SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-82345; File No. SR-LCH SA-2017-009)

December 18, 2017

Self-Regulatory Organizations; LCH SA; Order Approving Proposed Rule Change Relating to Wrong Way Risk Margin

I. Introduction

On October 30, 2017, Banque Central 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"),[1] and Rule 19b-4 thereunder,[2] a proposed rule change (SR-LCH SA-2017-009) to amend its Reference Guide: CDS Margin Framework ("CDSClear Margin Framework" or "Framework") to adjust the manner in which the wrong way risk ("WWR") margin component of the Framework addresses offsets between currencies when calculating WWR margin. The proposed rule change was published for comment in the Federal Register on November 16, 2017.[3] The Commission received no comment letters regarding the proposed change. For the reasons discussed below, the Commission is approving the proposed rule change.

II. Description of the Proposed Rule Change

LCH SA has proposed to amend its CDSClear Margin Framework to adjust the manner in which the WWR margin component of the Framework addresses offsets

---

1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 Securities Exchange Act Release No. 34-82043 (November 9, 2017), 82 FR 53536 (November 16, 2017) (SR-LCH-SA-2017-009) ("Notice").

between currencies when calculating WWR margin. According to LCH SA, the WWR component of the Framework is designed to cover the anticipated financial contagion effect that would arise in case of a clearing member being declared in default. The current WWR margin formula provides for offsets between currencies by allowing offset between WWR and right way risk ("RWR"). Specifically, under the current approach, a WWR currency offset is applied as the greater of: (x) the WWR amount in Euros minus the RWR amount in Euros[4]; and (y) the WWR amount in Euros multiplied by 1 minus a factor representing the correlation between European and U.S. financial institutions by calculating the average historical cross correlation of credit spreads on credit default swaps ("CDS") with respect to all pairs of European and U.S. financial institutions that are clearing members of LCH SA.[5] Under this approach, if one currency has WWR and the other has RWR, LCH SA would compare the WWR amount, as offset by the RWR, to the WWR amount, which is reduced by scaling the WWR by 1 minus the correlation factor, and take the greater of these two amounts.[6] As a result, either the full amount of RWR is allowed to offset the WWR, or only a portion of the WWR is taken into account without any regard to the amount of RWR.[7]

LCH SA proposed to revise this approach by amending the WWR currency offset formula in the Framework to set the WWR margin component of Framework as the

---

4 Amounts not denominated in Euros are converted to Euros using a foreign exchange rate plus or minus a haircut. See, Notice, 82 FR at 53536.

5 Id.

6 Id.

7 Id.

greater of: (i) the WWR amount in Euros, minus the RWR amount multiplied by the 10-year average historical correlation of credit spreads on CDS in respect of European and U.S. financial institutions; and (ii) zero. Thus, under the proposed approach, RWR would never completely offset WWR, but rather would offset WWR after discounting it based on the average of observed correlations of CDS credit spreads with respect to European and U.S. financial institutions.[8]

III. Discussion and 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 such proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to such organization.[9] Section 17A(b)(3)(F) of the Act[10] requires, among other things, that the rules of a registered clearing agency be designed to promote the prompt and accurate clearance and settlement of securities transactions and, to the extent applicable, derivative agreements, contracts, and transactions, as well as to assure the safeguarding of securities and funds which are in the custody and control of the clearing agency or for which it is responsible, and to protect investors and the public interest. Rule 17Ad-22(b)(2) requires, in relevant part, a registered clearing agency that performs central counterparty services to establish, implement, maintain and enforce written policies and procedures that are reasonably designed to use margin requirements to limit

---

8 Id.

9 15 U.S.C. 78s(b)(2)(C).

10 15 U.S.C. 78q-1(b)(3)(F).

its credit exposures to participants under normal market conditions and use risk-based models and parameters to set margin requirements.[11] Rules 17Ad-22(e)(6)(i) and (v) require 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, among other things, considers and produces margin levels commensurate with, the risks and particular attributes of each relevant product, portfolio, and market, and uses an appropriate method for measuring credit exposure that accounts for relevant product risk factors and portfolio effects across products.[12]

The Commission finds that the proposed rule change is consistent with Section 17A(b)(3)(F) of the Act and the relevant provisions of Rule 17Ad-22 thereunder**.** Specifically, the Commission believes that the proposed rule change will enhance LCH SA's assessment of the risks associated with clearing products that may exhibit WWR, and thereby collect an appropriate level of resources, which in turn will improve LCH SA's ability to withstand the default of a Clearing Member. As a result, the Commission believes that the proposed rule change will augment LCH SA's ability to safeguard the securities and funds which are in its custody and control. Therefore, the Commission finds that the proposed rule change is consistent with the requirements of Section 17A(b)(3)(F) of the Act.

Moreover, the Commission believes that WWR is a relevant factor when considering the risks associated with clearing securities products, including CDS products,

---

11 17 CFR 240.17Ad-22(b)(2).

12 17 CFR 240.17Ad-22(e)(6)(i) and (v).

and when developing margin models to cover credit exposures associated with providing clearance and settlement services for such products. By ensuring that it will take into consideration both WWR and RWR as proposed, LCH SA will have margin that more accurately measures the level of risk, and should therefore produce margin requirements that are commensurate with such risks, as well as the attributes of the products it clears. Accordingly, the Commission finds that the proposed rule change is consistent with the requirements of Rule 17Ad-22(b)(2) and Rule 17Ad-22(e)(6)(i) and (v).

IV. Conclusion

IT IS THEREFORE ORDERED pursuant to Section 19(b)(2) of the Act that the proposed rule change (SR-LCH SA-2017-009) be, and hereby is, approved.[13]

For the Commission by the Division of Trading and Markets, pursuant to delegated authority.[14]

Robert W. Errett
Deputy Secretary

---

13 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).

14 17 CFR 200.30-3(a)(12).