-2017-013) to adopt a wind down plan ("WDP").⁴ The proposed rule change was published for comment in the Federal Register on December 19, 2017.⁵ On January 23, 2018, the Commission designated a longer period for Commission action on both proposed

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 34-82316 (Dec. 13, 2017), 82 FR 60246 (Dec. 19, 2017) (SR-LCH-SA-2017-012) ("Notice 012").

⁴ Capitalized terms used in this order but not defined herein have the same meanings specified in LCH SA's rules.

⁵ Securities Exchange Act Release No. 34-82317 (Dec. 13, 2017), 82 FR 60238 (Dec. 19, 2017) (SR-LCH SA-2017-013) ("Notice 013").

rule changes.⁶ To date, the Commission has not received any comments on the proposed rule changes. The Commission is publishing this order to institute proceedings pursuant to Section 19(b)(2)(B)⁷ of the Act to determine whether to approve or disapprove the proposed rule changes.

Institution of proceedings does not indicate that the Commission has reached any conclusions with respect to the proposed rule changes, nor does it mean that the Commission will ultimately disapprove the proposed rule changes. Rather, as discussed below, the Commission seeks additional input on the proposed rule changes and issues presented by the proposed rule changes.

II. Description of the Proposed Rule Changes⁸

As a “covered clearing agency,”⁹ LCH SA is required to, among other things, “establish, implement, maintain and enforce written policies and procedures reasonably designed to . . . maintain a sound risk management framework for comprehensively managing legal, credit, liquidity, operational, general business, investment, custody, and other risks that arise in or are borne by the covered clearing agency, which . . . includes plans for the recovery and orderly wind-down of the covered clearing agency necessitated by credit losses, liquidity shortfalls,

⁶ Securities Exchange Act Release No. 34-82570 (Jan. 23, 2018), 83 FR 4088 (Jan. 29, 2018) and Securities Exchange Act Release No. 34-82571 (Jan. 23, 2018), 83 FR 4081 (Jan. 29, 2018).

⁷ 15 U.S.C. 78s(b)(2)(B).

⁸ The descriptions of the proposed rule changes are substantially excerpted from Notice 012 and Notice 013.

⁹ The term “covered clearing agency” is defined in SEC Rule 17Ad-22(a)(5), 17 CFR 240.17Ad-22(a)(5).

losses from general business risk, or any other losses.”¹⁰ The Commission has previously clarified that it believes that such recovery and wind-down plans are “rules” within the meaning of Exchange Act section 19(b) and Rule 19b-4 because such plans would constitute changes to a stated policy, practice or interpretation of a covered clearing agency.¹¹ Accordingly, a covered clearing agency, such as LCH SA, must file its RP and WDP with the Commission.

A. The RP (LCH SA-2017-012)

The Commission has previously explained that the term “recovery” refers to action taken to allow a financial company that is non-viable as a going concern or insolvent to sustain its critical operations and services.¹² To that end, LCH SA’s RP seeks to maintain the continuity of critical services in times of extreme stress and to facilitate the recovery of LCH SA from such stress. In particular, the RP describes (i) the scenarios and triggers for initiating recovery measures; (ii) various recovery tools used in such recovery; and (iii) the governance framework for managing the RP. Each of those aspects of the RP are discussed in more detail below.

The scenarios that could necessitate the implementation of the RP include the default of one or more clearing members, liquidity shortfalls as a result of the default of an investment counterparty of LCH SA or any other investment losses resulting from changes in the market value on the investments, a loss resulting from an event which impacts the critical services provided by LCH SA (e.g., failure in the provision of service by a third party), loss of critical

¹⁰ 17 CFR 240.17Ad-22(e)(3)(ii).

¹¹ Standards for Covered Clearing Agencies, Securities Exchange Act Release No. 34-78961 (Sep. 28, 2016), 81 FR 70786, 70809 (Oct. 13, 2016).

