

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-87881; File No. SR-LCH SA-2019-009)

January 2, 2020

Self-Regulatory Organizations; LCH SA; Order Approving Proposed Rule Change Relating to Amendments to CDSClear Reference Guide to allow Index Basis Packages Margining

I. Introduction

On October 29, 2019, Banque Centrale de Compensation, which conducts business under the name LCH SA (“LCH SA” or “CDSClear”), 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 thereunder² a proposed rule change relating to amendments to the CDSClear Reference Guide (the “CDSClear Risk Methodology”) to allow Index Basis Packages margining. The proposed rule change was published for comment in the Federal Register on November 19, 2019.³ The Commission did not receive comments regarding the proposed rule change. For the reasons discussed below, the Commission is approving the proposed rule change.

II. Description of the Proposed Rule Change

LCH SA is proposing to amend its CDSClear Risk Methodology in order to allow Index Basis Packages margining as a single instrument.⁴ LCH SA CDSClear currently clears CDS on a number of indices such as iTraxx Main, iTraxx Cross-over, iTraxx

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Self-Regulatory Organizations; LCH SA; Notice of Filing of Proposed Rule Change Relating to Amendments to CDSClear Reference Guide To Allow Index Basis Packages Margining; Exchange Act Release No. 87522 (Nov. 13, 2019); 84 FR 63912 (Nov. 19, 2019) (“Notice”).

⁴ The description herein is substantially excerpted from the Notice, 84 FR 63912.

Senior Financials as well as all the Single Name constituents of these indices. Indices and their constituents are currently managed and margined as independent instruments. However, market participants may execute Index Basis Packages consisting of an Index CDS trade and individual Single Name CDS trades on each of the reference entities constituents of such Index perfectly offsetting the Index.

A transaction would need to satisfy the following criteria to constitute an Index Basis Package:

- The package is constituted of an Index CDS and Single Name CDS on all the entities constituting the index;
- The position (Long / Short) on the Index offsets the positions on the Single Names (Short / Long);
- The notional of the Index and across all the Singles Names match exactly;
- All the Single Names CDS trades have the same currency, coupon, and maturity as constituents of the Index CDS; and
- All the Single Name CDS trades have the same Seniority, ISDA Definition and Restructuring Clause as constituents of the Index CDS.

Clearing Members and/or Clients would be required to identify all trades being part of an Index Basis Package and to notify LCH SA CDSClear. CDSClear would then perform controls to ensure all principles and requirements stated above for qualifying the trades as an Index Basis Package are satisfied and would flag them with a common ID number. These trades would continue to be margined as different trades until LCH SA completes these controls and confirms the qualification as an Index Basis Package.

Once an Index Basis Package is validated as complete, the margin enhancement proposed in the current rule change would then be applied as part of the overnight margin calculation.

In order to ensure that the trades continue to meet the criteria of an Index Basis Package, controls would be performed every day at the start of the overnight batch process.

Index Basis Packages identified and flagged as such would be excluded from compression runs with the rest of the portfolio in order to avoid breaking any packages.

Index Basis Packages could be un-flagged as such at the Clearing Member and/or Client's request. The Index CDS and the Single Name CDS would then be treated and margined separately as per the current framework.

In case of a Clearing Member's default, CDSClear would have the ability to liquidate Index Basis Packages in a dedicated auction should it be advised to do so by the Default Management Group in order to minimize the liquidation costs.

A. Proposed changes to CDSClear Risk Methodology

In order to take into account the specific risk created by Index Basis Packages positions, LCH SA proposes to amend the calculation of the Spread Margin and the calculation of the Liquidity Charge Margin as described in its Reference Guide, *CDSClear Margin Framework*.

1. Spread Margin

LCH SA CDSClear currently considers an Index Basis Package as multiple instruments in the calculation of its Spread Margin. In accordance with the portfolio margining requirements under Article 27 of Commission Delegated Regulation (EU) No

153/2013⁵ (the “RTS”), LCH SA CDSClear applies a cap of 80% to the possible margin offsets reduction. Therefore, the Spread Margin of an Index Basis Package is calculated as the maximum between the expected shortfall of the package and 20% of the sum of the expected shortfalls calculated for each components of the package.

