

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-88021; File No. SR-LCH SA-2019-011)

January 23, 2020

Self-Regulatory Organizations; LCH SA; Notice of Filing of Partial Amendment No. 1 and Order Granting Accelerated Approval of Proposed Rule Change, as Modified by Partial Amendment No. 1, Relating to Amendments to CDS Clearing Supplement to Reflect the ISDA NTCE Protocol and Supplement

I. Introduction

On November 21, 2019, 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 to amend its CDS Clearing Supplement (“LCH SA CDS Supplement”) to: (1) implement the 2019 Narrowly Tailored Credit Event Supplement to the 2014 ISDA Credit Derivatives Definitions (the “NTCE Supplement”) and (2) make certain clarifications as to the defined term “Outstanding Principal Balance”. The proposed rule change was published for comment in the Federal Register on December 9, 2019.³ The Commission did not receive comments on the proposed rule change. On January 6, 2020, LCH SA filed Partial Amendment No. 1 to the proposed rule change.⁴ The Commission is publishing

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 87649 (Dec. 3, 2019), 84 FR 67325 (Dec. 9, 2019) (SR-LCH-SA-2019-011) (“Notice”).

⁴ Partial Amendment No. 1 clarifies the proposed rule change by modifying certain references in the CDS Clearing Supplement. Currently, the CDS Clearing Supplement refers to certain supplements to the standard contract terms as published by ISDA on certain dates. Rather than referring to the supplements as published by ISDA on certain dates, Partial Amendment No. 1 modifies the CDS Clearing Supplement to refer to the latest versions of the supplements in force. In other words, Partial Amendment No. 1

this notice to solicit comments on Partial Amendment No. 1 from interested persons and is approving the proposed rule change, as modified by Partial Amendment No. 1 (hereinafter, “proposed rule change”) on an accelerated basis.

II. Description of the Proposed Rule Change

A. Background

Following certain events in the credit default swap (“CDS”)⁵ market, the International Swaps and Derivatives Association, Inc. (“ISDA”), in consultation with market participants, developed and published the NTCE Supplement.⁶ The NTCE Supplement reflects an effort by ISDA to address so-called narrowly-tailored credit events. According to ISDA, a narrowly-tailored credit event is an arrangement between a participant in the CDS marketplace and a corporation, through which the corporation triggers a credit event on CDS covering the

amends the CDS Clearing Supplement to incorporate whichever versions of the ISDA supplements are most recent and therefore currently effective, rather than referring to multiple supplements with specific dates.

⁵ The following description is substantially excerpted from the Notice. See Notice, 84 FR at 67325. Capitalized terms not otherwise defined herein have the meanings assigned to them in the LCH SA rulebook or LCH SA CDS Supplement.

⁶ See ISDA Board Statement on Narrowly Tailored Credit Events, available at <https://www.isda.org/2018/04/11/isda-board-statement-on-narrowly-tailored-credit-events/>; see also Joint Statement on Opportunistic Strategies in the Credit Derivatives Market (“The continued pursuit of various opportunistic strategies in the credit derivatives markets, including but not limited to those that have been referred to as ‘manufactured credit events,’ may adversely affect the integrity, confidence and reputation of the credit derivatives markets, as well as markets more generally.”) available at <https://www.sec.gov/news/press-release/2019-106>.

corporation, thereby increasing payment to the buyers of CDS protection on the corporation while minimizing the impact on the corporation.⁷

The NTCE Supplement, if applied to a CDS transaction, would make two principal changes to the 2014 ISDA Credit Derivatives Definitions to address narrowly-tailored credit events.⁸ First, the NTCE Supplement would change the definition of the “Failure to Pay” credit event to exclude certain narrowly-tailored credit events through a new Credit Deterioration Requirement. The Credit Deterioration Requirement would provide that a failure of a corporation to make a payment on an obligation would not constitute a Failure to Pay Credit Event triggering CDS on that corporation if the failure does not directly or indirectly result from, or result in, a deterioration in the creditworthiness or financial condition of the corporation.⁹ Thus, a narrowly-tailored or manufactured failure to pay that does not reflect or result in a credit deterioration by a corporation would not constitute a Credit Event for CDS Contracts that incorporate the NTCE Supplement and thus would not necessarily trigger payment to buyers of CDS protection. The NTCE Supplement would also provide guidance related to the factors that would be relevant to determining whether a Failure to Pay Credit Event satisfies the Credit Deterioration Requirement. As would be the case with other Failure to Pay Credit Events under CDS contracts, the relevant Credit Derivatives Determinations Committee would, in the normal

