

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-74917; File No. SR-ICC-2015-004)

May 8, 2015

Self-Regulatory Organizations; ICE Clear Credit LLC; Order Approving Proposed Rule Change Relating to Physical Settlement of CDS Contracts

I. Introduction

On March 11, 2015, ICE Clear Credit LLC (“ICC”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change SR-ICC-2015-004 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 March 27, 2015.³ The Commission received one comment.⁴ For the reasons discussed below, the Commission is approving the proposed rule change.

II. Description of the Proposed Rule Change

ICC proposes to amend its rules to modify the terms and conditions for physical settlement of cleared CDS Contracts, and to adopt certain new delivery procedures relating to physical settlement.

Under the current terms of the ICC Clearing Rules (“ICC Rules”), upon the occurrence of a credit event under a cleared CDS Contract, the contract is typically settled in cash in accordance with the terms of the ICC Rules, which incorporate the applicable ISDA Credit Derivatives Definitions (the “ISDA Definitions”) and the market-standard credit default swap

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 34-74563 (Mar. 23, 2015), 80 FR 16471 (Mar. 27, 2015) (File No. SR-ICC-2015-004).

⁴ See Comment from Kermit Kubitz, dated April 17, 2015, available at <https://www.sec.gov/comments/sr-icc-2015-004/icc2015004-1.htm>.

auction methodology for determining the cash settlement price. However, in certain circumstances, such as where the Credit Derivatives Determinations Committee decides not to hold a cash settlement auction for a particular credit event, or such an auction is cancelled under the terms of the auction methodology (including because of a failure to determine the auction settlement price), the CDS Contracts provide for a fallback settlement method of physical settlement. Under physical settlement of a CDS contract generally, the protection buyer will be entitled to deliver one or more qualifying deliverable obligations to the protection seller, in which case the protection seller will be required to pay the protection buyer a defined physical settlement amount. Under the current ICC Rules, if physical settlement applies,⁵ ICC will match clearing participants (“Participants”) that are protection buyers with Participants that are protection sellers in the relevant contract, and the two Participants will be responsible for effecting physical settlement between them. ICC does not itself perform or guarantee performance of physical settlement between the matched Participants. Once matching occurs, the contract is purely a bilateral contract between the matched Participants, and ICC has no further rights or obligations with respect to the contract. ICC does, however, collect and hold physical settlement margin as collateral agent on behalf of the protection buyer to secure the protection seller’s obligations to the protection buyer under physical settlement.

ICC proposes to amend the ICC Rules relating to physical settlement such that ICC will be responsible for financial performance of physical settlement. ICC notes that under the amended approach, it would still require payments and deliveries in the ordinary course under physical settlement to be made directly between the matched buying Participant and selling

⁵ ICC notes that to date, physical settlement has not been necessary for any of the CDS Contracts cleared by ICC.

Participant, with ICC only being obligated to make direct payments in the case of certain defined settlement failure scenarios. ICC believes that this proposed rule change will further the general policy goals of central clearing for CDS transactions, and is consistent with ICC's financial resources, risk management procedures and operational capabilities.⁶

ICC proposes to make certain amendments to Chapters 1, 4, 5, 21 and 22 of the ICC Rules. ICC also proposes to adopt a related set of Delivery Procedures and Physical Settlement and Notices Terms. Furthermore, ICC also proposes to make certain related and conforming changes to its Risk Management Framework. All capitalized terms not defined herein are defined in the ICC Rules.

In Chapter 1 of the ICC Rules, ICC proposes to amend the definition of "Client-Related Initial Margin" so that it now includes Physical Settlement Margin collected with respect to Client-Related Positions. As discussed below, according to ICC, such Physical Settlement Margin is intended to secure the obligations of a Participant to ICC in connection with physical settlement. Similarly, in Rule 403, ICC proposes to amend the definition of "Physical Settlement Margin" to refer to such obligations to ICC (as opposed to the obligations to the matched Participant under the current ICC Rules). In Rule 502(b), a conforming reference to Physical Settlement Margin will be updated. A conforming change is also made in Rule 2101-02(a)(iv).

