

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-80666; File No. SR-LCH SA-2017-005)

May 11, 2017

Self-Regulatory Organizations; LCH SA; Notice of Proposed Rule Change, as modified by Amendment No. 1 Thereto, to Add Rules Related to the Clearing of CDX.NA.HY CDS

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder² notice is hereby given that on April 28, 2017, Banque Centrale de Compensation, which conducts business under the name LCH SA (“LCH SA”), filed with the Securities and Exchange Commission (“Commission”) the proposed rule change described in Items I, II, and III below, which Items have been prepared primarily by LCH SA. On May 5, 2017, LCH SA filed Amendment No. 1 to the proposal.³ The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Clearing Agency’s Statement of the Terms of Substance of the Proposed Rule Change

LCH SA is proposing to amend its (i) CDS Margin Framework and (ii) CDSClear Default Fund Methodology to incorporate terms and make conforming changes to provide for credit default swaps (“CDS”) on the CDX.NA.HY index to be cleared by LCH SA.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ LCH SA filed Amendment No. 1 to replace the initial filing in its entirety for the purpose of clarifying various changes to its CDS Margin Framework.

II. Clearing Agency's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, LCH SA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. LCH SA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of these statements.

A. Clearing Agency's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The purpose of the proposed rule change is to modify LCH SA's CDS Margin Framework and CDSClear Default Fund Methodology to allow LCH SA to clear additional CDS contracts on the CDX.NA.HY index consisting of North America high-yield reference entities. Specifically, LCH SA proposes to amend Sections 3, 4, 5, 6, 8, 10, and 11 of its CDS Margin Framework and Section 2 and 3 of the CDSClear Default Fund Methodology. Each of these changes is described in further detail below.

With respect to the CDS Margin Framework, the heading in Section 3 and the fourth column in the table in Section 3.1.1 will be amended to clarify that the summary of the margin framework also applies to CDX HY contracts.

Section 4.1 of the CDS Margin Framework, setting forth the short charge component of LCH SA's margin methodology, will be amended to describe the purpose of the short charge component within LCH SA's margin methodology and to adjust the calculation to account for CDX.NA.HY index contracts. The purpose of the short charge component is to address the probability of a credit event occurring during the period from the default of a Clearing Member to liquidation of the defaulting Clearing Member's

portfolio, *i.e.*, the so-called “jump to default” risk. Under the proposed rule change, the short charge component of the margin methodology will take into account the risk of clearing CDS contracts on high yield indices. Currently, with respect to a Clearing Member’s portfolio, the short charge in the margin methodology considers the greater of (x) a “Global Short Charge,” derived from the Clearing Member’s largest, or “top,” net short exposure (in respect of any CDS contracts) and its top net short exposure amongst the three “riskiest” reference entities (in respect of any entity type) that are most probable to default in its portfolio and (y) the top two net short exposures in respect of CDS contracts on senior financial entities. Because high yield entities are riskier than senior financial entities by nature and historically defaults of high yield entities appeared more clustered than investment grade or European entities, LCH SA proposes to introduce a “High Yield Short Charge” to replace the top two net short exposures in respect of CDS on senior financial entities in the short charge calculation. Based upon historical data and the maximum number of defaults that have been observed in respect of reference entities in all CDSClear eligible contracts within a 5 business day period, LCH SA believes that the “High Yield Short Charge” should consider not only a Clearing member’s top net short exposure in respect of the high yield CDS contracts in its portfolio but also the top two net short exposures among the three “riskiest” high yield reference entities to reflect the possibility of defaults of multiple, or clustered, high yield entities. As a result, the new short charge under the proposed rule change will be the greater of (x) the “Global Short Charge,” as described above and (y) a “High Yield Short Charge,” derived from a member’s top net short exposure (in respect of high yield CDS) and its top two net short

exposures amongst the three “riskiest” reference entities (in the high yield category) in its portfolio.

