

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-87485; File No. SR-LCH SA-2019-005)

November 7, 2019

Self-Regulatory Organizations; LCH SA; Order Approving Proposed Rule Change Relating to (i) Introduction of Clearing of the New Markit iTraxx Subordinated Financials Index CDS and the Related Single Name CDS Constituents; (ii) Enhancements to Wrong Way Risk Margin; and (iii) Modification to Default Fund Additional Margin

I. Introduction

On August 2, 2019, Banque Centrale 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 to amend its rules to (i) introduce clearing of new Markit iTraxx Subordinated Financials Index CDS and the Related Single Name CDS Constituents (together “Subordinated Financials”); (ii) incorporate changes to the Wrong Way Risk (“WWR”) margin recommended as a result of a risk model validation; and (iii) modify the Default Fund Additional Margin (“DFAM”). The proposed rule change was published for comment in the Federal Register on August 9, 2019.³ On August 30, 2019, the Commission designated a longer period for taking action on the proposed rule change to November 7, 2019.⁴ The Commission did not receive comments on the proposed rule change. For the reasons discussed below, the Commission is approving the proposed rule change.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 86576 (Aug. 6, 2019), 84 FR 39386 (Aug. 9, 2019) (SR-LCH-SA-2019-005) (“Notice”).

⁴ Securities Exchange Act Release No. 86834 (Aug. 30, 2019), 84 FR 46984 (Sep. 6, 2019) (SR-LCH-SA-2019-005)

II. Description of the Proposed Rule Change

A. Subordinated Financials

To introduce clearing of Subordinated Financials,⁵ the proposed rule change would make changes to (i) the Reference Guide: CDSClear Margin Framework and CDSClear Default Fund Methodology (together the “CDSClear Risk Methodology”); (ii) the CDS Clearing Supplement (“Supplement”); and (iv) the CDS Clearing Procedures (“Procedures”).⁶

i. Changes to the CDSClear Risk Methodology

LCH SA’s existing Total Initial Margin Framework is comprised of the following components: Self Referencing Margin; Spread Margin; WWR Margin; Short Charge Margin; Interest Rate Risk Margin; Recovery Rate Margin; Vega Margin; and certain additional margins, including Liquidity and Concentration Risk Margin. The proposed rule change would apply LCH SA’s existing margin methodology to the clearing of Subordinated Financials, and in doing so, would adapt certain components of that margin methodology for the clearing of Subordinated Financials. Specifically, the proposed rule change would adapt the Spread Margin, WWR Margin, Short Charge Margin, and Liquidity and Concentration Risk Margin components to the clearing of Subordinated Financials.

With respect to the Spread Margin, LCH would use the historical data available for Subordinated Financials and would consider Subordinated Financials to be a different instrument than senior debt for purposes of portfolio margining.

⁵ The following description is substantially excerpted from the Notice. See Notice, 84 FR at 39386. For further explanation on the background and creation of Subordinated Financials, see Notice, 84 FR at 39386.

⁶ Capitalized terms not otherwise defined herein have the meanings assigned to them in the LCH SA rulebook, the CDSClear Risk Methodology, Supplement, or Procedures.

With respect to WWR Margin, the proposed rule change would cover Subordinated Financials with specific shocks calibrated from available historical data.

With respect to the Short Charge, the proposed rule change would apply to Subordinated Financials the existing global short charge that covers non-financials, but would consider shocks in the recovery rates to ensure that the short charge covers the different recovery rates for Subordinated Financials. With respect to calculating the short charge for portfolios containing Subordinated Financials, LCH believes that considering shocks in the recovery rates without modifying the number of defaults would lead to overly conservative margins where jump-to-default would outweigh other components of the margin methodology.⁷ To avoid this outcome the proposed rule change would decrease the number of expected credit events in the five days following the default of a Clearing Member from two to one, by moving the second credit event to the “extreme market conditions” category as opposed to the “normal market conditions” category. The proposed rule change would also calculate the exposure the portfolio has to each underlying reference entity and the probability of each combination of defaults, to define the maximum amount that could be lost with a 99.7% confidence due to default events. The proposed rule change would then retain the greater of this calculated amount and the top exposure with a shifted recovery rate as the Short Charge margin.

Finally, the proposed rule change would make similar changes with respect to the stressed short charge and global short charge, and a specific change for CDX.HY names, by taking the stress short charge as the maximum of the sum of the top two exposures and the average across the ten riskiest entities.