ICC proposes changes to Chapter 22 (which covers physical settlement) by adding a new Rule 2200 with definitions relating to the revised physical settlement provisions, including "Matched Delivery Buyer" and "Matched Delivery Seller," and the related terms "Matched Delivery Contract," "Matched Delivery Buyer Contract," "Matched Delivery Seller Contract"

⁶ ICC notes that a substantially similar approach to physical settlement is used in the ICE Clear Europe Limited CDS clearing service.

and “MP Delivery Amount.” As discussed below, these terms are used in connection with the matching of buying Participants and selling Participants in the revised settlement procedures. A new definition of “Asset Package Delivery Notice” has also been added to address notices in connection with Asset Package delivery under the 2014 ISDA Credit Derivatives Definitions (the “2014 ISDA Definitions”).

According to ICC, Rule 2201(a), which provides for matching of buying Participants and selling Participants into a Matched Delivery Pair in the case of physical settlement, will be revised to address scenarios where a Participant’s CDS contracts must be split and matched with multiple other Participants for purposes of physical settlement. Conforming changes to use applicable defined terms (such as Relevant Restructuring Credit Event) will also be made. Rule 2201(b), which addresses delivery of certain notices between a Matched Delivery Pair, will be revised to include references to Asset Package Delivery Notices. Rule 2201(c) will be deleted at the request of Participants as being inconsistent with the terms of uncleared CDS and unnecessary in light of the provisions of the ISDA Definitions and Rule 2202.

ICC also proposes changes to Rule 2202, which addresses resolution of disputes related to permissible deliverable obligations, in order to incorporate the concept of Asset Package Delivery under the 2014 ISDA Definitions, as well as related concepts of Prior Deliverable Obligations, Package Observable Bonds and Asset Package Delivery Notices. Rules 2202(b) and (c) will also be revised to address the consequences of a selling Participant’s refusal to accept delivery of a particular obligation, including for the offsetting transaction between ICC and the buying Participant.

Rule 2203 will be replaced with new provisions addressing ICC’s role in physical settlement. When a Matched Delivery Pair is established, the CDS Contract between the

Matched Delivery Buyer and ICC will be referred to as the Matched Delivery Buyer Contract, and the corresponding CDS Contract between ICC and the Matched Delivery Seller will be referred to as the Matched Delivery Seller Contract. Under the revised physical settlement approach, ICC intends to remain party to each such contract, but will require certain notices, payments and deliveries to take place directly between the Matched Delivery Buyer and Matched Delivery Seller. Accordingly, under Rule 2203(a), for each Matched Delivery Buyer Contract, ICC will designate the Matched Delivery Seller to receive on ICC's behalf notices and deliveries from the Matched Delivery Buyer and to make payments on ICC's behalf to the Matched Delivery Buyer. Similarly, under Rule 2203(b), for each Matched Delivery Seller Contract, ICC will designate the Matched Delivery Buyer to deliver on ICC's behalf notices and deliveries to the Matched Delivery Seller, and to receive on ICC's behalf payments from the Matched Delivery Seller. The result is that notices, payments and deliveries will be made directly between the Matched Delivery Buyer and Matched Delivery Seller, in satisfaction of the parties and ICC's respective obligations under both the Matched Delivery Buyer Contract and Matched Delivery Seller Contract. Rule 2203(c) further clarifies that the exercise of rights by Matched Delivery Buyer against ICC will be deemed the exercise by ICC of the corresponding rights against Matched Delivery Seller, and vice versa. Rules 2203(d) and (e) will provide for copies of relevant notices to be provided to ICC, as well as notice of the completion of settlement between the Matched Delivery Buyer and Matched Delivery Seller. Rule 2203(f) will clarify the obligations of the respective parties to a Matched Delivery Contract, and address a scenario where an Asset Package being delivered is deemed to have a value of zero under the 2014 ISDA Definitions. Rule 2203(g) will allocate costs and expenses that may be incurred by ICC in connection with physical settlement.