⁷ See ISDA Board Statement on Narrowly Tailored Credit Events, available at <https://www.isda.org/2018/04/11/isda-board-statement-on-narrowly-tailored-credit-events/>.

⁸ See ISDA 2019 NTCE Protocol FAQ, available at <https://www.isda.org/protocol/isda-2019-ntce-protocol>.

⁹ See ISDA 2019 Narrowly Tailored Credit Event Supplement to the 2014 ISDA Credit Derivatives Definitions (Published on July 15, 2019), available at <https://www.isda.org/a/KDqME/Final-NTCE-Supplement.pdf>.

course, make the determination as to whether a Failure to Pay Credit Event satisfies the Credit Deterioration Requirement.

Second, the NTCE Supplement would reduce the amount of payout a CDS protection buyer could claim in certain circumstances by imposing a new provision for Fallback Discounting. Fallback Discounting would discount a CDS protection buyer's claim for payout under a CDS contract where that claim for payout is based on an obligation issued by a corporation at a discount.¹⁰ This would address the potential scenario where a corporation issues a bond at a substantial discount to its principal amount and the bond is delivered in settlement of a CDS at its full principal amount. In this scenario, Fallback Discounting would prevent a buyer of CDS protection from using the full principal amount of the bond issued at a discount as a basis for payout under the CDS contract.

B. Changes to the LCH SA CDS Supplement

Because LCH SA will clear and settle CDS contracts to which the NTCE Supplement will apply, it must ensure that its relevant Rules accurately reflect the changes described above that will be implemented by the NTCE Supplement. Accordingly, the proposed rule change would ensure that the changes being implemented by the NTCE Supplement are accurately reflected in LCH SA's relevant Rules by making substantially similar amendments to both Part B of the CDS Supplement, which applies to single-name CDS contracts and components of index CDS contracts that incorporate the 2014 ISDA Credit Derivatives Definitions, and Part C of the CDS Supplement, which applies to swaptions transactions. The proposed rule change would do so by amending the CDS Clearing Supplement to incorporate the versions of the ISDA supplement and confirmations that are currently in-force. After the NTCE Supplement becomes

¹⁰ Id.

effective, the latest versions of the ISDA supplement and confirmations will incorporate the NTCE Supplement and by default specify that the two concepts described above—the Credit Deterioration Requirement and Fallback Discounting—are applicable. Thus, in specifying that the versions of the ISDA supplement and confirmations that are currently in-force would apply to single-name CDS contracts and components of index CDS contracts that incorporate the 2014 ISDA Credit Derivatives Definitions and swaptions, the proposed rule change would automatically apply the NTCE Supplement to such transactions.

The proposed rule change would also specify that the amendments resulting from the NTCE Supplement to the 2014 ISDA Credit Derivatives Definitions would only be applicable where the Protocol Effectiveness Condition, as defined in the ISDA 2019 Narrowly Tailored Credit Event Protocol, is satisfied. Because ISDA has already determined that the Protocol Effectiveness Condition is satisfied, effectively the proposed rule change would apply the amendments resulting from the NTCE Supplement to all single-name CDS contracts and components of index CDS contracts that incorporate the 2014 ISDA Credit Derivatives Definitions and all swaptions transactions currently in place or that are entered into on or after January 27, 2020 (the implementation date determined by ISDA).¹¹

