

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-76136; File No. SR-ICEEU-2015-010)

October 13, 2015

Self-Regulatory Organizations; ICE Clear Europe Limited; Order Approving Proposed Rule Change, as Modified by Amendment No. 1 Thereto, Relating to Credit Default Swap Risk Policies

I. Introduction

On June 25, 2015, ICE Clear Europe Limited (“ICE Clear Europe”) 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 certain of its credit default swap (“CDS”) risk policies (the “Risk Policy Amendments”) in order to enhance its current risk model (SR-ICEEU-2015-010). The proposed rule change was published for comment in the Federal Register on July 16, 2015.³ On July 21, 2015, ICE Clear Europe filed Amendment No. 1 to the proposed rule change solely to reflect the formal approval of the Risk Policy Amendments by the ICE Clear Europe Board.⁴ ICE Clear Europe consented to an extension of the time period in which the Commission shall approve, disapprove, or institute proceedings to determine whether to disapprove the proposed rule change to October 14, 2015. The Commission received no comment letters regarding the proposed change. For the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 34-75426 (July 10, 2015), 80 FR 42146 (July 16, 2015) (SR-ICEEU-2015-010).

⁴ In its filing on June 25, 2015, ICE Clear Europe represented that the Risk Policy Amendments would be approved by the ICE Clear Europe Board before implementation. ICE Clear Europe subsequently filed Amendment No.1 to state that the ICE Clear Europe Board approved the Risk Policy Amendments on July 8, 2015. Amendment No. 1 is not subject to notice and comment because it is a technical amendment that does not alter the substance of the proposed rule change or raise any novel regulatory issues.

reasons discussed below, the Commission is approving the proposed rule change, as modified by Amendment No. 1.

II. Description of the Proposed Rule Change

ICE Clear Europe has proposed amending certain risk policies relating to the CDS product category to incorporate enhancements to the existing CDS risk model. The relevant policies to be modified are the CDS Risk Policy (“CDS Risk Policy”) and the CDS Risk Model Description (“Risk Model Description”). ICE Clear Europe did not propose to make any changes to its Clearing Rules or Procedures in connection with these amendments.

ICE Clear Europe has proposed to, among other matters, (i) modify the credit spread response component of the risk model to devolatilize returns, (ii) enhance the portfolio spread response component of the risk model to limit procyclicality, (iii) establish a new framework for recovery rate sensitivity requirement (“RRSR”) parameters, (iv) modify the CDS Guaranty Fund allocation methodology, (v) modify index liquidity and concentration charges and (vi) revise procedures for intraday margin calls. The Risk Policy Amendments would also include certain other clarifications and conforming changes.

The following is a summary of the principal changes to be made by the Risk Policy Amendments:

Devolatilization of Credit Spread Response. Under the revised Risk Model Description, the credit spread response component of the margin model would be revised to provide that the tail estimation of the relevant fitted returns distribution is based on devolatilized returns. ICE Clear Europe has represented that the use of devolatilized returns in this manner facilitates the comparison of returns for periods with different volatilities.

Procyclicality of Portfolio Spread Response. In order to limit procyclicality of the spread response component of the model, ICE Clear Europe has proposed to modify the CDS Risk Policy and Risk Model Description to use an additional portfolio analysis that features price changes observed during and immediately after the Lehman Brothers default. According to ICE Clear Europe, the analysis considers price scenarios derived from the greatest price decrease and increase during and immediately after the Lehman Brothers default. ICE Clear Europe has designed these scenarios to capture the default of a major participant in the credit market and the market response to the event. ICE Clear Europe has defined the introduced scenarios in price terms to maintain the stress severity during periods of low credit spread levels (high price) when the spread response requirements, computed under the current framework, are expected to be lower. Furthermore, ICE Clear Europe has also incorporated the Lehman default price scenarios into the calculation of CDS Guaranty Fund requirements.⁵