Rule 2204, as revised, will address physical settlement of certain deliverable obligations that do not settle in the ordinary course on a delivery-versus-payment basis (“Non-DVP Obligations”). The rule establishes a procedure under which the Matched Delivery Seller will pay the physical settlement amount owed to ICC, which in turn will not pay such amount to the Matched Delivery Buyer until ICC receives notice that the obligation has been received by the Matched Delivery Seller from the Matched Delivery Buyer. If the obligation is not delivered, the physical settlement amount will be returned to the Matched Delivery Seller.

ICC states that Rule 2205 will address settlement failures by the Matched Delivery Seller or Matched Delivery Buyer. Under subsection (a), if the Matched Delivery Seller fails to pay the physical settlement amount when due, the Matched Delivery Buyer Contract will be cash settled as between the Matched Delivery Buyer and ICC. ICC thus will not be obligated to take delivery of the relevant deliverable obligations (and dispose of them in a situation where the Matched Delivery Seller has failed to perform), but will compensate the Matched Delivery Buyer for the value of the Matched Delivery Buyer Contract through the cash settlement process. Pursuant to subsection (b), ICC may, in addition to its other default remedies, terminate the Matched Delivery Seller Contract, in which case the Matched Delivery Seller will owe ICC an amount equal to the cash settlement amount ICC paid the Matched Delivery Buyer, together with other losses and expenses incurred by ICC as a result of the failure. Rule 2205(c) provides that, consistent with the terms of the ISDA Definitions applicable to a protection buyer generally, any failure by ICC to deliver any deliverable obligations to the Matched Delivery Seller (including as a result of a failure by the Matched Delivery Buyer to make a delivery) will not constitute a default by ICC, and the Matched Delivery Seller’s sole remedy will be as set forth in the Matched Delivery Seller Contract (which may include, for example, buy-in remedies of the

Matched Delivery Seller). ICC will not have any obligation to purchase or acquire deliverable obligations (other than in settlement of the Matched Delivery Buyer Contract) in order to settle the Matched Delivery Seller Contract. In the event of a delivery failure by a Matched Delivery Buyer, such party will be liable to ICC for any costs incurred by ICC in settling the corresponding Matched Delivery Seller Contract (in addition to ICC's other remedies for a default).

According to ICC, the changes to Rule 2206 are to cover certain other, non-default scenarios in which physical settlement fails to occur. Under Rules 2206(a) and (b), if physical settlement of the Matched Buyer Delivery Contract does not occur because the deliverable obligation is in less than the relevant minimum denomination or the Matched Delivery Seller is not a permitted transferee of the obligation, the failure will be treated as an illegality or impossibility outside of the parties' control, which will result in cash settlement⁷ under the ISDA Definitions. In this and other scenarios where a cash settlement fallback applies, the same cash settlement amount will apply to both the Matched Delivery Buyer Contract and Matched Delivery Seller Contract under Rule 2206(c). Similarly, in the case of a buy-in, the same buy-in price will apply to both contracts. Rule 2206(d) will provide for cash settlement of both the Matched Delivery Buyer Contract and Matched Delivery Seller Contract in certain cases where delivery does not occur between the Matched Delivery Buyer and the customer for which it is acting. Rule 2206(e) specifies the date of any cash settlement and provides for notice of the relevant amount owed.

⁷ Cash settlement in this context is different from the auction cash settlement that normally applies to CDS contracts under the ISDA Definitions, and is based on price quotations obtained by the relevant party to the contract for the obligation or obligations that cannot be delivered.

According to ICC, Rule 2207(a) will provide for certain standard representations and related provisions for physical settlement in the ISDA Definitions to apply as between the Matched Delivery Buyer and Matched Delivery Seller, and will clarify ICC's authority to designate a Participant to make or receive physical settlement on its behalf as provided in Rules 2203 and 2204 for purposes of Section 9.2(c)(iv) of the 2003 ISDA Credit Derivatives Definitions or Section 11.2(c)(iv) of the 2014 ISDA Definitions, even though the Participant is not its Affiliate. Rule 2207(b) will clarify certain procedures for obtaining price quotations for the relevant deliverable obligations in the event that a cash settlement fallback applies.

