

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-93176; File No. SR-LCH SA-2021-002)

September 29, 2021

Self-Regulatory Organizations; LCH SA; Order Approving Proposed Rule Change Relating to Eligible Collateral and Liquidity Risk Management

I. Introduction

On August 18, 2021, Banque Centrale de Compensation, which conducts business under the name LCH SA (“LCH SA”), filed with the Securities and Exchange Commission (“Commission” or “SEC”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”),¹ and Rule 19b-4,² a proposed rule change to expand the non-cash collateral that a Clearing Member may post with LCH SA to meet margin requirements and make certain other changes as described further below.³ The proposed rule change was published for comment in the Federal Register on August 27, 2021.⁴ The Commission did not receive comments regarding 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 Capitalized terms used but not defined herein have the meanings specified in the CDS Clearing Rule Book, the CDS Clearing Procedures, the Clearing Notice, or the Liquidity Risk Modelling Framework the Clearing Regulations, as applicable.

⁴ Self-Regulatory Organizations; LCH SA; Notice of Filing of Proposed Rule Change to Relating to Eligible Collateral and Liquidity Risk Management, Exchange Act Release No. 34-92723 (Aug. 23, 2021); 86 Fed. Reg. 48257 (Aug. 27, 2021) (SR-LCH SA-2021-002) (“Notice”).

II. Description of the Proposed Rule Change

A. Additional Eligible Collateral

The proposed rule change would expand the list of non-cash collateral that a Clearing Member may post with LCH SA to meet margin requirements to include certain non-Euro government securities.⁵ To carry out this change, LCH SA would publish a new Clearing Notice, in accordance with Article 4.2.6.1 of the CDS Clearing Rule Book (the “Rule Book”), specifying the additional acceptable non-Euro government securities.⁶ The Clearing Notice would refer to the additional acceptable non-Euro government securities as the “New Instruments.” The Clearing Notice would further specify that only New Instruments with a minimum outstanding amount equivalent of 500 million Euros would be eligible.

Moreover, the Clearing Notice would specify that New Instruments transferred by a Clearing Member to LCH SA as Collateral shall be taken into account to satisfy the Clearing Member’s Margin Requirements only up to 15% of the total Margin Requirements and New Instruments transferred by a Clearing Member to LCH SA as Collateral in excess of such 15% cap shall be ignored for the purposes of determining whether the Clearing Member’s Margin Requirements are satisfied. LCH SA is including this particular limitation because the European

⁵ This description is substantially excerpted from the Notice, 86 Fed. Reg. at 48257.

⁶ The additional non-Euro Eligible Collateral would be: (i) Australian Treasury Bills and Government Bonds; (ii) Canadian Treasury Bills and Government Bonds; (iii) Danish Treasury Bills and Government Bonds; (iv) Japanese Treasury Bills, Treasury Discount Bills, and Government Bonds; (v) Norwegian Treasury Bills and Government Bonds; (vi) Swedish Treasury Bills and Government Bonds; and (vii) Swiss Treasury Bills and Government Bonds.

Central Bank will not convert New Instruments to Euros and LCH SA currently does not otherwise have the operational capacity to convert New Instruments to Euros.⁷

Moreover, LCH SA has determined, at this time, not to treat New Instruments as Pledged Eligible Collateral. Pledged Eligible Collateral is that Eligible Collateral which a Clearing Member may pledge to LCH SA under a pledge agreement entered into between LCH SA and the Clearing Member. Under Article 3.2.3.2 of the Rule Book, Pledged Eligible Collateral is transferred to LCH SA using a Belgian law security interest with no title transfer pursuant to the applicable provisions of Belgian law. LCH SA determined that Clearing Member interest was not sufficient to justify the additional operational resources needed to allow the transfer of New Instruments as Pledged Eligible Collateral. Accordingly, the Clearing Notice would specify that New Instruments are not eligible as Pledged Eligible Collateral. Moreover, the proposed rule change would amend the definition of Pledged Eligible Collateral in Section 1.1.1 of the Rule Book to provide that the term means “Eligible Collateral as described in a Clearing Notice which is pledged in accordance with a Pledge Agreement.” Because the proposed Clearing Notice would specify that New Instruments are not Pledged Eligible Collateral, this proposed change would exclude New Instruments from the definition of Pledged Eligible Collateral in Section 1.1.1 of the Rule Book.