C. Outstanding Principal Balance

Unrelated to the changes discussed above, the proposed rule change would also harmonize the use of the term “Outstanding Principal Balance” throughout the LCH SA CDS Supplement by ensuring that the term is only used with capital letters. Section 1.1 of the LCH SA CDS Supplement specifies that capitalized terms not otherwise defined therein shall have the

¹¹ See ISDA 2019 NTCE Protocol, available at <https://www.isda.org/protocol/isda-2019-ntce-protocol/>.

meaning given pursuant to, among other documents, the ISDA 2003 and 2014 Credit Derivatives Definitions, and explicitly incorporates into the LCH SA CDS Supplement such defined terms. The term “Outstanding Principal Balance” is defined in the ISDA 2003 and 2014 Credit Derivatives Definitions, and according to LCH SA is intended to be incorporated into the LCH SA CDS Supplement. However, the term “Outstanding Principal Balance” is not consistently capitalized throughout the current version of the LCH SA CDS Supplement. Accordingly, because LCH SA intends that the term “Outstanding Principal Balance” should be an incorporated defined term as defined in Section 1.1 of the LCH SA CDS Supplement, the proposed rule change would amend the LCH SA CDS Supplement by capitalizing the term “Outstanding Principal Balance” where not already capitalized.

III. 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 the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to the organization.¹² For the reasons given below, the Commission finds that the proposed rule change is consistent with Section 17A(b)(3)(F) of the Act¹³ and Rule 17Ad-22(e)(1) thereunder.¹⁴

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, to

¹² 15 U.S.C. 78s(b)(2)(C).

¹³ 15 U.S.C. 78q-1(b)(3)(F).

¹⁴ 17 CFR 240.17Ad-22(e)(1).

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.¹⁵

As described above, the NTCE Supplement would amend the underlying legal terms applicable to CDS contracts and swaptions to which it applies by, among other things, limiting Credit Events to those that reflect a deterioration in the creditworthiness or financial condition of the relevant company. It also would reduce the amount of payout a CDS protection buyer could claim in certain circumstances where the claim for payout is based on an obligation issued by a company at a discount. Further, because ISDA has determined that the Protocol Effectiveness Condition is satisfied and set an implementation date of January 27, 2020, the NTCE Supplement will apply to all swaptions and single-name CDS contracts and components of index CDS contracts that incorporate the 2014 ISDA Credit Derivatives Definitions currently in place or entered into on or after that date.

As noted above, because LCH SA will clear and settle CDS contracts and swaptions that are subject to the changes being made by the NTCE Supplement, the proposed rule change would amend the LCH SA CDS Supplement to incorporate the amendments resulting from the NTCE Supplement, thereby ensuring that LCH SA's Rules accurately reflect and appropriately apply the legal terms and conditions applicable to such CDS contracts and swaptions. Separately, to help clarify and ensure that the term "Outstanding Principal Balance" is and remains an incorporated defined term pursuant to Section 1.1 of the CDS Supplement, the proposed rule change would amend the CDS Supplement to capitalize the term "Outstanding Principal Balance" consistently throughout the document.

¹⁵ 15 U.S.C. 78q-1(b)(3)(F).

In the Commission's view, a lack of clarity in the underlying legal terms and conditions applicable to the transactions that LCH SA clears and settles could hinder LCH SA's ability to promptly and accurately clear and settle such transactions. Likewise, disputes regarding the applicable legal terms and conditions of such transactions could lead to disputes or confusion regarding the necessary and appropriate margin submitted in connection with such transactions, thereby threatening LCH SA's ability to safeguard such margin. Accordingly, by making the changes described above, and in particular by ensuring LCH SA's Rules accurately reflect and appropriately apply the legal terms and conditions applicable to the CDS contracts and swaptions that are cleared and settled by LCH SA, the Commission believes that the proposed rule change would help ensure that LCH SA's Rules continue to promote the prompt and accurate clearance and settlement of such the CDS contracts and swaptions and assure the safeguarding of securities and funds in LCH SA's custody and control. For these same reasons the Commission also finds that the proposed rule change would, in general, protect investors and the public interest.