Rule 2208 will allow the Matched Delivery Buyer and Matched Delivery Seller to settle their rights and obligations as to physical settlement through an alternative arrangement agreed between them (referred to as a "CADP"), in lieu of settlement pursuant to Chapter 22 of the ICC Rules. If they so agree, ICC will have no obligation in respect of such alternative arrangement.

Rules 2209(a) and (c) will provide that margin (including physical settlement margin) will continue to be called and held through settlement. Rule 2209(b) will provide that ICC will apply physical settlement margin to satisfy the Matched Delivery Seller's obligation to pay the physical settlement amount, and call such seller for any shortfall.

ICC also proposes to adopt Delivery Procedures that will further specify certain operational and other details for the physical settlement process. According to ICC, Paragraph 1 will provide certain definitions used in the Delivery Procedures. Paragraph 3.2 will set out certain requirements for providing notices in connection with physical settlement. Paragraphs 3.3(a)-(e) will establish the procedures and timetable for ICC to allocate Matched Delivery Pairs and notify Participants accordingly. Paragraph 3.3(g) will address additional procedures concerning delivery of notices by Participants in connection with physical settlement, including

as to relevant notice deadlines, requirements for providing copies of notices to ICC, treatment of late notices and procedures for disputes involving notices. Paragraph 4 of the Delivery Procedures will specify certain deadlines in connection with the physical settlement of Non-DVP Obligations under Rule 2204. Finally, Paragraph 5 will specify the deadline for notices that parties have elected a CADP.

ICC also proposes to adopt a set of Physical Settlement and Notices Terms (“Notices Terms”) with respect to physical settlement. The Notices Terms are intended to set forth a uniform set of communications between a Participant and its customer in connection with physical settlement, including delivery of physical settlement notices and delivery and receipt of deliverable obligations as between the Participant and its customer. The Notices Terms will also address the operation of certain cash settlement and other fallbacks as between the Participant and its customer. The Notices Terms do not bind ICC and do not form part of the ICC Rules or ICC Procedures. The Notices Terms are published for the convenience and use of Participants and their customers, and are designed to be incorporated by reference in customer clearing documentation. However, a Participant and its customer may agree to vary the Notices Terms.

ICC also proposes to make certain changes to its Risk Management Framework to accommodate the changes relating to physical settlement that are being made to the ICC Rules and procedures as set forth herein. As revised, the Risk Management Framework reflects ICC’s obligations in respect of physical settlement as provided in the amended ICC Rules and procedures. It will set out the steps in the physical settlement process to be taken by ICC if physical settlement applies, including the matching of Participants into Matched Delivery Pairs, consistent with the ICC Rules and procedures. The revisions also address the calculation,

collection and use of margin (including physical settlement margin) where physical settlement applies.

III. Comments

The Commission received one comment concerning the proposed rule change. In this comment, the commenter expresses concern that ICC's proposed rule change to guarantee the financial performance of physical settlement, in addition to its existing guarantee of cash settlement, would add additional complexity to ICC's clearing business, particularly during times of financial stress. The commenter addresses three issues with the proposal. First, the commenter suggests that the "process, financial assets and liabilities, and legal obligations of all parties must be well understood,"⁸ both by ICC and the Commission. Second, "the SEC should have some periodic report on [ICC's] financial assets, potential obligations or value at risk, and ability to perform under normal or adverse circumstances."⁹ Finally, the commenter seeks assurance that the SEC would assess the impact ICC's guarantee of "physical clearing on market participants" in reducing those participants' "financial commitment" or leverage.¹⁰ The commenter did not opine on any particular aspects of the proposed rule change beyond these general statements.

IV. Discussion and Commission Findings

Section 19(b)(2)(C) of the Act¹¹ directs the Commission to approve a proposed rule change of a self-regulatory organization if the Commission finds that such proposed rule change

⁸ Comment from Kermit Kubitz, dated April 17, 2015, available at <https://www.sec.gov/comments/sr-icc-2015-004/icc2015004-1.htm>.

⁹ Id.

¹⁰ Id.

¹¹ 15 U.S.C. 78s(b)(2)(C).

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 Act¹² 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.