Conforming changes will be made throughout Section 4.1.1, which describes the “net short exposure” calculation, to accommodate CDX.NA.HY contracts and to clarify that to obtain margin in Euros all USD denominated variables are converted to Euros utilizing the current USD/Euro foreign exchange rate and calibrated haircut based upon historical data. Similarly, conforming changes will be made in Section 4.1.2 of the CDS Margin Framework, which describes the “top exposure” component of the short charge and Section 4.1.3 of the CDS Margin Framework, which describes the process by which LCH SA identifies the “riskiest” entities in determining the short charge, to incorporate terms for CDX.NA.HY index contracts and to clarify the calculation as it applies to high yield indices. Clarification changes will be made in Section 4.1.4 of the CDS Margin Framework to summarize the calculation for the short charge amount.

Section 4.3 of the CDS Margin Framework will be deleted in its entirety because the substance of that section will be contained in Section 4.1, as described above.

In addition, LCH SA also proposes to amend Section 5.1 of the CDS Margin Framework, which sets forth the wrong way risk (“WWR”) component of LCH SA’s methodology. Currently, LCH SA considers the correlation between the default of a Clearing Member and the default(s) of one or more other financial institutions as part of its WWR management. Specifically, the current approach leverages on the Short Charge framework by calculating the top two net short exposures of financial entities in a Clearing Member’s portfolio following the algorithm described above for the Short Charge margin. LCH SA then compares these top two net short exposures of financial

entities to the short charge margin and imposes the greater of those two as the adjusted jump-to-default charge, to address the WWR arising from the correlation between a Clearing Member default and the default(s) of one or more financial entities in the Clearing Member's portfolio. The proposed rule change does not substantively change this approach but amends Section 5.1 of the CDS Margin Framework to clarify that, when the top two net short exposures in respect of financial entities exceeds the short charge margin, as described above, LCH SA will impose a charge equal to such excess to address the jump-to-default WWR.

Other conforming changes in the CDS Margin Framework will be made in Sections 5, 6, 8, 10, and 11 to clarify that those sections also apply to high yield indices.

With respect to the CDSClear Default Fund Methodology, Section 2.3 will be amended to facilitate clearing of CDS contracts on the CDX High Yield index and to modify the existing stressed short charge component of the CDSClear Default Fund Methodology. Currently, the stressed short charge covers the greater of (x) the top net short exposure plus the top two net short exposures amongst the three entities most likely to default in the Clearing Member's portfolio and (y) the top two net short exposures which are senior financial entities plus the top net short exposures amongst the three senior financial entities most likely to default in the Clearing Member's portfolio. The proposed rule change will take the default of high yield entities into account and add a third prong to the stressed short charge calculation, which will take the greater of (x) and (y), each as described above, and (z) the top two net short exposure which are high yield

entities plus the top two net short exposures amongst the three high yield entities most likely to default in the Clearing Member's portfolio.

Finally, Section 3.8 of the CDSClear Default Fund Methodology, which describes the correlation between index families and series, will be updated to reflect additional data.

2. Statutory Basis.

LCH SA believes that the proposed rule change and the clearing of CDX.NA.HY contracts is consistent with the requirements of Section 17A of the Act⁴ and the regulations thereunder, including the standards under Rule 17Ad-22.⁵ Section 17(A)(b)(3)(F) of the Act⁶ requires, among other things, that the rules of a clearing agency be designed to promote the prompt and accurate clearance and settlement of securities transactions and derivative agreements, contracts, and transactions and 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. As noted above, the proposed rule change is designed to provide for the clearing of CDX.NA.HY contracts. CDX.NA.HY contracts are similar to the contracts currently cleared by LCH SA and will be cleared in the same manner as other index contracts, consistent with LCH SA's existing operational arrangements. Clearing of the additional contracts will allow market participants to manage additional risk and ensure the safeguarding of margin and assets pursuant to LCH SA's rules. Therefore, LCH SA believes that the clearing of CDX.NA.HY and the related changes described herein are consistent with the prompt

⁴ 15 U.S.C. 78q-1.

⁵ 17 CFR 240.17Ad-22.

