

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-95503; File No. SR-LCH SA-2022-004)

August 16, 2022

Self-Regulatory Organizations; LCH SA; Order Approving Proposed Rule Change Relating to the Clearing of Markit iTraxx® Australia Indices and the Associated Single-Name Constituents and Remediation of WWR Margin Instability

I. Introduction

On June 30, 2022, 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 the Methodology Services Reference Guide: Credit Default Swap (“CDS”) Margin Framework (“CDSClear Risk Methodology”) and its CDS Clearing Supplement (the “Clearing Supplement”) to permit the clearing of Markit iTraxx® Australia indices and the associated single-name constituents. The proposed rule change was published for comment in the Federal Register on July 13, 2022.³ 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 Self-Regulatory Organizations; LCH SA; Notice of Filing of Proposed Rule Change Relating to the Clearing of Markit iTraxx® Australia Indices and the Associated Single Name Constituents and Remediation of WWR Margin Instability; Exchange Act Release No. 34-95207 (July 7, 2022); 87 Fed. Reg. 41788 (July 13, 2022) (File No. SR-LCH SA-2022-004) (“Notice”).

II. Description of the Proposed Rule Change

LCH SA is proposing to amend its CDSClear Risk methodology and its Clearing Supplement to allow LCH SA to clear Markit iTraxx® Australia indices and the associated single-name constituents. The proposal would apply LCH SAs' current risk management processes to the management of risks posed by such products. Additionally, LCH SA proposes changes to its rules to remediate the recommendation of an independent model validation regarding the wrong-way risk (“WWR” or “Wrong-Way Risk”) margin instability.⁴

A. Amendments to the Clearing Supplement

The proposed rule change would amend the Clearing Supplement in order to include the relevant provisions to allow the clearing of the new Markit iTraxx® Australia indices and the associated single-name constituents. The proposed rule change would amend Part B of the Clearing Supplement, Section 1.2 (*Terms defined in the CDS Clearing Supplement*) to include a new sub-paragraph (a) to the definition of an “Index Cleared Transaction Confirmation” in order to make a reference to the form of confirmation which incorporates the iTraxx® Asia/Pacific Untranching Standard Terms Supplement. As a consequence, the sub-paragraphs (a), (b), (c), and (d) have been re-lettered as (b), (c), (d), and (e), respectively.

Further, Section 2.2 (*Index Cleared Transaction Confirmation*) of Part B of the Clearing Supplement would be amended to make appropriate references to any Index

⁴ The description that follows is substantially excerpted from the Notice. Capitalized terms not otherwise defined herein have the meanings assigned to them in the LCH SA CDSClear Risk methodology, CDS Clearing Supplement or LCH SA rules, as applicable.

Cleared Transaction that is a Markit iTraxx® Australia Index in paragraphs (a)(i), (b)(i), (c)(i) and (f)(i).

B. Proposed amendments to the CDSClear Risk framework

The proposed rule change would amend Section 2.1.1.1 (*Interest Rate Curve*) of the CDSClear Risk Methodology by removing the specific interest rate curve name used with the International Swaps and Derivatives Association, Inc. (ISDA) standard model pricer (used as a converter between upfront cash and quoted spread in basis points, as described on www.cdsmodel.com). The proposal would instead refer to the ISDA website such that when the standard model moves to using new benchmark interest rates instead of LIBOR (such as the Secured Overnight Financing Rate and the Sterling Overnight Index Average) (collectively, the “Risk Free Rates”), the CDSClear Risk Methodology will continue to refer to current information without risking becoming outdated.

For clarity, the proposal would remove “through a CDS index” under the provisions of Section 3.2 (*Self-referencing margin risk*) because the Self-Referencing Margin would apply as soon as a clearing member sells protection on itself regardless of the financial instrument used.

The proposed rule change would also add iTraxx® Australia to the list of indices on which index basis packages can be cleared under Section 3.4.5 (*Portfolio Margining*).