Rules 17Ad-22(b)(2-3)¹³ require each registered clearing agency that performs central counterparty services to establish, implement, maintain and enforce written policies and procedures reasonably designed to use margin requirements to limit its credit exposures to participants under normal market conditions and use risk-based models and parameters to set margin requirements and review such margin requirements and the related risk-based models and parameters at least monthly, and maintain sufficient financial resources to withstand, at a minimum, a default by the two participant families to which it has the largest exposures in extreme but plausible market conditions, in its capacity as a central counterparty for security based swaps.

Rule 17Ad-22(d)(15)¹⁴ requires each registered clearing agency to establish, implement, maintain and enforce written policies and procedures reasonably designed to state to its participants the clearing agency's obligations with respect to physical deliveries and identify and manage the risks from these obligations.

¹² 15 U.S.C. 78q-1(b)(3)(F).

¹³ 17 CFR 240.17Ad-22(b)(2-3).

¹⁴ 17 CFR 240.17Ad-22(d)(15).

The Commission finds that the modification of the terms and conditions for physical settlement of cleared CDS Contracts and the adoption of certain new delivery procedures relating to physical settlement is consistent with the requirements of Section 17A of the Act¹⁵ and the regulations thereunder applicable to ICC.

The proposed rule change will provide greater certainty and timeliness with respect to the clearance and settlement of CDS transactions in circumstances where physical settlement applies. Although physical settlement applies only rarely, and as a fallback to the normal procedure for cash settlement, the proposed rule change will prevent Participants from being exposed to the credit risk of other Participants with respect to the financial performance of physical settlement by guaranteeing timely payment of settlement amounts that are due to a non-defaulting party. As a result, the Commission believes the proposed rule change will promote the prompt and accurate clearing and settlement of CDS contracts, and, in general, protect investors and the public interest consistent with the requirements of Section 17A(b)(3)(F) of the Act.¹⁶

Moreover, the proposed rule change will require ICC to collect Physical Settlement Margin¹⁷ (in addition to initial and variation margin) to cover the specific obligations of each

¹⁵ 15 U.S.C. 78q-1.

¹⁶ 15 U.S.C. 78q-1(b)(3)(F).

¹⁷ The Physical Settlement Margin is calculated as the notional value minus the estimated value of the deliverable obligation and collected from the Matched Delivery Seller and held by ICC until such time the Matched Delivery Buyer and the Matched Delivery Seller as a pair confirm that settlement has been occurred. Physical Settlement Margin is not collected from the Matched Delivery Buyer. The estimated value of the deliverable obligation will be determined by ICC using a “haircut” approach. ICC will use the price of the cheapest-to-deliver bond as the basis for the “haircut” estimation. However, if

Matched Delivery Seller to the clearinghouse with respect to physical settlement. Therefore, the Commission believes ICC will be able to maintain financial resources sufficient to support its clearing operations, including operations under the amended physical settlement procedures, in a manner consistent with the requirements of Rule 17Ad-22(b)(2-3).¹⁸ Furthermore, ICC proposes to amend text of ICC Rules 2203(a) – (g), to address the legal obligations that arise between Participants when settling a CDS Contract that is to be physically settled, with corresponding changes to its Delivery Procedures. The Commission believes that ICC’s Rules, as amended, establish ICC’s and Participants’ obligations for performance (including financial performance) of physically settled contracts, the procedures for settlement and the mechanism for ICC to effect settlement in cash without having to acquire or dispose of the underlying deliverable obligations, consistent with the requirements of Rule 17Ad-22(d)(15).¹⁹

reliable pricing is not available, ICC reserves the right to determine a price of zero and therefore charge the full notional amount as the Physical Settlement Margin to the seller.

¹⁸ 17 CFR 240.17Ad-22(b)(2-3).

¹⁹ 17 CFR 240.17Ad-22(d)(15).

V. 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 Act²⁰ and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²¹ that the proposed rule change (SR-ICC-2015-004) be, and hereby is, approved.²²

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²³

Robert W. Errett
Deputy Secretary

²⁰ 15 U.S.C. 78q-1.

²¹ 15 U.S.C. 78s(b)(2).

²² 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).

²³ 17 CFR 200.30-3(a)(12).