⁶ 15 U.S.C. 78q-1(b)(3)(F).

and accurate clearance and settlement of securities transactions and derivative agreements, contracts and transactions, in accordance with 17(A)(b)(3)(F) of the Act.⁷

In addition, the proposed amendments to LCH SA's CDS Margin Framework and CDS Clear Default Fund Methodology also satisfy the relevant requirements of Rule 17Ad-22, including Rule 17Ad-22(b)(2), (b)(3), (e)(4) and (e)(6).⁸ Rule 17Ad-22(b)(2) requires a clearing agency 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.⁹ Rule 17Ad-22(e)(4)(i) requires a covered clearing agency to maintain sufficient financial resources to cover its credit exposure to each participant fully with a high degree of confidence,¹⁰ and Rule 17Ad-22(e)(6)(i) requires a covered clearing agency that provides central counterparty services 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.¹¹ The proposed rule change to LCH SA's CDS Margin Framework will take into account the risk particular to clearing CDS on high yield entities as part of LCH SA's jump-to-default risk management and wrong way risk management and produce margin levels commensurate with the risks and attributes of CDS on high yield entities and maintain margin sufficient to cover its credit exposure to its participants fully in normal market conditions, consistent with

⁷ 15 U.S.C. 78q-1(b)(3)(F).

⁸ 17 CFR 240.17Ad-22.

⁹ 17 CFR 240.17Ad-22(b)(22).

¹⁰ 17 CFR 240.17Ad-22(e)(4)(i).

¹¹ 17 CFR 240.17Ad-22(e)(6)(i).

requirements of Rule 17Ad-22(b)(2), (e)(4)(i) and (e)(6)(i).¹² Moreover, Rule 17Ad-22(b)(3) requires a clearing agency acting as a central counterparty for security-based swaps to establish policies and procedures reasonably designed to 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 (the “cover two standard”).¹³ Similarly, Rule 17Ad-22(e)(4)(ii) requires a covered clearing agency that provides central counterparty services for security-based swaps to maintain financial resources additional to margin to enable it to cover a wide range of foreseeable stress scenarios that include, but are not limited to, meeting the cover two standard.¹⁴ LCH SA believes that its CDSClear Default Fund Methodology, with the modifications described herein, will provide a stress short charge appropriately incorporating the risk of clearing CDS on high yield entities, which, together with its margin methodology, will ensure that LCH SA maintains sufficient financial resources to meet the cover two standard, in accordance with Rule 17Ad-22(b)(3) and (e)(4)(ii).¹⁵ LCH SA also believes that the clearing of CDX.NA.HY contracts is consistent with Rule 17Ad-22(d)(4) and (e)(17),¹⁶ in that clearing the additional contracts will be substantially the same from an operational perspective as clearing existing contracts and LCH SA believes that its existing systems are adequately scalable to facilitate the clearing of additional contracts

¹² 17 CFR 240.17Ad-22(b)(2), (e)(4)(i) and (e)(6)(i).

¹³ 17 CFR 240.17Ad-22(b)(3).

¹⁴ 17 CFR 240.17Ad-22(e)(4)(ii).

¹⁵ 17 CFR 240.17Ad-22(b)(3) and (e)(4)(ii).

¹⁶ 17 CFR 240.17Ad-22(d)(4) and (e)(17).

B. Clearing Agency's Statement on Burden on Competition

Section 17A(b)(3)(I) of the Act requires that the rules of a clearing agency not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.¹⁷ LCH SA does not believe that its clearing of CDX.NA.HY contracts will adversely affect the trading market for those contracts or CDS generally. By allowing LCH SA to clear CDX.NA.HY contracts, market participants will have additional choices on where to clear CDX.NA.HY contracts, which, in turn, will promote competition and further the development of CDX.NA.HY contracts for risk management. Further, LCH SA will apply its existing fair and open access criteria to the clearing of CDX.NA.HY contracts. Accordingly LCH SA does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Clearing Agency's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

Written comments relating to the proposed rule change have not been solicited or received. LCH SA will notify the Commission of any written comments received by LCH SA.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period up to 90 days (i) as the Commission may designate if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

¹⁷ 15 U.S.C. 78q-1(b)(3)(I).

(A) by order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change 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-2017-005 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-2017-005. 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 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, DC 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 <http://www.lch.com/asset-classes/cdsclear>.

All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-LCH SA-2017-005 and should be submitted on or before [Commission to insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁸

Brent J. Fields
Secretary

¹⁸ 17 CFR 200.30-3(a)(12).