

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-72756; File No. SR-ICEEU-2014-10)

August 4, 2014

Self-Regulatory Organizations; ICE Clear Europe Limited; Order Granting Accelerated Approval of Proposed Rule Change to CDS Policies Relating to EMIR

I. Introduction

On June 30, 2014, ICE Clear Europe Limited (“ICE Clear Europe”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change SR-ICEEU-2014-10 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder.² The proposed rule change was published for comment in the Federal Register on July 10, 2014.³ The Commission received no comment letters regarding the proposed change. For the reasons discussed below, the Commission is granting approval of the proposed rule change on an accelerated basis.

II. Description of the Proposed Rule Change

ICE Clear Europe is proposing this change to amend certain of the ICE Clear Europe credit default swaps (“CDS”) risk policies (“Risk Policy Amendments”) in order to facilitate compliance with requirements under the European Market Infrastructure Regulation (including regulations thereunder, “EMIR”)⁴ that will apply to ICE Clear Europe as an authorized central counterparty.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 34-72544 (July 3, 2014), 79 FR 39421 (July 10, 2014) (SR-ICEEU-2014-10).

⁴ Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

ICE Clear Europe states that the relevant policies being modified by the proposed change are (i) the CDS Risk Policy (“Risk Policy”); (ii) the Risk Model Description (“Model Description”); (iii) the CDS Clearing Back-Testing Framework (“Back-Testing Framework”); (iv) the CDS Clearing Stress-Testing Framework (“Stress-Testing Framework”); and (v) the CDS Default Management Framework (“Default Management Framework”).

ICE Clear Europe states that the changes to the Risk Policy amend the calculation of CDS initial margin requirements to comply with margin requirements under EMIR Article 41 and Article 24 of the implementing Regulatory Technical Standards.⁵ ICE Clear Europe contends that, as revised, the initial margin methodology is designed to provide portfolio risk coverage against at least 5-day market realizations that would occur with probability 99.5% (previously 99.0%), that is, the estimated requirements provide risk protection equivalent to at least a 5-day 99.5% Value-at-Risk measure. In addition, ICE Clear Europe states that in order to address requirements under EMIR related to procyclicality (Article 28 of the Regulatory Technical Standards) changes were made to the maximum scale used for the initial margin approach by adding a volatility scale that assigns a 25% weight to stressed period observations during the lookback period from April 2007 to the present (consistent with Article 28(b) of the Regulatory Technical Standards). ICE Clear Europe expects the revised initial margin requirement, including certain portfolio benefit assumptions, to result in more conservative initial margin requirements than under the previous approach.

ICE Clear Europe states that similar amendments to those described above are also made to the Model Description. ICE Clear Europe contends that under the revised Model Description,

⁵ Commission Delegated Regulation (EU) No. 153/2013 of 19 December 2012 Supplementing Regulation (EU) No. 648/2012 of the European Parliament and of the Council with regard to Regulatory Technical Standards on Requirements for Central Counterparties (the “Regulatory Technical Standards”).

the overall initial margin methodology, post portfolio benefits and other risk components (e.g. jump-to-default and wrong way risk), will provide portfolio risk coverage against at least 5-day market realizations that would occur with probability 99.5% or higher. ICE Clear Europe states that conforming changes with respect to the 99.5% confidence interval are also made in the Model Description. ICE Clear Europe also states that the revised Model Description reflects the use of stressed observations described above to limit procyclicality. Furthermore, ICE Clear Europe states that the Model Description has also been revised to include the Clearing House's Monte Carlo Approach for Risk Management ("MC"), which has previously been applied to Western European sovereign CDS and is proposed to be extended to all CDS.

ICE Clear Europe states that the CDS MC approach aims to model the spread risk component of initial margin by combining individual risk factors ("RFs"), i.e., single name or index family of instruments, into a copula. ICE Clear Europe further states that marginal distributions for individual RFs are joined together under a Student-t copula. In this way, ICE Clear Europe contends, the model preserves historical behavior of RFs and their dependencies and that the value-at risk (VaR) for the profit and loss distribution can be estimated by sampling from this copula.