In furtherance with this change, the proposed rule change also would amend Section 3.13 of the CDS Clearing Procedures. Section 3.13 describes how Clearing Members may transfer Eligible Collateral pursuant to a Pledge Agreement under Article 3.2.3.2 of the Rule Book. The

⁷ Notice, 86 Fed. Reg. at 48257.

proposed rule change would clarify that the term Eligible Collateral, as used in Section 3.13, means Eligible Collateral as described in a Clearing Notice. Because the proposed Clearing Notice would specify that New Instruments are not Pledged Eligible Collateral, this proposed change would exclude New Instruments from amended Section 3.13 of the CDS Clearing Procedures.

The proposed rule change also would amend LCH SA's Liquidity Risk Modelling Framework (the "Framework") to take into account this expansion of Eligible Collateral. The Framework describes the Liquidity Stress Testing framework by which the Collateral and Liquidity Risk Management department of LCH Group Holdings Limited ("CaLM") assures that LCH SA has enough cash available to meet any financial obligations, both expected and unexpected, that may arise over the liquidation period for each of the clearing services that LCH SA offers. The proposed rule change would amend Sections 4.1.3, 4.1.4, 5.2.1.1, 5.3.5, and 5.4.3 of the Framework to clarify that LCH SA will exclude New Instruments from the calculation of LCH SA's liquidity resources. The proposed rule change would further specify the reason for this exclusion: New Instruments are not European Central Bank eligible and currently not covered by CaLM's activities for transformation into Euros. In other words, the European Central Bank will not convert New Instruments to Euros and LCH SA currently does not otherwise have the operational capacity to convert them to Euros.⁸ For this same reason, the

⁸ Notice, 86 Fed. Reg. at 48257.

proposed rule change would amend Section 5.5.1 of the Framework to clarify that Non-Euro, non-cash Collateral like the New Instruments are not European Central Bank eligible assets.

Finally, in accordance with these changes, the proposed rule change also would amend Section 3.9 of the CDS Clearing Procedures to update the link to the portion of LCH SA's website that contains a list of Eligible Collateral.

B. Other Changes

In addition to the expansion of Eligible Collateral, the proposed rule change would also expand the custodians at which Clearing Members may deposit Eligible Collateral by adding Clearstream Banking Luxembourg as a central securities depository for LCH SA. The proposed rule change would amend Section 3.4(d) of the CDS Clearing Procedures to include Clearing Banking Luxembourg in the list of entities through which securities may be transferred to LCH SA. Similarly, the proposed rule change would amend Sections 3.10 and 3.12 to include Clearing Banking Luxembourg in the list of central securities depositories in which LCH SA holds Eligible Collateral.

Moreover, unrelated to the expansion of Eligible Collateral, the proposed rule change also would amend the Framework to clarify certain sections, tables, and formula in response to model validations and other routine updates. Beginning in Section 4.1.1, Description of sources of liquidity, the proposed rule change would add description to clarify LCH SA's ability to use Collateral as a source of liquidity. Specifically, the proposed rule change would clarify that, with limited exceptions, LCH SA generally receives Collateral on a full title transfer basis, which permits LCH SA to use such collateral, to offset it with all related claims and to consider such Collateral available for liquidity purposes. As would be described, the two exceptions are: (i)

Collateral deposited through a pledge and (ii) Collateral deposited through a central bank guarantee.

Next, in Sections 4.1.3 and 4.1.4, the proposed rule change would clarify that Collateral deposited through a pledge may be used for liquidity purposes only if the Clearing Member pledging such Collateral has defaulted.

The proposed rule change also would amend Section 4.1.4 regarding the use of non-Euro cash Collateral posted in full title by Clearing Members (*i.e.* Collateral that is not pledged). Section 4.1.4 currently describes how such Collateral may be used to raise liquidity and how CaLM has demonstrated its ability to raise Euro cash with non-Euro non-cash collateral. The proposed rule change would specify that the non-Euro non-cash collateral used by CaLM in that case was collateral in USD and GBP. The proposed rule change also would add to Section 4.1.4 a short explanation of the overdraft facility in place with Citibank that allows LCH SA to source non-Euro currencies in case of liquidity needs.

In Section 4.2.1.4, the proposed rule change would update the table of figures of the liquidity injected in the settlement system to smooth settlement activity. LCH SA represents that these figures are updated periodically in line with the observed cash flows.⁹

In Section 5.1.1, the proposed rule change would clarify that LCH SA has a group policy that allows LCH SA to perform an extraordinary margin call if liquidity deteriorates.

Section 5.1.2 currently describes how LCH SA monitors liquidity risks potentially arising from operational issues at settlement platforms and how any warnings about such risks are

⁹ Notice, 86 Fed. Reg. at 48258.

escalated to senior management to provide colours. The proposed rule change would replace the word “colours” with “justifications.”