Recovery Rate Sensitivity Requirements. ICE Clear Europe has proposed to revise the Risk Model Description to incorporate a more sensitive parameter estimation approach for the RRSR computation. The RRSR factor is designed to capture the risk of fluctuations in market expected recovery rates under CDS transactions. Under the current model, the RRSR is determined using fixed minimum and maximum recovery rate stress scenarios based on sector levels. In calculating the RRSR, all instruments belonging to a risk factor (“RF”) or risk sub-factor (“RSF”) are subjected to recovery rate stress scenarios to obtain resulting profit/loss

⁵ ICE Clear Europe has represented that this enhancement also addresses a regulatory requirement in Article 30 of the Regulatory Technical Standards implementing the European Market Infrastructure Regulations (“EMIR”). 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”).

responses, and the worst scenario response is chosen for the estimation of the RRSR. (In addition, these same recovery rate stress scenarios are used in determination of jump-to-default requirements.)

ICE Clear Europe has proposed separating the recovery rate stress levels for these two computations in order to introduce more dynamic and appropriate estimations of the recovery rate stress levels for RRSR purposes. Under the revised framework, the recovery rate levels for RRSR purposes will be determined using a 5-day, 99% confidence interval expected shortfall risk measure assuming a distribution of recovery rate fluctuations. The proposal will also eliminate index RRSR, as index recovery rates are assumed under relevant market convention and are thus not subject to market uncertainty. ICE Clear Europe represents that the dynamic feature of the revised stress level estimations is achieved by analyzing historical time series of recovery rates in order to calibrate a statistical model with a time varying volatility. In ICE Clear Europe's view, the proposed enhancements provide a robust and quantitative driven approach for establishing the recovery rate stress scenarios.

Modifications to Guaranty Fund Methodology. ICE Clear Europe has proposed certain clarifications and enhancements to its CDS Guaranty Fund methodology. The Risk Model Description will be revised to clarify that the CDS Guaranty Fund size is calculated to cover losses associated with the default of the two Clearing Members and their affiliates that create the greatest cumulative uncollateralized loss under extreme but plausible scenarios. Certain other clarifications will be made in the calculation of the various components of the overall CDS Guaranty Fund requirement.

ICE Clear Europe has also proposed to modify the procedure for allocating CDS Guaranty Fund requirements among the CDS Clearing Members. Under the existing model,

CDS Guaranty Fund allocations reflect a risk “silo” approach, in which a Clearing Member's contribution reflects its uncollateralized exposure for each CDS Guaranty Fund component or “silo”. Under the current approach, allocations can significantly fluctuate in response to position changes in the portfolios of the Clearing Members that drive the CDS Guaranty Fund size, and in response to the distribution of the total CDS Guaranty Fund size across all “silos”. ICE Clear Europe has proposed modifying the methodology, so that the allocations are based on the Clearing Members' total unconditional uncollateralized losses in the CDS product category.⁶ ICE Clear Europe represents that under the proposed approach, the allocations are independent of the distribution of the uncollateralized losses across the “silos”. In ICE Clear Europe's view, the new allocation methodology reflects an improved and more stable approach which allows for easier attributions of contributions to individual CDS Clearing Member or client portfolios.

ICE Clear Europe has also proposed revising the CDS Risk Policy's discussion of the initial CDS Guaranty Fund contribution to be consistent with the requirements of the Finance Procedures.

Index Liquidity and Concentration Charges. ICE Clear Europe has proposed to modify the liquidity charge calculation in the margin model as it applies to index CDS positions. (The existing liquidity charge calculation for single-name CDS will remain unchanged.) ICE Clear Europe represents that the revised approach will address calculation of liquidity charges where index CDS is traded under either price or spread terms, and will calculate a separate liquidity charge for positions in each series of the relevant index. ICE Clear Europe also represents that the revised approach limits the reduction in liquidity charge for offsetting positions across different series of the same index family, by applying the greater of the liquidity charge

⁶ ICE Clear Europe has represented that the existing specific wrong way risk component of the CDS Guaranty Fund calculation is maintained.

applicable to the long and short positions in the relevant portfolio in the same index family. According to ICE Clear Europe, under the revised methodology, the reduction in liquidity charge is greatest across positions in the “on-the-run” (current) index and first (most recent) “off-the-run” indices, with a higher reduction during the period immediately following the index roll (when the two indices are treated as effectively the same index) and a lower reduction over time as the liquidity of contracts in the two series diverge.