ICE Clear Europe contends that the MC method offers a number of advantages over the existing scenario-based spread response method (the "Decomp SR"), in that (1) the dependence structure of RFs is encoded into the copula, as opposed to the long-short offsets algorithm used to determine portfolio benefits under the Decomp SR; and (2) the copula can also capture tail dependence, such that various extreme scenarios can be easily simulated.

ICE Clear Europe states that the scenario-based approach of the spread risk component with its portfolio benefit assumptions is generally expected to result in a more conservative

requirement when compared to the MC VaR approach for the same coverage level. ICE Clear Europe further states that in order to ensure compliance with the 99.5% confidence interval requirement for OTC derivatives under EMIR, the final spread response charge will be determined as the more conservative of the Decomp SR and the MC VaR calculated at a 99.5% confidence interval.

ICE Clear Europe also states that the CDS pricing model, used since the inception of clearing, has also been attached to the Risk Model Description as an annex.

ICE Clear Europe states that the changes to the Back-Testing Framework are also meant to implement the 99.5% confidence interval. ICE Clear Europe states that the historical volatility calculation has changed in the Back-Testing Framework to use data from, at minimum, the most recent year (or, if shorter, the period in which the relevant contract has been cleared). In addition, ICE Clear Europe contends that, per the amendments, on at least a monthly basis, the CDS Risk Department will report the CDS back testing results and analysis to the CDS Risk Committee in order to seek their review and, if needed, their recommendations of the CDS margin model. ICE Clear Europe also states that CDS back testing results and analyses are made available to all CDS Clearing Members and clients (where known to ICE Clear Europe) for their own portfolios and that disclosed information is aggregated in a form that does not breach confidentiality. ICE Clear Europe also contends that the policy also provides a framework for monitoring and remediating breaches that arise during back-testing, based on the so-called “Basel Traffic Light System,” depending on the number and magnitude of the exceedances. Finally, ICE Clear Europe states that the Back-Testing Framework will be reviewed and approved by the CDS Risk Committee and ICE Clear Europe Board at least annually.

ICE Clear Europe states the Stress-Testing Framework is amended to provide further detail as to its use of daily stress testing, which allows ICE Clear Europe to discover any potential weaknesses in the risk methodologies as well as to exercise short-term measures if the tests reveal that any counterparties are inadequately collateralized. ICE Clear Europe contends that a detailed analysis of the stress testing and sensitivity testing results is to be performed by the CDS Risk Department at least on a monthly basis, or more frequently in stressed market conditions, to ensure the adequacy of the existing stress test scenarios and framework. ICE Clear Europe states the Stress-Testing Framework amendments would also add pure historical scenarios, as required under EMIR, that are applied at the single name level, using the same date across all instruments. ICE Clear Europe also states that single-name specific stress scenarios are based on the same 5-day period when the on-the-run indices had the greatest observed related spread increases or decreases. ICE Clear Europe also states that the guaranty fund stress scenario has also been clarified, and is designed to account for: (1) the occurrence of credit events for two Clearing Members and three reference entities on which the defaulted Clearing Members sold protection, (2) adverse contracting or widening credit spread scenarios, (3) adverse widening of Index-single name “basis,” and (4) adverse changes of the default-free discount terms structure. ICE Clear Europe contends that CDS stress testing results and analyses are made available to all CDS Clearing Members and clients (where known to ICE Clear Europe) for their own portfolios and disclosed information is aggregated in a form that does not breach confidentiality. Finally, ICE Clear Europe states the CDS Stress Testing framework is to be reviewed and approved by the CDS Risk Committee and ICE Clear Europe Board at least annually.

ICE Clear Europe contends that minor improvements have been made to the Default Management Framework, namely, (1) ICE Clear Europe will conduct a quarterly (rather than annual) review of its Default Management Framework, and (2) ICE Clear Europe will perform a mock Clearing Member default test at least annually.