⁷ See Notice, 84 FR at 39387.

With respect to Liquidity and Concentration Risk Margin, the proposed rule change would apply the existing liquidity charge to Subordinated Financials as a new instrument but would consider Subordinated Financials jointly with Senior CDS for purposes of the concentration charge component of the margin charge.

ii. Changes to the Supplement

The proposed rule change would amend the Supplement, which establishes the legal terms for CDS transactions cleared by LCH SA. The proposed rule change would amend the Supplement to include relevant language needed for clearing Subordinated Financials. Specifically, with respect to defining Credit Events, the proposed rule change would change various references to “Restructuring Credit Event” to “M(M)R Restructuring” or add references “M(M)R Restructuring”, to make clear that these provisions apply to a restructuring that is a “M(M)R Restructuring.” This change is needed because clearing Subordinated Financials would introduce transactions for which Restructuring is a Credit Event but where “M(M)R Restructuring” is not applicable, and thus, in specifying provisions that would apply to “M(M)R Restructuring” the proposed rule change would clarify that these provisions would not apply to a restructuring of Subordinated Financials. Moreover, a number of provisions of the Supplement, such as the defined terms, apply to all Cleared Transactions that refer to a Reference Entity, which would include Cleared Transactions involving Subordinated Financials. However, the clearing of Subordinated Financials would mean that a portfolio could contain CDS contracts that have the same underlying Reference Entity but which reference different seniorities of debt issued by that Reference Entity. Certain Credit Events or Succession Events with respect to a Reference Entity could apply or not apply to a CDS contract, depending on seniority and / or transaction type. Thus, where appropriate and necessary, the proposed rule change would add wording to the relevant provisions of the Supplement to clarify that that, depending on the

Reference Entity, Transaction Type, or Reference Obligation, those provisions may apply or not apply to a specific transaction. In connection with this change, the proposed rule change would also add a definition for, and various references to, the term “Component Transaction” to distinguish further cleared transactions by Reference Entity and Transaction Type. The proposed rule change would also make various modifications to use of the Physical Settlement Matrix to accommodate clearing of Subordinated Financials.

Finally, unrelated to the clearing of Subordinated Financials, the proposed rule change would modify inaccurate references to the CCM Client account structure. Earlier this year, LCH SA amended its rules to permit Clearing Members to create multiple account structures for a single client and multiple trade accounts per client within a single omnibus account structure.⁸ In line with that change, the proposed rule change would update certain portions of the Supplement to make clear that Clearing Members may create multiple account structures for a single client and multiple trade accounts per client within a single omnibus account structure. LCH SA did not make these changes in the earlier amendment, and the proposed rule change would make these changes now to ensure consistency with the amendment from earlier this year. The proposed rule change would also make various typographical and technical corrections to the CDS Clearing Supplement and update references as needed.

iii. Changes to the Procedures

Consistent with the changes to the Supplement, the proposed rule change would modify Section 4 of the Procedures to treat transactions differently depending upon the Transaction Type and/or seniority of a transaction. Similarly, the proposed rule change would add a reference to

⁸ Securities Exchange Act Release No. 86376 (July 15, 2019), 84 FR 34955 (July 19, 2019) (SR-LCH-SA-2019-003).

seniority and Reference Entity, Transaction Type, and Reference Obligation in Procedure 4.3. As discussed above, the clearing of Subordinated Financials would mean that a portfolio could contain CDS contracts that have the same underlying Reference Entity but which reference different seniorities of debt issued by that Reference Entity. Thus, the proposed rule change would modify Section 4 of the Procedures to distinguish the Reference Obligation by seniority level, if applicable.

B. WWR Margin

To address certain recommendations arising out of a recent model validation, the proposed rule change would make two changes to WWR margin designed to enhance the WWR margin's stability and decrease its volatility. First, the proposed rule change would calculate WWR margin as if it was inside the expected shortfall. Second, the proposed rule change would include the iTraxx Main index in the WWR margin calculation, with a dedicated shock defined separately from the iTraxx Senior Financials and iTraxx Subordinated Financials indices.