¹² Id. at 70808, n. 251.

contracts with exchanges, or the operational or financial failure of a financial market infrastructure such as an allied clearing house or trade repository.¹³

The default management process is used to re-establish a matched book and return to business as usual and therefore LCH SA considers it to be a recovery tool.¹⁴ When pre-funded resources, such as defaulter's margin, defaulter's default fund contributions, LCH SA's capital, and non-defaulters' default fund contributions, are no longer available to meet obligations due to member and non-member losses, the RP lists various measures or tools that LCH SA can use to return to business as usual.¹⁵ The RP is organized to discuss each tool by the nature of the loss (e.g., clearing member default losses, liquidity shortfalls, operational, business, and investment risks). The RP also discusses the sequence in which these tools would be used and the relative strength of each.¹⁶

When pre-funded resources have been exhausted after a clearing member default, LCH SA can call a default fund assessment up to a cap, request voluntary payments from all non-defaulting members, and effectuate service closure.¹⁷ In the event such tools are unavailable certain other business as usual tools, such as default fund additional margin, may enable LCH SA to collect additional resources.

¹³ See Notice 012, 82 FR at 60247.

¹⁴ Id.

¹⁵ Id.

¹⁶ Id. at 60249-60250.

¹⁷ Id. at 60249.

In the event of a liquidity shortfall, LCH SA may use its central bank credit line to deposit securities received on behalf of defaulting clearing members and obtain liquidity.¹⁸ Other potential tools to manage a liquidity stress situation are limits with respect to illiquid collateral, the application of increased haircuts on certain types of collateral to incentivize the use of more liquid collateral, or specific liquidity margins.¹⁹ LCH SA could also defer funding for the settlement platform for a limited period of time but views this as a tool of last resort.²⁰

For most investment, business, and operational losses, LCH SA can allocate its capital surplus against losses.²¹ Further down the list of preferable recovery tools for non-clearing member defaults are the abilities to raise capital or utilize insurance meant to cover a specific operational risk event.²² For any disruption or loss of key third-party service provider, LCH SA would be able to exercise several contractual rights and maintains exit plans which are intended to safeguard the continuity of services.²³

The RP discusses the governance surrounding its creation, invocation, and operation.²⁴ LCH SA relies upon its existing governance forums for both the creation and on-going monitoring and operation of the RP. Specifically, the LCH SA Management Committee is responsible for the preparation of the RP and the monitoring and implementation of the recovery

¹⁸ Id.

¹⁹ Id.

²⁰ Id.

²¹ Id.

²² See Notice 012, 82 FR at 60249.

²³ Id. at 60250.

²⁴ Id.

tools set forth in the RP.²⁵ The LCH SA Risk Committee reviews and makes a recommendation to the Board, who ultimately has the power to approve the RP.²⁶ However, before submission to the LCH SA Risk Committee, the RP is reviewed and validated by the Executive Risk Committee of LCH Group.²⁷

The Default Management Group is responsible for the management of clearing member defaults while all critical decisions are escalated and submitted to the LCH SA Default Crisis Management Team (“DCMT”).²⁸ The triggering of recovery measures is subject to discussion in the DCMT and approval by the LCH SA CEO.²⁹

The management of non-clearing member events will vary based on the nature of the event.³⁰ For example, investment losses and liquidity shortfalls are managed by the departments responsible for controlling such risks within the parameters set by the Board.³¹ Similarly, operational risks are managed by each business line in accordance with the operational risk policy approved by the Board.³² Business risk is managed by individual business lines, with a second line challenge performed by the risk and finance departments to verify if sufficient capital

25 Id.

26 Id.

27 Id.

28 Id.

29 Id.

30 Id.

31 Id.

32 Id.

buffers are available for the applicable business risks.³³ Matters are escalated to the Management Committee when the RP is triggered and the LCH SA Board will approve implementation of the RP.³⁴

B. The WDP (LCH SA-2017-013)

In the event a recovery is not successful, LCH SA would invoke its WDP to wind down its operations to full service closure in an orderly manner, thereby minimizing the disruption to clearing members, market participants, and the broader financial system. The WDP would be triggered after a determination by the LCH SA Board that all the recovery tools have been exhausted and have failed to return LCH SA to business as usual.³⁵ A voluntary wind-down not precipitated by these extreme events would not be considered.³⁶ The WDP would set forth clear mechanisms for the transfer of LCH SA's membership and business, and would be designed to facilitate continued access to critical services and to minimize market impact.³⁷

The decision to wind down would be taken by the Board and ultimately the shareholders' meeting, upon advice of the Executive Risk Committee and Local Management Committee ("LMC").³⁸ The implementation of the WDP would be monitored by the LCH SA LMC or Default Crisis Management Team, the executive committee in charge of the coordination of

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Id.