Section 5.2.1.1 currently notes that investments maturing over the operational target are not factored as liquidity resources for certain purposes. The proposed rule change would replace the word “over” with “beyond.”

In Section 5.3.1, which provides an overview of the Liquidity Coverage Ratio (“LCR”), the proposed rule change would add an explanation that the LCR is an internal ratio similar, but not equivalent, to the banking metric defined in the Basel III framework and is used to ensure compliance with EMIR. The proposed rule change would also correct two typographical errors in Section 5.3.1.

Section 5.3.1.1 currently describes the assessment of the market risk related to the volatility of the value of the securities arising from RepoClear settlement and pledged at the Banque de France. The proposed rule change would add further description of the formula and assumptions used in making that assessment.

Next, the proposed rule change would amend Section 5.3.1.3, to clarify the treatment of settlement risk to account for early exercise of American-style options. The proposed rule change would describe how the liquidity needs coming from American-style options are computed.

Section 5.3.1.4 currently specifies that the liquidity needs arising from variation margin are assessed consistent with the relevant listed derivatives stress scenario. The proposed rule change would specify that such scenario includes spread shifts and implied volatility shifts, thus clarifying the calculation of that particular LCR component. The proposed rule change would make similar updates to Sections 5.3.1.5 and 5.3.4.

In Section 5.5, the proposed rule change would delete a duplicated sentence.

Section 5.5.1 of the Framework describes the independent stress of various risk factors, and it includes a discussion of how many defaults LCH SA can sustain before generating a liquidity shortfall. The proposed rule change would add a clarification to this discussion that, when considering multiple defaults, the clearing members with the worst credit quality are assumed defaulting first.

Finally, the proposed rule change would update Appendix 3 and Appendix 5 to add description of the overdraft facility in place with Citibank that allows LCH SA to source non-Euro currencies in case of liquidity needs.

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.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)(5), (e)(7), and (e)(7)(ix).¹²

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)(5), (e)(7), and (e)(7)(ix).

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 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 or control of LCH SA or for which it is responsible.¹³ As discussed in more detail below, the Commission finds that the proposed rule change is consistent with Section 17A(b)(3)(F) of the Act.¹⁴

i. Additional Eligible Collateral

As discussed above, the proposed rule change would expand the list of non-cash collateral that a Clearing Member may post with LCH SA to meet margin requirements to include New Instruments, which would be certain non-Euro government securities. The proposed rule change would do so by issuing a new Clearing Notice to specify the New Instruments and amending Section 3.9 of the CDS Clearing Procedures to update the link to the portion of LCH SA's website that contains a list of Eligible Collateral. The Commission believes that by expanding the collateral that Clearing Members may post to satisfy margin requirements to include New Instruments and accordingly updating the link to the portion of LCH SA's website that contains a list of Eligible Collateral, these proposed changes would promote the ability of Clearing Members to meet margin requirements and therefore clear and settle transactions at

¹³ 15 U.S.C. 78q-1(b)(3)(F).

¹⁴ 15 U.S.C. 78q-1(b)(3)(F).

LCH SA. Thus, the Commission believes these aspects of the proposed rule change would promote the prompt and accurate clearance and settlement of securities transactions.

Moreover, the Commission believes that the conditions placed upon New Instruments would promote the prompt and accurate clearance and settlement of securities transactions and assure the safeguarding of securities and funds which are in the custody or control of LCH SA or for which it is responsible. The Commission believes that, for example, limiting New Instruments to those with a minimum outstanding amount equivalent to 500 million Euros would help to ensure that LCH SA is able to liquidate posted New Instruments if necessary. Moreover, given that that the European Central Bank will not convert New Instruments to Euros and LCH SA currently does not otherwise have the operational capacity to convert New Instruments to Euros, the Commission believes that limiting the amount of additional Eligible Collateral to 15% of a Clearing Member's total Margin Requirements should help to ensure that LCH SA is able to maintain sufficient liquidity even while accepting New Instruments as Eligible Collateral. Similarly, the Commission believes that amending the Framework to clarify that LCH SA will exclude New Instruments from the calculation of LCH SA's liquidity resources and that non-Euro, non-cash Collateral like New Instruments are not European Central Bank eligible assets, should help to ensure that LCH SA is able to maintain sufficient liquidity. The Commission believes that maintaining sufficient liquidity should, in turn, help to ensure that LCH SA is able to continue clearing and settling securities transactions and safeguarding securities and funds in the face of a Clearing Member default or other liquidity need, and therefore the Commission

believes these aspects of the proposed rule change would be consistent with Section 17A(b)(3)(F) of the Act.¹⁵

Finally, as discussed above, LCH SA has determined, at this time, not to treat New Instruments as Pledged Eligible Collateral due to a lack of Clearing Member interest and the additional operational resources required to allow such treatment. Accordingly, the proposed rule change would amend the Rule Book and the CDS Clearing Procedures to ensure that New Instruments are not treated as Pledged Eligible Collateral. The Commission believes these changes in particular should help to ensure that LCH SA is able to focus its operations and resources on clearing and settling securities transactions and assuring the safeguarding of securities and funds.