Because there are financial single-name constituents in the iTraxx® Australia index family, LCH SA proposes to subject positions on this index to a wrong-way risk margin requirement, which aims at capturing the potential contagion effect off the default of a clearing member (that is a financial institution) on instruments with open positions in

the defaulter's portfolio ("Wrong Way Risk" or "WWR"). Specifically, the application of wrong-way risk margin is designed to address the risk that Australian financials credit spreads may widen following the default of a clearing member to an extent that goes beyond the spread move already covered by the spread margin. Because of this requirement, coupled with the need to address a recommendation raised by the independent risk model validation on the instability of the Wrong Way Risk margin component, the proposal would amend the provisions under Section 3.8 of the CDS Clear Risk Methodology about the Wrong Way Risk margin to introduce the following updates:

- the introduction of the shocks applied to Australian entities in Section 3.8.1.1 (*Spread parallel moves*), alongside the shocks applied to existing products.
- a generalization of the calculation to all indices under Section 3.8.1.4 (*Index Shocks*) instead of specifically referring to Senior Financial or its parent index Main as is currently the case in Section 3.8.1.3.
- a description of the way the shocks on indices are defined in Section 3.8.1.4 (*Index Shocks*) as being derived directly from the shocks applied on constituents as a spread and CS01 weighted average.⁵
- a specification that the contribution to the spread margin used to derive the spread_SM under Sections 3.8.1.5 (*Wrong-Way/Right-Way P&L*) and 3.8.1.6 (*Instrument level Expected Shortfall*) would now consider the contribution of a

⁵ The new definition would apply to iTraxx® Australia as well as other indices containing financial names; however, LCH SA states that no financial impact is expected since index shocks are currently calibrated as the average shock of their constituents. Notice, 87 Fed. Reg. at 41789.

single tenor, instead of the joint contribution of all tenors on a given product, to address the WWR margin instability observed with curve trades.⁶

- the introduction of iTraxx® Australia alongside other regions under Section 3.8.1.8 (*Trigger*) when aggregating Wrong-Way and Right-Way risk across regions.

- Some of the existing provisions under Sections 3.8.2 (Offsets inter-region) and 3.8.3 (Final WWR Margin) would be moved to the general Section 3.8.1 explaining the overall WWR calculation. Specifically, LCH SA proposed moving (i) the shocks defined when extending to CDX products are now part of the table inside Section 3.8.1.1 (Spread parallel moves) and the relevant provision would be moved at the end of this same section. Further, a provision in Section 3.8.2 regarding Sub Financials would be moved to the Section 3.8.1.2 (Sub Financials) as a subsection of 3.8.1 (WWR: Parallel Move).

In addition to the changes to Section 3.8, LCH SA proposes to update the provisions of Section 4 on Additional Margin for the Liquidity and Concentration Risk Margin under paragraphs 4.1.2 (*Macro Hedging Phase*) and 4.1.4.1 (*Diversification Ratio*) to specify that iTraxx® Australia index would be used for hedging and would define an additional sub-portfolio when considering liquidation costs.

⁶ LCH SA states that such specification is required to address the recommendation raised by the Independent Model Validation. Notice, 87 Fed. Reg. at 41789. Specifically, curve trades are trades involving long or short positions on the same index but along a set of [?] different maturity points. LCH SA calculates the WWR charge by converting positions into an equivalent 5-year notional position. This conversion can, in certain limited circumstances for curve trades, result in a WWR that is unreasonably high.

Finally, the proposed changes would, for consistency purposes, remove any reference to LIBOR curves in Section 2.1.1.1 of the CDSClear Risk Methodology, and refer instead to the cdsmodel.com website, which details the pricer used by all market participants to convert from quoted spreads to upfronts in parallel to the cessation of LIBOR and the transition to Risk Free Rates. The proposed changes would also clarify in Section 1, Introduction that the short charge can cover 1 or 2 credit events, as the CDX.HY component does cover 2 defaults.

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.⁷ For the reasons discussed below, the Commission finds that the proposed rule change is consistent with Section 17A(b)(3)(F) of the Act⁸ and Rule 17Ad-22(e)(6)(i) thereunder.⁹

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.¹⁰

⁷ 15 U.S.C. 78s(b)(2)(C).

⁸ 15 U.S.C. 78q-1(b)(3)(F).

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

¹⁰ 15 U.S.C. 78q-1(b)(3)(F).

As noted above, the proposed rule change would amend the Clearing Supplement and the CDS Clear Risk Methodology to allow and account for the clearing of the new Markit iTraxx® Australia indices and the associated single-name constituents. The Commission has reviewed the terms and conditions of the additional new Markit iTraxx® Australia indices proposed for clearing and has determined that those terms and conditions are substantially similar to the terms and conditions of the other indices LCH SA currently clears, with the key difference being the constituents. Moreover, after reviewing the Notice and LCH SA's policies and procedures, the Commission understands that LCH SA would clear Markit iTraxx® Australia indices and the associated single-name constituents pursuant to its existing clearing arrangements and related financial safeguards, protections, and risk management procedures. The Commission also understands that LCH SA would revise its existing margin methodology to accommodate the clearing of iTraxx Australian indices and the associated single-name constituents, but that LCH SA would not change its existing default management policies and procedures and operational process because the proposed product does include new risk factors not already addressed with regard to the Corporates and Financials indices or single-names that LCH SA currently clears.