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Id.

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Notice 013, 82 FR at 60239.

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Id.

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Id. at 60239-60240.

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Id. at 60239.

defaults.³⁹ All relevant regulatory authorities would be consulted before such a decision is taken, and the French *Autorité de Contrôle Prudentiel et de Resolution* would have to approve such a decision, unless all clearing services have already been closed.⁴⁰ These authorities would then be kept regularly informed of the plan's implementation.⁴¹ Any decision to wind-down while in resolution would be taken by the relevant governing resolution authority.⁴²

The WDP assumes that LCH SA's businesses would be wound down until full closure and that the closure of various business lines could occur at different times, with some business functions significantly scaled down or even closed by the time the decision to wind-down is officially made.⁴³ The WDP also states that LCH SA would publish written notice to the clearing members that a wind-down event has occurred and potential dates by which transactions will no longer be accepted for clearing.⁴⁴ In a non-default situation or in a situation where the corresponding business line is still active, LCH SA would attempt to give clearing members the maximum time necessary to clear transactions in the normal course, close-out positions, and switch to another central counterparty.⁴⁵

The WDP also provides detail about the closure of supporting functions. For instance, the treasury function would close once all clearing services have ceased and monies are paid by

³⁹ Id.

⁴⁰ Id.

⁴¹ Id.

⁴² Id.

⁴³ Id.

⁴⁴ Id. at 60239-60240.

⁴⁵ Id. at 60240

LCH SA and its members.⁴⁶ Any other supporting operational, information technology, or risk functions would be kept active until all positions are closed.⁴⁷ Further, once the WDP is implemented, LCH SA would deposit remaining cash in central bank accounts or invest the cash in instruments with maturities no longer than same-day repos.⁴⁸ The WDP further notes that LCH SA's contractual agreements with third-party service providers, such as information technology or venue providers, contain wind-down provisions that permit LCH SA to exit the agreements under particular conditions.⁴⁹ Finally, the WDP provides citations to its various clearing services' rule book provisions giving a legal basis for the actions taken to effectuate the plan.⁵⁰

III. Proceedings to Determine Whether to Approve or Disapprove the Proposed Rule Changes and Grounds for Disapproval Under Consideration

The Commission is instituting proceedings pursuant to Section 19(b)(2)(B) of the Act to determine whether the proposed rule changes should be approved or disapproved.⁵¹ Institution of proceedings is appropriate at this time in view of the legal and policy issues raised by the proposed rule changes. As noted above, institution of proceedings does not indicate that the

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Id.

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Id.

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Id.

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Id.

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Id.

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15 U.S.C. 78s(b)(2)(B) (providing that proceedings to determine whether to disapprove a proposed rule change must be concluded within 180 days of the date of publication of notice of the filing of the proposed rule change. The time for conclusion of the proceedings may be extended for up to an additional 60 days if the Commission finds good cause for such extension and publishes its reasons for so finding or if the self-regulatory organization consents to the extension).

Commission has reached any conclusions with respect to any of the issues involved. Rather, the Commission seeks and encourages interested persons to comment on the proposed rule changes and provide arguments to support the Commission's analysis as to whether to approve or disapprove the proposals.

Pursuant to Section 19(b)(2)(B) of the Act,⁵² the Commission is providing notice of the grounds for disapproval under consideration. The Commission is instituting proceedings to allow for additional analysis of, and input from, commenters with respect to the proposed rule changes' consistency with the Act⁵³ and the rules thereunder, including the following provisions:

- Section 17A(b)(3)(F) of the Act, which requires that the rules of a clearing agency be designed to, among other things, assure the safeguarding of securities and funds which are in the custody or control of the clearing agency for which it is responsible;⁵⁴
- Rule 17Ad-22(e)(2) under the Act, which requires that a covered clearing agency establish, implement, maintain, and enforce written policies and procedures reasonably designed to provide for governance arrangements that are clear and transparent and support the public interest requirements in Section 17A of the Act applicable to clearing agencies, and the objectives of owners and participants;⁵⁵
- Rule 17Ad-22(e)(3)(ii) under the Act, which requires that covered clearing agencies, among other things, “establish, implement, maintain and enforce written

⁵² 15 U.S.C. 78s(b)(2)(B).

⁵³ 15 U.S.C. 78q-1.