Therefore, for the reasons discussed above, the Commission finds that these aspects of the proposed rule change are consistent with the Section 17A(b)(3)(F) of the Act.¹⁶

ii. Other Changes

In addition to the expansion of Eligible Collateral, the Commission believes that the other changes discussed above would promote the prompt and accurate clearance and settlement of securities transactions and would assure the safeguarding of securities and funds which are in the custody or control of LCH SA or for which it is responsible. In particular, the Commission believes that amending Section 3 of the CDS Clearing Procedures to include Clearing Banking Luxembourg in the list of central securities depositories through which securities may be

¹⁵ 15 U.S.C. 78q-1(b)(3)(F).

¹⁶ 15 U.S.C. 78q-1(b)(3)(F).

transferred to LCH SA would provide Clearing Members and LCH SA an additional option to use as a central securities depository, therefore increasing LCH SA's operational resiliency. The Commission believes that increasing operational resiliency, in turn, should promote the prompt and accurate clearance and settlement of securities transactions and assure the safeguarding of securities and funds which are in the custody or control of LCH SA or for which it is responsible by reducing the likelihood that Clearing Members would be unable to provide collateral to LCH SA.

Moreover, the Commission believes that the other clarifications, updates, and corrections to the Framework described in Section II.B above would be consistent with the Section 17A(b)(3)(F) of the Act.¹⁷ As discussed above, these changes would, among other things, clarify LCH SA's ability to use Collateral, including Collateral that is pledged; describe the overdraft facility in place with Citibank that allows the LCH SA to source non-Euro currencies in case of liquidity needs; update the figures describing the liquidity injected in the settlement system to smooth settlement activity; clarify the treatment of settlement risk related to American-style options and other aspects of liquidity stress scenarios; and correct typographical and drafting errors. The Commission believes that all of the changes described in Section II.B above would improve the Framework by increasing its clarity and readability and helping to ensure that the Framework accurately describes how LCH SA considers and covers its liquidity needs. The Commission believes that increasing the clarity and readability of the Framework should help to avoid errors and inconsistencies in the application of the Framework and this should, in turn,

¹⁷ 15 U.S.C. 78q-1(b)(3)(F).

improve LCH SA's ability to maintain sufficient liquidity using the Framework. Because the Commission believes that having sufficient liquidity should help to ensure that LCH SA is able to continue clearing and settling securities transactions and safeguarding securities and funds in the face of a Clearing Member default or other liquidity need, the Commission therefore finds these aspects of the proposed rule change are consistent with Section 17A(b)(3)(F) of the Act.¹⁸

B. Consistency with Rule 17Ad-22(e)(5)

Rule 17Ad-22(e)(5) requires that LCH SA establish, implement, maintain and enforce written policies and procedures reasonably designed to limit the assets it accepts as collateral to those with low credit, liquidity, and market risks, and set and enforce appropriately conservative haircuts and concentration limits if LCH SA requires collateral to manage its or its participants' credit exposure; and require a review of the sufficiency of its collateral haircuts and concentration limits to be performed not less than annually.¹⁹ As discussed above, under the proposed new Clearing Notice, only those New Instruments with a minimum outstanding amount equivalent to 500 million Euros would be eligible for posting to LCH SA. The Commission believes that this aspect of the proposed rule change would help to ensure that New Instruments are limited to those assets with low liquidity risks, consistent with Rule 17Ad-22(e)(5),²⁰ by setting a reasonable condition that would help to ensure that LCH SA is able to liquidate the additional Eligible Collateral if necessary. Moreover, as discussed above, under the proposed

¹⁸ 15 U.S.C. 78q-1(b)(3)(F).

¹⁹ 17 CFR 240.17Ad-22(e)(5).