CDSClear believes that this does not appropriately reflect the actual risk of an Index Basis Package meeting the criteria stated above, so it is proposing to amend its CDSClear Risk Methodology in order to consider Index Basis Packages identified as such as a single instrument when calculating the amount of margins required. In particular, the 80% cap on offsets between the components of the Index Basis Package would not be applied in the calculation of the Spread Margin, but would be maintained between an Index Basis Package and all the other positions in the portfolio. This may result in a lower amount of margin being collected on an Index Basis Package.

In the opinion published in April 2017⁶ and clarifying the application of Article 27 of the RTS, the European Securities and Market Authority (“ESMA”), acknowledges the low level of risk presented by a package consisting of a future on an index and futures on each of the constituents of the index and allows a CCP to acknowledge margin reduction in excess of 80% in this specific case. This proposal acknowledges this position.

⁵ See <https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:052:0041:0074:EN:PDF>.

⁶ See https://www.esma.europa.eu/sites/default/files/library/esma70-708036281-18_opinion_on_portfolio_margining.pdf.

2. Liquidity Charge Margin

Considering that an Index Basis Package would likely be sold off in a dedicated auction in case of default of a Clearing Member, LCH SA also proposes to amend the calculation of the Liquidity Charge Margin described in the CDS Clear Risk Methodology in order to better reflect the actual cost it would incur when liquidating an Index Basis Package. CDS Clear proposes to charge a specific bid/ask spread for each Index family underlying an Index Basis Package identified as such rather than use the current Liquidity Charge Margin algorithm based on charging bid/ask spreads for each individual component in the package taken independently. The current Liquidity Charge Margin methodology would nevertheless remain in the calculation specific to Index Basis Packages identified as such by acting as a cap to the new calculation method. Because the bid/ask spread may be smaller, a lower amount of this category of margin could be collected.

3. Other Exclusions

Finally, Index Basis Packages flagged as such would be excluded from the Recovery Risk, Interest Risk, or Wrong Way Risk Margin calculations as by construction Index Basis Packages are immune to the risks these margins aim at capturing.

III. Discussion and Commission Findings

Section 19(b)(2)(C) of the Act directs the Commission to approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to such organization.⁷ For the reasons given below, the Commission finds that

⁷ 15 U.S.C. 78s(b)(2)(C).

the proposed rule change is consistent with Section 17A(b)(3)(F) of the Act⁸ and Rules 17Ad-22(e)(6)(i) and (iii) thereunder.⁹

A. Consistency with Section 17A(b)(3)(F) of the Act

Section 17A(b)(3)(F) of the Act requires, among other things, that the rules of LCH SA be designed to promote the prompt and accurate clearance and settlement of securities transactions and, to the extent applicable, derivative agreements, contracts, and transactions, as well as to assure the safeguarding of securities and funds which are in the custody or control of LCH SA or for which it is responsible, and, in general, to protect investors and the public interest.¹⁰ As discussed above, the proposed rule change would amend the LCH SA CDSClear Risk Methodology to allow Index Basis Packages margining as a single instrument. As a result, LCH SA would require a lesser amount of margin to better reflect the lower risk of an Index Basis Package compared to its individual component instruments. The Commission believes that these changes would help ensure that LCH SA's margin requirements are commensurate with the risks associated with clearing Index Basis Packages, which in turn would help ensure that LCH SA does not require higher margins than necessary and that Clearing Members are able to effectively accumulate and manage their financial resources.

Additionally, as noted above, LCH SA also proposes to amend the calculation of the Liquidity Charge Margin to better reflect the actual cost it would incur when liquidating an Index Basis Package. Similarly, LCH SA proposes to exclude Index Basis

⁸ 15 U.S.C. 78q-1(b)(3)(F).

⁹ 17 CFR 240.17Ad-22(e)(6)(i) and (iii).

¹⁰ 15 U.S.C. 78q-1(b)(3)(F).

Packages from inapplicable margin calculations such as the Recovery Risk, Interest Risk, and Wrong Way Risk Margin calculations because Index Basis Packages are not subject to these risks. Similar to the Spread Margins discussed above, the Commission believes that these changes would result in the collection of margins more commensurate to the risks associated with clearing Index Basis Packages, which in turn would help ensure that LCH SA does not require higher margins than necessary and that Clearing Members are able to effectively accumulate and manage their financial resources.