⁵⁴ 15 U.S.C. 78q-1(b)(3)(F).

⁵⁵ 17 CFR 240.17Ad-22(e)(2).

policies and procedures reasonably designed to . . . maintain a sound risk management framework for comprehensively managing legal, credit, liquidity, operational, general business, investment, custody, and other risks that arise in or are borne by the covered clearing agency, which . . . includes plans for the recovery and orderly wind-down of the covered clearing agency necessitated by credit losses, liquidity shortfalls, losses from general business risk, or any other losses;” and

- Rules 17Ad-22(e)(15)(i)-(ii),⁵⁶ which require LCH SA to establish, implement, maintain and enforce written policies and procedures reasonably designed to determine the amount of liquid net assets funded by equity based upon its general business risk profile and the length of time required to achieve a recovery or orderly wind-down, as appropriate, of its critical operations and services if such action is taken and to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide for holding liquid net assets funded by equity equal to the greater of either six months of its current operating expenses or the amount determined by the board of directors to be sufficient to ensure a recovery or orderly wind-down of critical operations and services of the covered clearing agency, as contemplated by the plans established under Rule 17Ad-22(e)(3)(ii).⁵⁷

IV. Request for Written Comments

⁵⁶ 17 CFR 240.17Ad-22(e)(15)(i)-(ii).

⁵⁷ 17 CFR 240.17Ad-22(e)(3)(ii).

The Commission requests that interested persons provide written submissions of their views, data, and arguments with respect to the issues raised by the proposed rule changes. In particular, the Commission invites the written views of interested persons concerning whether the proposed rule changes are inconsistent with Section 17A(b)(3)(F) of the Act⁵⁸ and Rules 17Ad-22(e)(2),⁵⁹ 17Ad-22(e)(3)(ii),⁶⁰ and 17Ad-22(e)(15)(i)-(ii),⁶¹ under the Act, or any other provision of the Act or rules and regulations thereunder.

Although there do not appear to be any issues relevant to approval or disapproval that would be facilitated by an oral presentation of views, data, and arguments, the Commission will consider, pursuant to Rule 19b-4, any request for an opportunity to make an oral presentation.⁶²

Interested persons are invited to submit written data, views, and arguments regarding whether the proposed rule changes should be approved or disapproved on or before [insert date 21 days from publication in the Federal Register]. Any person who wishes to file a rebuttal to any other person's submission must file that rebuttal on or before [insert date 35 days from publication in the Federal Register]. Comments may be submitted by any of the following methods:

⁵⁸ 15 U.S.C. 78q-1(b)(3)(F).

⁵⁹ 17 CFR 240.17Ad-22(e)(2).

⁶⁰ 17 CFR 240.17Ad-22(e)(3)(ii).

⁶¹ 17 CFR 240.17Ad-22(e)(15)(i)-(ii).

⁶² Section 19(b)(2) of the Act, as amended by the Securities Acts Amendments of 1975, Pub. L. 94-29, 89 Stat. 97 (1975), grants the Commission flexibility to determine what type of proceeding – either oral or notice and opportunity for written comments – is appropriate for consideration of a particular proposal by a self-regulatory organization. See Securities Acts Amendments of 1975, Report of the Senate Committee on Banking, Housing and Urban Affairs to Accompany S. 249, S. Rep. No. 75, 94th Cong., 1st Sess. 30 (1975).

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-LCH SA-2017-012 and SR-LCH SA-2017-013 on the subject line.

Paper comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, N.E., Washington, D.C. 20549.

All submissions should refer to SR-LCH SA-2017-012 and SR-LCH SA-2017-013. These file numbers should be included on the subject line if e-mail 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 submissions, all subsequent amendments, all written statements with respect to the proposed rule changes that are filed with the Commission, and all written communications relating to the proposed rule changes 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, N.E., Washington, D.C. 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filings also will be available for inspection and copying at the principal office of LCH SA and on LCH SA's website at <http://www.lch.com/asset-classes/cdsclear>. 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-LCH SA-2017-012 and SR-LCH SA-2017-013 and should be submitted on or before [insert date 21 days from publication in the Federal Register]. If comments are received, any rebuttal comments should be submitted on or before [insert date 35 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁶³

Eduardo A. Aleman
Assistant Secretary

⁶³ 17 CFR 200.30-3(a)(12).