

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-89678; File No. SR-LCH SA-2020-002)

August 26, 2020

Self-Regulatory Organizations; LCH SA; Order Approving Proposed Rule Change, as Modified by Amendment No. 1, Relating to Clearing of Markit iTraxx MSCI ESG Screened Europe Index Contracts

I. Introduction

On June 26, 2020, 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”)<sup>1</sup> and Rule 19b-4,<sup>2</sup> a proposed rule change to amend the LCH SA Methodology Services Reference Guide: CDS Margin Framework (“CDS Margin Framework”) to: (i) permit the clearing of CDS contracts on the iTraxx MSCI ESG Screened Europe index (the “ESG Index”); (ii) make certain clarifications to facilitate validations of the CDS Margin Framework; and (iii) correct drafting errors in the CDS Margin Framework. On July 8, 2020, LCH SA filed Amendment No. 1 to the proposed rule change.<sup>3</sup> The proposed rule change, as modified by Amendment No. 1 (hereafter the “proposed rule change”), was published for comment in the Federal Register on July 15, 2020.<sup>4</sup> The Commission did not receive comments on the proposed

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> Amendment No. 1 corrected minor errors in the description of the proposed rule change as originally filed with the Commission by explaining the clarifications made to Sections 3.2 and 3.8 of the CDS Margin Framework and removing a description of a change not being made as part of this filing.

<sup>4</sup> Self-Regulatory Organizations; LCH SA; Notice of Filing of Proposed Rule Change, as Modified by Amendment No. 1, Relating to Introduction of Clearing of the New Markit

rule change. For the reasons discussed below, the Commission is approving the proposed rule change.

## II. Description of the Proposed Rule Change

### A. Clearing of the ESG Index

As described further in the Notice, the ESG Index is a subset of the iTraxx Europe Main Index containing companies from the iTraxx Europe Main Index (transactions on which LCH SA currently clears) that meet certain corporate responsibility criteria.<sup>5</sup> Before clearing CDS contracts on the ESG Index, LCH SA must ensure it can account for the risks associated with clearing transactions in the ESG Index. To account for such risks, LCH SA would apply its CDS Margin Framework to CDS contracts on the ESG Index. Thus, by modifying the CDS Margin Framework to apply to CDS contracts on the ESG Index, the proposed rule change would permit LCH SA to clear transactions in the ESG Index.

To apply the CDS Margin Framework to transactions in the ESG Index, the proposed rule change would make two changes to the CDS Margin Framework. First, in Sections 2.3.3 and 3.8.1.3, the proposed rule change would remove references to specific CDS indices so that the CDS Margin Framework no longer refers to these indices by name (like the iTraxx Europe Main Index). The proposed rule change would replace these specific references with generic references to an index or indices. Thus, the proposed rule change would help to ensure that the CDS Margin

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iTraxx MSCI ESG Screened Europe Index Contracts, Exchange Act Release No. 89268 (July 9, 2020), 85 Fed. Reg. 42959 (July 15, 2020) (SR-LCH-SA-2020-002) (“Notice”).

<sup>5</sup> See Notice, 85 Fed. Reg. at 42960. This description is excerpted from the Notice, 85 Fed. Reg. at 42959. Capitalized terms not otherwise defined herein have the meanings assigned to them in the CDS Margin Framework or the LCH SA CDS Clearing Rule Book, as applicable.

Framework applies to CDS contracts on all indices that LCH SA clears, including the ESG Index, rather than the specific indices currently named in the CDS Margin Framework.

Second, in Section 3.8.1.3, the proposed rule change would replace a specific reference to the constituents of the iTraxx Europe Main Index with a more generic reference to the constituents of the indices cleared by LCH SA and revise a formula to make the formula applicable to the iTraxx Europe Main Index and its sub-indices, which would include the ESG Index (as mentioned above, the ESG Index is a subset of the iTraxx Europe Main Index). Again, these changes would help to ensure that these aspects of the CDS Margin Framework apply to CDS contracts on all indices that LCH SA clears, including the ESG Index.

LCH SA represents that clearing of CDS contracts on the ESG Index will not require any other changes to the CDS Margin Framework or LCH SA CDS Clearing Rule Book.<sup>6</sup>

B. Clarifications to the CDS Margin Framework to Facilitate Validations

The proposed rule change would also make the following changes to the CDS Margin Framework. These changes address changes requested by LCH SA's Risk Model Validation team so that it can better assess the CDS Margin Framework.