In addition, based on its own experience and expertise, including a review of data on expected volume, market share, and the number of LCH SA Clearing Participants ("CPs") expected to trade in Markit iTraxx® Australia indices and the associated single-name constituents as well as certain model parameters for Markit iTraxx® Australia indices, the Commission believes that LCH SA's rules, policy, and procedures, including as amended by the proposed rule change, are reasonably designed to (i) price and

measure the potential risk presented by Markit iTraxx® Australia indices and the associated single-name constituents, (ii) collect financial resources in proportion to such risk, and (iii) liquidate these products in the event of a CP default. The design of LCH SA's rules, policies, and procedures should, therefore, help ensure LCH SA's ability to maintain sufficient financial resources to support its critical services and function as a central counterparty, thereby promoting the prompt and accurate settlement of the additional Markit iTraxx® Australia indices and other transactions. Further, as noted above, LCH SA would apply its existing margin methodology, including its Wrong Way Risk margin framework noted above, to the new iTraxx® Australia Index, which are similar to the European indices currently cleared by LCH SA. The Commission believes that this will, in turn, strengthen LCH SA's ability to calculate margin requirements sufficient to cover its credit exposure to its clearing members.

Additionally, LCH SA is proposing a number of clarifying changes. Specifically, the proposed rule change would remove "through a CDS index" under the provisions of Section 3.2 (*Self-referencing margin risk*) of the CDSClear Risk Methodology as needlessly specific. The proposal would also remove the interest rate curve name used with the ISDA standard model pricer,¹¹ because it does not need to be specified in this risk documentation. Instead, the proposal would refer to the original website when the market moves to the new Risk Free Rates, so that the CDSClear Risk Methodology always automatically refers to the latest state in the market without risking becoming outdated. The Commission believes that such changes would strengthen LCH SA's risk

¹¹ Used as a converter between upfront cash and quoted spread in basis points, as described on www.cdsmodel.com.

documentation by ensuring it is clear and current, which, in turn, would support LCH SA's ability to manage risk and maintain financial resources to promptly and accurately clear and settle trades.

For these reasons, the Commission believes the proposed rule changes are consistent with Section 17A(b)(3)(F) of the Act.¹²

B. 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.¹³

As noted above, because there are financial single-name constituents in the iTraxx® Australia index family and positions on this index will therefore be subject to the Wrong Way Risk margin, the proposed rule change would apply LCH SA's existing margin methodology, including its Wrong Way Risk margin framework, to the new iTraxx® Australia Index. The Commission believes that by proposing to include the new iTraxx® Australia Index in LCH SA's existing margin methodology, the proposed rule change supports LCH SA's ability to have a risk-based margin system that considers, and produces margin levels commensurate with the risks and particular attributes of each relevant product, including the iTraxx® Australia Index and the associated single-name

¹² 15 U.S.C. 78q-1(b)(3)(F).

¹³ 17 CFR 240.17Ad-22(e)(6)(i).

constituents. As noted above, the Commission has reviewed the terms and conditions of the additional new Markit iTraxx® Australia indices proposed for clearing and has determined that those terms and conditions are substantially similar to the terms and conditions of the other indices LCH SA currently clears, with the key difference being the constituents. Because of this similarity, LCH SA would apply its existing margin methodology, with the revisions discussed above, to the new iTraxx® Australia Index.

For this reason, the Commission believes that the proposed rule change is consistent with Rule 17Ad-22(e)(6)(i).¹⁴

¹⁴ 17 CFR 240.17Ad-22(e)(6)(i).

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 Act¹⁵ and Rule (e)(6)(i) thereunder.¹⁶

IT IS THEREFORE ORDERED pursuant to Section 19(b)(2) of the Act¹⁷ that the proposed rule change (SR-LCH SA-2022-004) be, and hereby is, approved.¹⁸

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁹

Jill M. Peterson
Assistant Secretary

¹⁵ 15 U.S.C. 78q-1(b)(3)(F).

¹⁶ 17 CFR 240.17Ad-22(e)(6)(i).

¹⁷ 15 U.S.C. 78s(b)(2).

¹⁸ 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).

¹⁹ 17 CFR 200.30-3(a)(12).