C. Modification to DFAM

Independent of and unrelated to LCH SA's proposal to introduce the clearing of Subordinated Financials, the proposed rule change would also modify DFAM. LCH SA's intent in collecting DFAM is to ensure that LCH SA collects from a Clearing Member additional margin to account for the stress risk of that Clearing Member above a certain threshold (defined as a percentage of the size of the Default Fund and dependent on the internal credit score of the Clearing Member). In other words, DFAM gradually demutualizes a Clearing Member's stress risk above and beyond a certain threshold of the Default Fund by collecting additional margin from that Clearing Member (rather than covering such stress risk through the Default Fund). However, according to LCH SA, it does not intend to require Clearing Members to deposit a

total amount of resources for a given clearing service higher than that Clearing Member's worst stress loss for that service. To ensure that the sum of all resources called from a Clearing Member, including DFAM, does not exceed the stress tested loss measured for that Clearing Member, consistent with LCH SA's intent in collecting DFAM,⁹ the proposed rule change would put in place a cap on the amount of DFAM to ensure that, in collecting DFAM, LCH SA does not unintentionally require a Clearing Member to contribute resources greater than the Clearing Member's worst stress loss. The proposed rule change would do so by amending the CDSClear Default Fund Methodology to ensure that DFAM could not exceed a Clearing Member's Stress Test Loss Over Additional Margin, which would be defined as a Clearing Member's Stress Test Loss, minus that Clearing Member's contribution to the Default Fund.

III. 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 the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to the organization.¹⁰ For the reasons given below, the Commission finds that the proposed rule change is consistent with Section 17A(b)(3)(F) of the Act¹¹ and Rules 17Ad-22(e)(1) and (e)(6)(i) thereunder.¹²

A. Consistency with Section 17A(b)(3)(F) of the Act

Section 17A(b)(3)(F) of the Act requires, among other things, that the rules of LCH SA be designed to promote the prompt and accurate clearance and settlement of securities

⁹ See Notice, 84 FR at 39387.

¹⁰ 15 U.S.C. 78s(b)(2)(C).

¹¹ 15 U.S.C. 78q-1(b)(3)(F).

¹² 17 CFR 240.17Ad-22(e)(1) and (e)(6)(i).

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 LCH SA or for which it is responsible, and, in general, to protect investors and the public interest.¹³

As described above, the proposed rule change would facilitate the clearing of Subordinated Financials by LCH SA, which, as discussed above, consist of the Markit iTraxx Subordinated Financials Index CDS and Related Single Name CDS Constituents. To do so, the proposed rule change would amend the CDSClear Risk Methodology to apply LCH SA's existing margin methodology to Subordinated Financials and, relatedly, amend the Supplement and the Procedures to add new terms and revise existing terms and references as necessary to ensure that Subordinated Financials are clearly and accurately defined and referenced throughout LCH SA's existing rulebook. By making these changes to facilitate LCH SA's clearance and settlement of these additional CDS contracts, the Commission believes the proposed rule change would promote the prompt and accurate clearance and settlement of securities transactions.

Moreover, as described above, the proposed rule change would make a number of changes to LCH SA's margin methodology, which the Commission believes would improve the operation and effectiveness of the margin methodology. First, in adapting LCH SA's margin methodology to the clearance and settlement of Subordinated Financials, the Commission believes that the proposed rule change would help to ensure that LCH SA's margin system effectively deals with, and collects margin to cover, the risks associated with clearing these additional CDS contracts. Second, the Commission believes that, by incorporating the changes to the WWR margin described above, the proposed rule change would help to ensure that WWR margin operates effectively and accurately captures and covers the wrong-way-risk associated

¹³ 15 U.S.C. 78q-1(b)(3)(F).

with clearing certain portfolios. Finally, the Commission believes that in establishing a cap on DFAM the proposed rule change would help to ensure that LCH SA does not require Clearing Members to deposit a total amount of resources for a given clearing service higher than their worst stress loss for that service, consistent with LCH SA's intent in collecting DFAM.

Given that an effective margin system is necessary to manage LCH SA's credit exposures to its Clearing Members and the risks associated with clearing security based swap-related portfolios, the Commission believes that the proposed rule change would help improve LCH SA's ability to avoid potential losses that could result from the mismanagement of credit exposures and the risks associated with clearing security based swap-related portfolios. Because such losses could disrupt LCH SA's ability to promptly and accurately clear security based swap transactions, the Commission believes that the proposed rule change, by improving the operation and effectiveness of LCH SA's margin system, would thereby help promote the prompt and accurate clearance and settlement of securities transactions. Similarly, given that such losses could threaten LCH SA's ability to operate, thereby threatening access to securities and funds in LCH SA's control, the Commission believes that the proposed rule change would help assure the safeguarding of securities and funds which are in the custody or control of the LCH SA or for which it is responsible. For both of these reasons, the Commission believes the proposed rule change would, in general, protect investors and the public interest. Finally, the Commission believes that in helping to ensure that LCH SA does not collect from a Clearing Member DFAM higher than its worst stress loss, the proposed rule change would leave a Clearing Member with additional liquidity to engage in CDS transactions, which would therefore promote the clearance and settlement of CDS transactions.