First, the proposed rule change would amend Section 3.8 with respect to wrong way risk margin. In Section 3.8.1.2, the proposed rule change would add a distinction between CDS contracts on Senior Unsecured Debt securities and CDS contracts on Senior Loss Absorbing Capacity securities. With this change, LCH would calculate wrong way risk margin for CDS contracts on these securities separately, as two different instruments. Next, the proposed rule change would add explanation to Section 3.8.2 to better describe the calibration of certain

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<sup>6</sup> See Notice, 85 Fed. Reg. at 42960.

changes to the calculation of the wrong-way risk component of margin when applying that component to certain indices that contain U.S.-based companies.

Similarly, the proposed rule change would amend Section 4.1, regarding liquidity and concentration risk margin. The proposed rule change would add further description to Section 4.1 of the parameters used in a formula that is part of the calculation of liquidity and concentration risk margin. Also in Section 4.1, the proposed rule change would add description to explain further a variable in a formula that LCH SA uses to compute the Average Liquidity Score and how the value of that variable corresponds to the particular days in the time period that LCH uses to compute the average of the score. Finally, the proposed rule change would amend Section 4.1.8, regarding a formula used in the determination of the liquidity charge for index basis packages, to make a component of that formula an absolute value.

Finally, in anticipation of the transition from the Euro Overnight Index Average (EONIA) to the new Euro Short-Term Rate and the Fed Funds Rate to the Secured Overnight Financing Rate, the proposed rule change replace references to a specific named interest rate (like EONIA) with more generic references to a rate, in Section 5.2.

### C. Corrections to the CDS Margin Framework

In addition to the clarifications requested by LCH SA's Risk Model Validation team, the proposed rule change would make a number of other updates to the CDS Margin Framework to correct drafting errors.

First, Section 2.3.3 names three specific dealers that LCH may use as sources for historical price data. The proposed rule change would remove references to these specific dealers and instead refer generically to dealers and their history of prices. LCH SA is making this change because it may wish to contact other dealers, as needed, beyond those currently named in Section

2.3.3. Thus, the revised drafting would remove an unintentional limitation on LCH SA's ability to obtain historical price data from a variety of dealers.

Next, Section 3.2 contains a table that describes, in a summary format, the various components of LCH SA's margin methodology and whether those components apply to CDS and options on index CDS. This table in Section 3.2 currently incorrectly states that wrong way risk margin does not apply to options on index CDS. The proposed rule change would correct this drafting error by amending the table to state that wrong way risk margin does apply to options on index CDS.

Section 3.5.6 contains formulas that LCH SA uses to calculate profit and loss for the spread margin and short charge component of margin. The proposed rule change would correct these formulas to reflect the fact that the same date is selected to calculate the portfolio profit and loss for all contracts in the portfolio.

Similarly, the proposed rule change would update the list of CDS contracts considered in Section 3.6. Section 3.6 describes LCH SA's calculation of margin associated with interest rate risk. This calculation considers CDS contracts of varying lengths, starting at one month. The proposed rule change would remove from this calculation CDS contracts lasting nine months. Due to a change imposed by ISDA related to the interest rate curve, LCH SA represents that it is no longer correct to include CDS contracts lasting nine months.

Section 3.8 provides an overview of wrong way risk margin. As part of this overview, Section 3.8 also describes the short charge component of margin. As currently stated, this description of the short charge component is incorrect because it states that short charge covers the risk that two entities default. LCH SA represents that this is not correct and is a drafting error because the short charge component covers the risk that at least one entity defaults. The proposed

rule change would correct this description to note that the short charge covers the risk that at least one entity defaults.

Finally, Section 3.8.1 contains a number of formulas related to the calculation of wrong way risk margin. LCH SA states that these formulas as drafted are incomplete because they are missing a second value of zero. The proposed rule change would correct this drafting error by adding to the formulas the second value of zero.

### 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.<sup>7</sup> For the reasons given below, the Commission finds that the proposed rule change is consistent with Section 17A(b)(3)(F) of the Act<sup>8</sup> and Rule 17Ad-22(e)(6)(i) thereunder.<sup>9</sup>

#### 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 and to assure the safeguarding of securities and funds which are in the custody or control of LCH SA or for which it is responsible.<sup>10</sup>

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<sup>7</sup> 15 U.S.C. 78s(b)(2)(C).

<sup>8</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>9</sup> 17 CFR 240.17Ad-22(e)(6)(i).

<sup>10</sup> 15 U.S.C. 78q-1(b)(3)(F).

The Commission believes the changes to the CDS Margin Framework described in Section II.A above should facilitate LCH SA's clearing of CDS contracts on the ESG Index by ensuring that LCH SA's margin calculations apply to the risks of clearing such contracts. Because accounting for the risks of clearing CDS contracts on the ESG Index is necessary before LCH SA may begin clearing such contracts, the Commission believes this aspect of the proposed rule change should facilitate LCH SA's clearing of CDS contracts on the ESG Index and, therefore, the prompt and accurate clearance and settlement of CDS contracts and transactions.