Therefore, the Commission finds that the proposed rule change is consistent with Section 17A(b)(3)(F) of the Act.¹⁶

B. Consistency with Rule 17Ad-22(e)(1)

Rule 17Ad-22(e)(1) requires that LCH SA establish, implement, maintain, and enforce written policies and procedures reasonably designed to provide for a well-founded, clear, transparent, and enforceable legal basis for each aspect of its activities in all relevant jurisdictions.¹⁷ As discussed above, the proposed rule change would help to clarify and ensure that LCH SA's Rules accurately reflect and appropriately apply the legal terms and conditions

¹⁶ 15 U.S.C. 78q-1(b)(3)(F).

¹⁷ 17 CFR 240.17Ad-22(e)(1).

applicable to the CDS contracts and swaptions that are cleared and settled by LCH SA. The Commission believes that this, in turn, would help ensure that the LCH SA CDS Supplement provides a consistent and enforceable legal basis for clearing and settling CDS contracts and swaptions to which the NTCE Supplement applies in light of the amendments made by the NTCE Supplement.

Therefore, the Commission finds that the proposed rule change is consistent with Rule 17Ad-22(e)(1).¹⁸

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as modified by Partial Amendment No. 1, is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-LCH SA-2019-011 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. 20549-1090.

All submissions should refer to File Number SR-LCH SA-2019-011. This file number 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

¹⁸ Id.

all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>).

Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, 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 filing also will be available for inspection and copying at the principal office of LCH SA and on LCH SA's website at: <https://www.lch.com/resources/rules-and-regulations/proposed-rule-changes-0>. 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-2019-011 and should be submitted on or before [Commission to insert date 21 days from publication in the Federal Register].

V. Accelerated Approval of the Proposed Rule Change, as Modified by Partial Amendment No. 1

The Commission finds good cause, pursuant to Section 19(b)(2) of the Act,¹⁹ to approve the proposed rule change prior to the 30th day after the date of publication of Partial Amendment No. 1 in the Federal Register. As discussed above, Partial Amendment No. 1 amends the CDS Clearing Supplement so that, instead of referring to the specific date for various ISDA supplements, it explicitly refers to and incorporates whichever

¹⁹ 15 U.S.C. 78s(b)(2).

versions of the supplements to the standard contract terms are currently effective. By providing this additional clarity, Partial Amendment No. 1 provides for a more clear and comprehensive understanding of the estimated application of the proposed rule change, which helps to improve the Commission's review of the proposed rule change for consistency with the Act and helps market participants understand the impact of the proposed rule change.

Additionally, because Partial Amendment No. 1 would help clarify and ensure that the appropriate legal terms and conditions are applied to the CDS contracts and swaptions cleared and settled by LCH SA, and for similar reasons as discussed above, the Commission finds that Partial Amendment No. 1 is designed to promote the prompt and accurate clearance and settlement of securities transactions, help assure the safeguarding of securities and funds which are in the custody or control of LCH SA, and, in general, to protect investors and the public interest, consistent with Section 17A(b)(3)(F) of the Act.²⁰ Accordingly, the Commission finds good cause for approving the proposed rule change, as modified by Partial Amendment No. 1, on an accelerated basis, pursuant to Section 19(b)(2) of the Exchange Act.²¹

²⁰ 15 U.S.C. 78q-1(b)(3)(F).

²¹ 15 U.S.C. 78s(b)(2).

VI. 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 Act²² and Rule 17Ad-22(e)(1) thereunder.²³

IT IS THEREFORE ORDERED pursuant to Section 19(b)(2) of the Act²⁴ that the proposed rule change, as modified by Partial Amendment No. 1 (SR-LCH-SA-2019-011), be, and hereby is, approved on an accelerated basis.²⁵

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁶

Jill M. Peterson
Assistant Secretary

²² 15 U.S.C. 78q-1(b)(3)(F).

²³ 17 CFR 240.17Ad-22(e)(1).

²⁴ 15 U.S.C. 78s(b)(2).

²⁵ 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).

²⁶ 17 CFR 200.30-3(a)(12).