Finally, as discussed above, the proposed rule change would correct typographical errors, make technical corrections, and update references as needed to the Supplement and Procedures, including modifying inaccurate references to the CCM Client account structure. The Commission believes that these changes would help to ensure that the Supplement and Procedures are clear and operate effectively, consistent with LCH SA's intent. The Commission further believes that clear and effective Supplement and Procedures are necessary for LCH SA to promptly and accurately clear and settle CDS transactions, and therefore that this aspect of the proposed rule change also would promote the prompt and accurate clearance and settlement of securities transactions.

Therefore, the Commission finds that the proposed rule change would promote the prompt and accurate clearance and settlement of securities transactions, assure the safeguarding of securities and funds in LCH SA's custody and control, and in general, protect investors and the public interest, consistent with the Section 17A(b)(3)(F) of the Act.¹⁴

B. Consistency with Rule 17Ad-22(e)(1)

Rule 17Ad-22(e)(1) requires that LCH SA establish, implement, maintain, and enforce written policies and procedures reasonably designed to provide for a well-founded, clear, transparent, and enforceable legal basis for each aspect of its activities in all relevant jurisdictions.¹⁵ The Commission believes that the proposed rule change, in introducing new terms, as well as correcting typographical errors and updating references, would help to ensure that the Supplement and Procedures provide a consistent and enforceable legal basis for clearing

¹⁴ 15 U.S.C. 78q-1(b)(3)(F).

¹⁵ 17 CFR 240.17Ad-22(e)(1).

Subordinated Financials. Therefore, the Commission finds that the proposed rule change is consistent with Rule 17Ad-22(e)(1).¹⁶

C. Consistency with Rule 17Ad-22(e)(6)(i)

Rule 17Ad-22(e)(6)(i) requires that LCH SA establish, implement, maintain, and enforce written policies and procedures reasonably designed 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.¹⁷

The Commission believes that the proposed rule change, in adapting LCH SA's margin methodology to the clearance and settlement of Subordinated Financials, would help to ensure that LCH SA's margin system considers, and produces margin levels commensurate with, the risks and particular attributes of these additional CDS contracts. Moreover, the Commission believes that, by incorporating the changes to the WWR margin described above, the proposed rule change would help to ensure that LCH SA's margin system considers, and produces margin levels commensurate with, the wrong-way-risk associated with clearing certain portfolios. Finally, in capping DFAM to ensure that Clearing Members are not required to deposit a total amount of resources for a given clearing service higher than their worst stress loss for that service, consistent with LCH SA's intent, the Commission believes that the proposed rule change would help to ensure that LCH SA's margin requirement does not exceed the stress loss risk associated with a Clearing Member, and thus is set at a level commensurate with the stress risk posed by a particular Clearing Member's portfolio. Because the proposed rule change would not

¹⁶ Id.

¹⁷ 17 CFR 240.17Ad-22(e)(6)(i).

prevent LCH SA from collecting DFAM up to the stress loss risk associated with a Clearing Member, however, the Commission believes the proposed rule change would not interfere with LCH SA's ability to cover its credit exposures to Clearing Members through DFAM.

Therefore, the Commission finds that the proposed rule change is consistent with Rule 17Ad-22(e)(6)(i).¹⁸

¹⁸

Id.

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(b)(3)(F) of the Act¹⁹ and Rules 17Ad-22(e)(1) and (e)(6)(i) thereunder.²⁰

IT IS THEREFORE ORDERED pursuant to Section 19(b)(2) of the Act²¹ that the proposed rule change (SR-LCH-SA-2019-005), be, and hereby is, approved.²²

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

Jill M. Peterson
Assistant Secretary

¹⁹ 15 U.S.C. 78q-1(b)(3)(F).

²⁰ 17 CFR 240.17Ad-22(e)(1) and (e)(6)(i).

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).