Taken together, the Commission believes that these changes would enhance the operation and effectiveness of LCH SA's margin collection system, which is necessary to manage LCH SA's credit exposures to its Clearing Members and the risks associated with clearing security based swap-related portfolios. By managing such exposures and risks, LCH SA's margin system helps it avoid losses that could result from the mismanagement of such credit exposures and risks. Because such losses could disrupt LCH SA's ability to promptly and accurately clear security based swap transactions, by making the above-described improvements to LCH SA's margin system, the proposed rule change would help promote the prompt and accurate clearance and settlement of securities transactions. Similarly, given that such losses could threaten LCH SA's access to securities and funds in LCH SA's control, by making the above-described improvements to LCH SA's margin system, the Commission believes that the proposed rule change would help assure the safeguarding of funds and securities which are in the custody or control of LCH SA or for which it is responsible. As noted above, the Commission believes that these changes also would help promote the prudent and accurate accumulation and management of financial resources by both LCH SA and its Clearing Members.

Therefore, for the reasons stated above, the Commission finds that the proposed rule change would promote the prompt and accurate clearance and settlement of securities transactions, assure the safeguarding of securities and funds in LCH SA's custody and control, and, in general, protect investors and the public interest, consistent with the Section 17A(b)(3)(F) of the Act.¹¹

B. Consistency with Rule 17Ad-22(e)(6)(i)

Rule 17Ad-22(e)(6)(i) requires a covered clearing agency that provides central counterparty services to cover its credit exposures to its participants by establishing a risk-based margin system that, as applicable, considers, and produces margin levels commensurate with, the risks and particular attributes of each relevant product, portfolio, and market¹². As noted above, LCH SA is proposing to amend its CDSClear Risk Methodology in order to allow Index Basis Packages margining as a single instrument as long as it meets the criteria noted above. As a result, LCH SA would amend its Spread Margin and Liquidity Charge Margin so that these margin requirements reflect a single rather than separate trades, which may result in a lower level of margin being collected. The Commission believes that these changes would help ensure that LCH SA's margin requirements are commensurate with the risks associated with clearing Index Basis Packages, including by reflecting the lower risk levels commensurate with Index Basis Packages viewed as a single instrument, as opposed to the individual component instruments that make up the Index Basis Package.

¹¹ 15 U.S.C. 78q-1(b)(3)(F).

¹² 17 CFR 240.17Ad-22(e)(6)(i).

Therefore, for the above reasons the Commission finds that the proposed rule change is consistent with Rule 17Ad-22(e)(6)(i).¹³

C. Consistency with Rule 17Ad-22(e)(6)(iii)

Rule 17Ad-22(e)(6)(iii) requires a covered clearing agency that provides central counterparty services to cover its credit exposures to its participants by establishing a risk-based margin system that, as applicable, calculates margin sufficient to cover its potential future exposure to participants in the interval between the last margin collection and the close out of positions following a participant default.¹⁴ As noted above, with respect to the liquidity charge margin, LCH SA proposes to charge a specific bid/ask spread for each Index family underlying an Index Basis Package identified as such, rather than use the current Liquidity Charge Margin algorithm based on charging bid/ask spreads for each individual component in the package taken independently. These proposed changes reflect that, in the event of a Clearing Member default, Index Basis Packages most likely would be sold off as a single instrument in a dedicated auction, rather than broken apart into individual components with each component instrument sold in an independent auction. By helping to ensure that the liquidity charge margin applied to Index Basis Packages would be commensurate with the risks associated with clearing Index Basis Packages, the Commission believes that the proposed rule change would be consistent with the requirement to have margin sufficient to cover potential future exposure to participants in the interval between the last margin collection and the close out of positions following a participant default.

¹³ 17 CFR 240.17Ad-22(e)(6)(i).

¹⁴ 17 CFR 240.17Ad-22(e)(6)(iii).

IV. Conclusion

On the basis of the foregoing, the Commission finds that the proposed rule change is consistent with the requirements of the Act, and in particular, with the requirements of Section 17A(b)(3)(F) of the Act¹⁵ and Rules 17Ad-22(e)(6)(i) and (iii) thereunder.¹⁶

It is therefore ordered pursuant to Section 19(b)(2) of the Act¹⁷ that the proposed rule change (SR-LCH SA-2019-009), be, and hereby is, approved.¹⁸

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁹

J. Matthew DeLesDernier
Assistant Secretary

¹⁵ 15 U.S.C. 78q-1(b)(3)(F).

¹⁶ 17 CFR 240.17Ad-22(e)(6)(i) and (iii).

¹⁷ 15 U.S.C. 78s(b)(2).

¹⁸ In approving the proposed rule change, the Commission considered the proposal's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹⁹ 17 CFR 200.30-3(a)(12).