²⁰ 17 CFR 240.17Ad-22(e)(5).

new Clearing Notice, New Instruments transferred by a Clearing Member to LCH SA as Collateral shall be taken into account to satisfy the Clearing Member's Margin Requirements only up to 15% of the total Margin Requirements. The Commission believes this aspect of the proposed rule change would set an appropriate limit that should help to ensure that a Clearing Member's collateral is not overly concentrated in New Instruments. The Commission further believes this limit is important given that the European Central Bank will not convert New Instruments to Euros and LCH SA currently does not otherwise have the operational capacity to convert New Instruments to Euros.

Thus, the Commission finds that these aspects of the proposed rule change are consistent with Rule 17Ad-22(e)(5).²¹

C. Consistency with Rules 17Ad-22(e)(7) and (e)(7)(ix)

Rule 17Ad-22(e)(7) generally requires that LCH SA establish, implement, maintain and enforce written policies and procedures reasonably designed to effectively measure, monitor, and manage the liquidity risk that arises in or is borne by LCH SA, including measuring, monitoring, and managing its settlement and funding flows on an ongoing and timely basis, and its use of intraday liquidity.²² As discussed in Part II.B above, the proposed rule change would add to the Framework description of Collateral as a source of liquidity -- that LCH SA generally can use Collateral for liquidity purposes except (i) Collateral that is pledged (which could only be used for liquidity purposes if the Clearing Member pledging such Collateral has defaulted) and (ii)

²¹ 17 CFR 240.17Ad-22(e)(5).

²² 17 CFR 240.17Ad-22(e)(7).

Collateral deposited through a central bank guarantee. The Commission believes that this additional description would help to clarify the sources of liquidity that LCH SA would use to, among other things, manage its liquidity risk. Moreover, the proposed rule change would clarify how CaLM has used collateral in USD and GBP to raise Euro cash and update the table of figures of the liquidity injected in the settlement system to smooth settlement activity. Again, the Commission believes this additional description would help to clarify LCH SA's sources of liquidity and how it manages settlement and funding flows. Finally, the proposed rule change would add a general explanation of the LCR and how it relates to the Basel III framework. The proposed rule change similarly would add further explanations of some of the assumptions used in calculating the LCR, such as settlement risk associated with American-style options, liquidity needs arising from variation margin, and that when considering multiple defaults Clearing Members with the worst credit quality are assumed defaulting first. Because LCH SA uses the LCR to ensure that it has sufficient liquidity, the Commission believes that the additional description would help to clarify the LCR and therefore how LCH SA manages its liquidity risk. Thus, the Commission believes these aspects of the proposed rule change generally would be consistent with Rule 17Ad-22(e)(7).²³

Rule 17Ad-22(e)(7)(ix), in particular, requires that LCH SA establish, implement, maintain and enforce written policies and procedures reasonably designed to effectively measure, monitor, and manage the liquidity risk that arises in or is borne by LCH SA, including measuring, monitoring, and managing its settlement and funding flows on an ongoing and timely

²³ 17 CFR 240.17Ad-22(e)(7).

basis, and its use of intraday liquidity by, at a minimum describing LCH SA's process to replenish any liquid resources that LCH SA may employ during a stress event.²⁴ As discussed in Part II.B above, the proposed rule change would add description to the Framework of LCH SA's group policy that allows LCH SA to perform an extraordinary margin call if liquidity deteriorates and description of the overdraft facility in place with Citibank that allows the LCH SA to source non-Euro currencies in case of liquidity needs. The Commission believes that these clarifications would help to describe LCH SA's process to replenish any liquid resources that LCH SA may employ during a stress event, consistent with Rule 17Ad-22(e)(7)(ix).²⁵

Thus, the Commission finds that these aspects of the proposed rule change are consistent with Rule 17Ad-22(e)(7) generally and (e)(7)(ix) in particular.²⁶

²⁴ 17 CFR 240.17Ad-22(e)(7)(ix).

²⁵ 17 CFR 240.17Ad-22(e)(7)(ix).

²⁶ 17 CFR 240.17Ad-22(e)(7) and (e)(7)(ix).

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 Act²⁷ and Rules 17Ad-22(e)(5), (e)(7), and (e)(7)(ix).²⁸

IT IS THEREFORE ORDERED pursuant to Section 19(b)(2) of the Act²⁹ that the proposed rule change (SR-LCH SA-2021-002) be, and hereby is, approved.³⁰

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³¹

J. Matthew DeLesDernier
Assistant Secretary

²⁷ 15 U.S.C. 78q-1(b)(3)(F).

²⁸ 17 CFR 240.17Ad-22(e)(5), (e)(7), and (e)(7)(ix).

²⁹ 15 U.S.C. 78s(b)(2).

³⁰ 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).

³¹ 17 CFR 200.30-3(a)(12).