ICE Clear Europe has proposed to modify the concentration charge calculation for index CDS positions. (Again, the existing approach for single-name CDS will not change.) ICE Clear Europe represents that the revised framework provides for calculation of series-specific concentration charges, based on the direction of the 5-year equivalent notional amount or the net notional amount of positions in the particular series and a series threshold limit (above which the concentration charge is imposed). According to ICE Clear Europe, series threshold limits are expected to be higher for the on-the-run and the first off-the-run index series, and are determined based on a formula comparing the open interest in the series to the on-the-run open interest.

Intraday Margin Calls. ICE Clear Europe has proposed certain amendments to the intraday risk monitoring and special margin call processes. Under ICE Clear Europe’s proposal, intra-day margin calls will be made based on an “Intraday Risk Limit.” The Intraday Risk Limit will be set at the Clearing Member level and is calculated based on 40% of the total initial margin requirements (across all account classes), with a minimum amount of EUR 15 million and a maximum of EUR 100 million. Intra-day margin calls will be made on the following basis: (i) Where there has been a 50% erosion of the Intraday Risk Limit, the Risk Department will investigate what is driving the shortfall and monitor the CDS Clearing Member, (ii) where the erosion of the Intraday Risk Limit exceeds 50%, the Risk Department will inform the CDS

Clearing Member that its initial margin may cease to be sufficient and that it may be subject to an intraday margin call, and (iii) where there has been a 100% erosion of the Intraday Risk Limit, the Risk Department will issue an intraday margin call to the CDS Clearing Member (and will also contact it by telephone and/or email) for a sum sufficient to reduce the level of Intraday Risk Limit erosion back to 0%. The member intraday shortfall is the sum of intraday shortfalls at the account level (i.e. house and client accounts), and the account level shortfall represents the unrealized profit and loss from the aggregate change in the Mark-to-Market Margin and Initial Margin.

Governance. ICE Clear Europe has proposed revising the CDS Risk Policy to address in further detail management and governance oversight in a new Management and Governance Oversight section. The new section will provide that the CDS Director of Risk is responsible for ensuring that the CDS Risk Policy remains up-to-date and is reviewed in accordance with certain guidelines. The Risk Working Group (“RWG”) and Trading Advisory Committee (“TAC”) will provide on-going consultation and support with respect to the CDS Risk Policy. The composition of the RWG and the TAC will include both ICE Clear Europe Management and Clearing Member representatives, mainly from risk, trading and compliance areas.

Under ICE Clear Europe’s proposal, changes to the CDS Risk Policy will be subject to initial approval by the Director of Risk and may be determined in consultation with the RWG and/or the TAC. Any changes that affect the risk profile of ICE Clear Europe will be subject to Board approval on the advice and support of the CDS Risk Committee and the Board Risk Committee. In addition, the CDS Risk Policy will be subject to at least an annual routine approval by the Board, after consultation with the CDS Risk Committee and the Board Risk

Committee. CDS risk model performance testing will be subject to review by the Director of Risk and reported to the CDS Risk Committee and the Board Risk Committee.

Additional Changes. ICE Clear Europe has proposed certain other clarifications and enhancements in the Risk Policy Amendments. Certain clarifications will be made in the CDS Risk Policy with respect to wrong way risk requirements. The policy will also be revised to clarify that the currency specific initial margin requirements must cover at least the specific and general wrong way risk components of the initial margin requirement for the relevant currency. ICE Clear Europe has also revised the CDS Risk Policy to incorporate (without change) from the its existing CDS clearing membership policy the capital-to-margin ratio limit (which requires that certain remedial actions be taken if the margin requirement for a Clearing Member's CDS positions would exceed three times the Clearing Member's capital as set forth on its balance sheet). The description of the Clearing House's Monte Carlo model will be revised to clarify that model parameters used are the same as those used in the credit spread model. Various other defined terms and certain obsolete references will be updated throughout the CDS Risk Policy and Risk Model Description.