III. Discussion and Commission Findings

Section 19(b)(2)(C) of the Act⁶ directs the Commission to approve a proposed rule change of a self-regulatory organization if the Commission finds that such proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to such self-regulatory organization. Section 17A(b)(3)(F) of the Act⁷ requires, among other things, that the rules of a clearing agency are designed to promote the prompt and accurate clearance and settlement of securities transactions and, to the extent applicable, derivative agreements, contracts, and transactions, to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible and, in general, to protect investors and the public interest. In addition, Rule 17Ad-22(b)(1)-(3) requires a registered clearing agency that performs central counterparty services to establish, implement, maintain and enforce written policies and procedures reasonably designed to, among other things, measure its credit exposures to its participants at least once a day and limit its exposures to potential losses from defaults by its participants, use margin requirements to limit its credit exposures to participants under normal market conditions, and if it performs central counterparty services for security-based swaps, maintain sufficient financial resources to withstand, at a

⁶ 15 U.S.C. 78s(b)(2)(C).

⁷ 15 U.S.C. 78q-1(b)(3)(F).

minimum, a default by the two participant families to which it has the largest exposures in extreme but plausible market conditions.⁸

The Commission finds that the proposed rule change is consistent with Section 17A of the Act⁹ and the rules thereunder applicable to ICE Clear Europe. ICE Clear Europe represents that the proposed rule change will enhance the financial resources available to the Clearing House by imposing more conservative initial margin requirements, while also reducing the risk of loss to market participants resulting from a default by a Clearing Member or other customer. ICE Clear Europe further states that the proposed rule change will impose more frequent reviews and tests of its risk management procedures. The Commission therefore believes that the proposed enhancements to ICE Clear Europe's risk policies are designed to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible consistent with Section 17A(b)(3)(F).¹⁰ In addition, the Commission believes the proposed Risk Policy Amendments are reasonably designed to ensure that ICE Clear Europe continues to meet the risk management requirements of Rule 17Ad-22(b)(1)-(3).¹¹

Section 19(b)(2)(C)(iii) of the Act¹² allows the Commission to approve a proposed rule change earlier than 30 days after the date of publication of the notice of the proposed rule change in the Federal Register where the Commission finds good cause for so doing and publishes the reason for the finding. In its filing, ICE Clear Europe requested that the Commission approve the proposed rule change on an accelerated basis for good cause shown. ICE Clear Europe has

⁸ 17 CFR 240.17Ad-22(b)(1)-(3).

⁹ 15 U.S.C. 78q-1.

¹⁰ 15 U.S.C. 78q-1(b)(3)(F).

¹¹ 17 CFR 240.17Ad-22(b)(1)-(3).

¹² 15 U.S.C. 78s(b)(2)(C)(iii).

represented that the proposed Risk Policy Amendments are necessary in order to comply with requirements under EMIR in connection with its authorization as a central counterparty under EMIR. ICE Clear Europe further notes that failure to have the amendments in effect, and to be in compliance with the EMIR requirements, may adversely affect the approval of its authorization application and therefore its ability to do business as a recognized central counterparty. Accordingly, the Commission finds that good cause exists to approve the proposed rule change on an accelerated basis pursuant to Section 19(b)(2)(C)(iii) of the Act.¹³

¹³ 15 U.S.C. 78s(b)(2)(C)(iii).

IV. Conclusion

On the basis of the foregoing, the Commission finds that the proposal is consistent with the requirements of the Act and in particular with the requirements of Section 17A of the Act¹⁴ and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁵ that the proposed rule change (File No. SR-ICEEU-2014-10) be, and hereby is, approved on an accelerated basis.¹⁶

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁷

Kevin M. O'Neill
Deputy Secretary

¹⁴ 15 U.S.C. 78q-1.

¹⁵ 15 U.S.C. 78s(b)(2).

¹⁶ 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).

¹⁷ 17 CFR 200.30-3(a)(12).