Moreover, the Commission believes the changes to the CDS Margin Framework described in Section II.B above should improve LCH SA's ability to assess and validate the CDS Margin Framework.<sup>11</sup> Because such assessments could identify potential errors or other issues with the CDS Margin Framework, the Commission believes that, by improving LCH SA's ability to assess and validate the CDS Margin Framework, the changes described in Section II.B above should help to ensure the continued performance of the CDS Margin Framework and, therefore, LCH SA's ability to calculate margin using the CDS Margin Framework. For similar reasons, the Commission believes the changes described in Section II.C above should improve the CDS Margin Framework, and LCH SA's ability to calculate margin using the CDS Margin Framework, by correcting drafting errors.

Because they should improve LCH SA's ability to calculate margin using the CDS Margin Framework, the Commission believes that the changes described in Section II.B and

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<sup>11</sup> The Commission notes that, pursuant to Rule 17Ad-22(e)(6)(vii), LCH SA must establish, implement, maintain, and enforce written policies and procedures reasonably designed to cover its credit exposures to its participants by establishing a risk-based margin system that, at a minimum requires a model validation for its margin system and related models to be performed not less than annually or more frequently as required by its risk management framework.

Section II.C above should enhance LCH SA's ability to use margin to avoid losses that could result from miscalculating the risks associated with clearing transactions. The Commission further believes that these losses could negatively affect LCH SA's ability to clear and settle transactions and safeguard funds. Therefore, the Commission believes that by improving LCH SA's ability to avoid losses that could result from mismanaging the risks associated with clearing transactions, these aspects of the proposed rule change should promote the prompt and accurate clearance and settlement of CDS contracts and transactions and assure the safeguarding of securities and funds which are in the custody or control of LCH SA or for which it is responsible.

For these reasons, the Commission finds that the proposed rule change is consistent with Section 17A(b)(3)(F) of the Act.<sup>12</sup>

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

Rule 17Ad-22(e)(6)(i) requires that LCH SA establish, implement, maintain, and enforce written policies and procedures reasonably designed to cover its credit exposures to its participants by establishing a risk-based margin system that, at a minimum considers, and produces margin levels commensurate with, the risks and particular attributes of each relevant product, portfolio, and market.<sup>13</sup> As discussed above, the Commission believes the changes to the CDS Margin Framework described in Section II.A above should facilitate LCH SA's clearing of CDS contracts on the ESG Index by modifying LCH SA's margin calculations to take into account the risks of clearing such contracts. The Commission therefore believes these changes should help to ensure that LCH SA's margin system considers, and produces margin levels commensurate with, the risks and particular attributes of CDS contracts on the ESG Index.

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<sup>12</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>13</sup> 17 CFR 240.17Ad-22(e)(6)(i).

Moreover, as discussed above, the Commission believes the changes described in Section II.B above should improve LCH SA's ability to assess and validate the CDS Margin Framework. The Commission further believes this aspect of the proposed rule change should help LCH SA to identify any possible errors in, and make improvements to, the CDS Margin Framework. Similarly, as discussed above, the Commission believes the changes described in Section II.C above should improve the CDS Margin Framework by correcting drafting errors. The Commission further believes this aspect of the proposed rule change should help resolve possible errors in applying the CDS Margin Framework and reduce the possibility for confusion or mistakes in using the CDS Margin Framework. Finally, by helping to improve the CDS Margin Framework, resolve possible errors, and reduce the possibility for confusion or mistakes, the Commission believes that the changes described in Section II.B and Section II.C above should help to ensure that LCH SA's margin system considers, and produces margin levels commensurate with, the risks and particular attributes of the transactions cleared by LCH SA.

For these reasons, the Commission finds that the proposed rule change is consistent with Rule 17Ad-22(e)(6)(i).<sup>14</sup>

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<sup>14</sup> 17 CFR 240.17Ad-22(e)(6)(i).

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 Act<sup>15</sup> and Rule 17Ad-22(e)(6)(i) thereunder.<sup>16</sup>

IT IS THEREFORE ORDERED pursuant to Section 19(b)(2) of the Act<sup>17</sup> that the proposed rule change, as modified by Amendment No. 1 (SR-LCH-SA-2020-002), be, and hereby is, approved.<sup>18</sup>

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

Jill M. Peterson  
Assistant Secretary

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<sup>15</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>16</sup> 17 CFR 240.17Ad-22(e)(6)(i).

<sup>17</sup> 15 U.S.C. 78s(b)(2).

<sup>18</sup> 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).

<sup>19</sup> 17 CFR 200.30-3(a)(12).