III. Discussion and Commission Findings

Section 19(b)(2)(C) of the Act⁷ 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 Act⁸ 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

⁷ 15 U.S.C. 78s(b)(2)(C).

⁸ 15 U.S.C. 78q-1(b)(3)(F).

agreements, contracts, and transactions and, in general, to protect investors and the public interest.

The Commission finds that the proposed rule change, as modified by Amendment No. 1, is consistent with Section 17A of the Act⁹ and the rules thereunder applicable to ICE Clear Europe, including the requirements of Rule 17Ad-22.¹⁰ The Commission believes that using devolatilized returns should enhance the credit spread response component of the margin model by enabling comparison of returns for periods with different volatilities. The Commission also believes that the proposed framework for establishing RRSR parameters would use a more robust and quantitative driven approach for establishing the RR stress scenarios, resulting in more dynamic and appropriate estimations of the RR stress levels for RRSR purposes. Additionally, the Commission finds that the incorporation of the Lehman Brothers default price scenarios into the computation of the spread response requirements enhances the anti-procyclical feature of ICE Clear Europe's risk methodology.

The Commission further finds that the proposed modifications to the CDS Guaranty Fund allocation methodology to reflect the Clearing Member's total uncollateralized losses across all Guaranty Fund components regardless of the fluctuation of the Clearing Member's uncollateralized losses with respect to each Guaranty Fund component should result in more stable attributions of GF contributions to individual Clearing Member or portfolios. The Commission also believes that the proposed rule change to establish series-specific index liquidity and concentration charges should generally apply a more conservative approach to these margin components. Additionally, the Commission believes that the proposed rule change to intraday margin calls, in conjunction with ICE Clear Europe's existing risk policies and other

⁹ 15 U.S.C. 78q-1.

¹⁰ 17 CFR 240.17Ad-22.

proposed changes to the risk methodology, is reasonably designed to allow ICE Clear Europe to collect sufficient margin to meet its requirements and obligations, including under scenarios where it may have to call for margin on an intraday basis. The Commission also finds that the proposed rule change with respect to governance appropriately engages management and Clearing Member representatives in the oversight of the effectiveness ICE Clear Europe's risk management function. The Commission believes that the proposed additional changes are each designed to enhance ICE Clear Europe's risk management functions and more accurately reflect ICE Clear Europe's current practices. The new provisions in the CDS Risk Policy concerning (i) the responsibilities of the CDS Director of Risk to ensure that the CDS Risk Policy remains up to date and is reviewed in accordance with certain guidelines, to approve changes to the CDS Risk Policy, and to review and report to the CDS Risk Committee and the Board Risk Committee concerning CDS risk model performance testing; and (ii) the roles of the CDS Risk Committee and Board Risk Committee in providing advice on and approving, respectively, changes that affect the risk profile of ICE Clear Europe, improve the clarity of ICE Clear Europe's governance arrangements and promote the effectiveness of the clearing agency's risk management procedures, consistent with Rule 17Ad-22(d)(8).

The Commission therefore believes that the proposed rule change, as modified by Amendment No. 1, is designed to promote the prompt and accurate clearance and settlement of securities transactions and derivative agreements, contracts and transactions cleared by ICE Clear Europe and, in general, to protect investors and the public interest, consistent with Section

17A(b)(3)(F) of the Act¹¹ and is reasonably designed to meet the margin, financial resource and governance requirements of Rules 17Ad-22(b)(2), (b)(3) and (d)(8).¹²

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 of the Act¹³ and the rules and regulations thereunder.

¹¹ 15 U.S.C. 78q-1(b)(3)(F).

¹² 17 CFR 240.17Ad(22)(b)(2), (b)(3) and (d)(8).

¹³ 15 U.S.C. 78q-1.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁴ that the proposed rule change (SR-ICEEU-2015-010), as modified by Amendment No. 1 thereto be, and hereby is, approved.¹⁵

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁶

Robert W. Errett
Deputy Secretary

¹⁴ 15 U.S.C. 78s(b)(2).

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

¹⁶ 17 CFR 200.30-3(a)(12).