

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-80849; File No. SR-LCH SA-2017-004)

June 2, 2017

Self-Regulatory Organizations; LCH SA; Order Approving Proposed Rule Change
Relating to LCH SA's CDS Margin and Extreme Credit Spread Curves

I. Introduction

On April 4, 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-004) to amend its CDS margin framework to replace an algorithm-based approach to pricing credit default swaps ("CDS") in the event extreme spread curves cause the International Swaps and Derivatives Association Standard Model for pricing credit default swaps ("ISDA Pricer") to fail with an approximation-based method.³ The proposed rule change was published for comment in the Federal Register on April 19, 2017.⁴ The Commission received no comment letters regarding the proposed 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 For additional information regarding the ISDA Standard Model, see www.cdsmodel.com. The Commission is providing this link solely for informational purposes.

⁴ Securities Exchange Act Release No. 34-80451 (April 13, 2017), 82 FR 18515 (April 19, 2017) (SR-LCH SA-2017-004) ("Notice").

II. Description of the Proposed Rule Change

LCH SA has proposed to amend its CDS margin framework. The proposed change would alter the approach used by LCH SA when the ISDA Pricer, used in pricing CDS, fails as a result of extreme spread curves. Under its current CDS margin framework, LCH SA uses the ISDA Pricer to calibrate credit spread curves as part of its spread margin component. According to LCH SA, the ISDA Pricer cannot be used to calibrate credit spread curves where “extreme” credit spread curves exist.⁵ In the event that the ISDA Pricer fails due to the existence of extreme credit spread curves, LCH SA has established a dichotomy-based algorithm that it uses to adjust the inputs and calibrate the spread curves iteratively until it identifies the tenor causing the calibration to fail, and the closest spread to that tenor that will allow the curve to appropriately calibrate.⁶

LCH SA represented that this dichotomy-based algorithm can consume significant amounts of time to process because of the number of repetitions that may be necessary for the process to produce the appropriate results, which could result in delays in calculating margin requirements.⁷ To ameliorate the potential for these delays, LCH SA has proposed to amend its approach by replacing the dichotomy-based algorithm described above with an approximation-based approach under which LCH SA would, in the event that the ISDA Pricer fails, construct a piecewise hazard rate curve and a

⁵ Notice, 82 FR at 18515.

⁶ Id.

⁷ Id.

piecewise constant interest rate curve, and then apply average hazard and interest rates for the relevant period to price the relevant CDS.⁸

LCH SA represents that it has performed quantitative analysis, which indicates that the revised approach to calculating margin requirements in the event that the ISDA Pricer fails is a reliable pricing tool.⁹ Therefore, this revised approach is not likely to result in significant changes to CDS prices and margin requirements calculated using LCH SA's current approach.

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 Section 17A(b)(3)(F) of the Act 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.¹¹ Rule 17Ad-22(e)(17) requires, in relevant part, that each covered clearing agency establish, implement, maintain, and enforce written policies and procedures reasonably designed to manage a covered clearing agency's operational risk by identifying the plausible sources of operational risk, both internal and external, and mitigating their impact through the use of

⁸ Id.

⁹ Notice, 82 FR at 18516.

¹⁰ 15 U.S.C. 78s(b)(2)(C).

¹¹ 15 U.S.C. 78q-1(b)(3)(F).

appropriate systems, policies, procedures and controls, as well as to ensure that systems have a high degree of security, resiliency, operational reliability, and adequate, scalable capacity.¹² Rule 17Ad-22(b)(1) 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 measure the registered clearing agency's credit exposures to its participants at least once daily and limit its exposures to potential losses from participant defaults under normal market conditions.¹³ 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 its credit exposures to participants under normal market conditions and use risk-based models and parameters to set margin requirements.¹⁴ Rule 17Ad-22(e)(6) requires, in relevant part, 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, and marks participant positions to market and collects margin, including variation margin or equivalent charges if relevant, at least daily.¹⁵

¹² 17 CFR 240.17Ad-22(e)(17).

¹³ 17 CFR 240.17Ad-22(b)(1).

¹⁴ 17 CFR 240.17Ad-22(b)(2).

¹⁵ 17 CFR 240.17Ad-22(e)(6)(i) and (ii).

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. The Commission believes that the proposed rule change will reduce the risk that the process for determining spread margin requirements will require excessive time to process in the event that extreme spread curves cause the ISDA Pricer to fail; the proposed rule change thereby will improve LCH SA's operational ability to calculate its margin requirements promptly without sacrificing accuracy. Because it will facilitate the calculation of margin requirements in a timely fashion, the proposed rule change is consistent with the prompt and accurate clearance and settlement requirement of Section 17A(b)(3)(F) of the Act and with operational risk requirements of Rule 17Ad-22(e)(17).

The Commission also believes that the proposed rule change provides for an approach that takes into consideration relevant risks (including hazard rates and interest rates) in order to provide for appropriate method for calculating CDS prices, and consequently the measurement of LCH SA's credit exposures and margin requirements, in the event that the ISDA Pricer fails. As a result, the proposed rule change is consistent with requirements of Rules 17Ad-22(b)(1) and (2), and Rule 17Ad-22(e)(6).

IV. Conclusion

IT IS THEREFORE ORDERED pursuant to Section 19(b)(2) of the Act that the proposed rule change (SR-LCH SA-2017-004) be, and hereby is, approved.¹⁶

For the Commission by the Division of Trading and Markets, pursuant to delegated authority.¹⁷

Eduardo A. Aleman
Assistant Secretary

¹⁶ 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).

¹⁷ 17 CFR 200.30-3(a)(12).