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SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-68955; File No. SR-ICEEU-2012-11)

February 20, 2013

Self-Regulatory Organizations; ICE Clear Europe Limited; Order Approving Proposed Rule Change, as Modified by Amendment No. 1 Thereto, Relating to Enhanced Margin Methodology

I. Introduction

On December 28, 2012, ICE Clear Europe Limited (“ICE Clear Europe”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change SR-ICEEU-2012-11 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder.² The proposed rule change was published for comment in the Federal Register on January 8, 2013.³ On February 14, 2013, ICE Clear Europe filed Amendment No. 1 to the proposed rule change.⁴ The Commission received one comment regarding this proposal.⁵ For the reasons discussed below, the Commission is granting approval of the proposed rule change.

II. Description

ICE Clear Europe proposes to implement an enhanced margin methodology (“Decomp Model”) that addresses the risk of both index and single-name credit default swaps (“CDS”) cleared by ICE Clear Europe and permits appropriate portfolio margining between related index and single-name CDS positions. ICE Clear Europe believes that the Decomp Model will

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 68563 (January 2, 2013), 78 FR 1281 (January 8, 2013).

⁴ In Amendment No. 1, ICE Clear Europe clarified the description of the current and proposed approaches to its concentration charge calculations.

⁵ See Comment from Mark Sokolow dated January 17, 2013, available at <http://www.sec.gov/comments/sr-iceeu-2012-11/iceeu201211.shtml>.

enhance its own risk management, as discussed below, and thereby facilitate the prompt and accurate settlement and risk management of swaps and contribute to the safeguarding of securities and funds associated with CDS transactions.

A fundamental aspect of the Decomp Model is the recognition that index CDS instruments cleared by ICE Clear Europe are essentially a composition of specific single-name CDS. The Decomp Model includes the following enhancements to the ICE Clear Europe margin methodology (“Margin Methodology Enhancements”) for index CDS instruments (which are already in place for single-name CDS): replacing standard deviation with mean absolute deviation (MAD) as a measure of credit spread variability, use of an auto regressive process to obtain multi-horizon risk measures, an increased number of spread response scenarios, and introduction of liquidity requirements. These enhancements and the enhancements referenced below have been reviewed and/or recommended by the ICE Clear Europe risk management personnel, risk and model review working groups and committees, the ICE Clear Europe Risk Committee and an independent third-party risk expert (Finance Concepts). Implementation of these enhancements to the ICE Clear Europe risk methodology will result specifically in a better measurement of the risk associated with clearing index CDS.

As a result of the decomposition of the index CDS, ICE Clear Europe also will be able to (1) incorporate jump-to-default risk as a component of the risk margin associated with index CDS (which is already in place for single-name CDS) and (2) provide appropriate portfolio margin treatment between index CDS and offsetting single-name CDS positions. Incorporating jump-to-default risk as a component of the Decomp Model will result in a better measurement of the risk associated with clearing index CDS (as is already the case for single-name CDS). Recognizing the highly correlated relationship between long-short positions in index CDS and

the underlying single-name CDS constituents of an index CDS will provide for fundamental and appropriate portfolio margin treatment.

Upon approval of the Decomp Model, ICE Clear Europe would initially make appropriate portfolio margining available with respect to its Clearing Members' proprietary positions. ICE Clear Europe does not currently clear CDS positions of customers of its Clearing Members, but it plans to introduce customer clearing for CDS upon receipt of applicable regulatory approvals.⁶ The Commission has granted an exemptive order permitting ICE Clear Europe to commingle customer positions in index CDS and single-name CDS carried through FCM/BD Clearing Members in a single account;⁷ in addition, ICE Clear Europe has petitioned the Commodity Futures Trading Commission ("CFTC") to permit such commingling.⁸ Following the commencement of customer clearing for CDS, and upon receipt of all necessary regulatory approvals, ICE Clear Europe would make appropriate portfolio margining available to commingled customer positions in index and single-name CDS using the Decomp Model. Accordingly, the Decomp Model is an important component of ICE Clear Europe's planned customer clearing offering.

ICE Clear Europe has stated that it does not believe that the expected phased implementation of the portfolio margining element of the proposed Decomp Model (commencing with proprietary positions) raises an issue of unfair discrimination. ICE Clear

⁶ The Commission recently approved proposed rule changes by ICE Clear Europe to implement customer clearing for CDS. See Securities Exchange Act Release No. 68812 (February 1, 2013), 78 FR 9088 (February 7, 2013).

⁷ See Securities Exchange Act Release No. 68433 (December 14, 2012), 77 FR 75211 (December 19, 2012).

⁸ See letter from Paul Swann, President & Chief Operating Officer, ICE Clear Europe to Mr. David Stawick, Secretary, CFTC, dated May 31, 2012, available at <http://www.cftc.gov/stellent/groups/public/@requestsandactions/documents/ifdocs/icecleareurope4dfrequest.pdf>.

Europe believes the portfolio margining aspect of the Decomp Model does not unfairly discriminate with respect to similarly situated participants because it is available to any participant for whom ICE Clear Europe is currently able to provide portfolio margin treatment. Once ICE Clear Europe makes customer clearing available and obtains all necessary regulatory approvals, ICE Clear Europe will offer portfolio margining with respect to its Clearing Members' customer positions. ICE Clear Europe believes the proposed rule amendments are therefore not designed to permit unfair discrimination among participants in the use of ICE Clear Europe's clearing services.

In addition, as part of the implementation of the proposed Decomp Model, ICE Clear Europe proposes to (1) reduce the current level of risk mutualization among ICE Clear Europe's CDS Clearing Members through the default resources held in the mutualized CDS Guaranty Fund and significantly increase the level of resources held as initial margin for CDS Contracts (the "Guaranty Fund/IM Modification"), (2) modify the initial margin risk model approach in a manner that will make it easier for market participants to measure their risks, by removing the conditional recovery rate stress scenarios and adding a new recovery rate sensitivity component (the "IM Recovery Rate Modification"), (3) modify the concentration charge calculation by introducing the net notional amount ("NNA") per single-name/index calculation and applying the more conservative concentration charge based on the 5-Year equivalent notional amount ("5Y ENA") or NNA (the "IM Concentration Charge Modification"), (4) add a new basis risk component from single-name CDS positions that are offset by index-derived single-name CDS positions (the "IM Basis Risk Modification") and (5) combine a single guaranty fund calculation for index CDS and single-name CDS positions (the "Guaranty Fund Modification").

Currently, ICE Clear Europe maintains a high percentage of its default resources for CDS Contracts in the CDS Guaranty Fund, as compared to initial margin for CDS Contracts. This reflects the fact that the current CDS Guaranty Fund model is designed to cover the uncollateralized losses that would result from the three single names that would cause the greatest losses when entering a state of default. The Guaranty Fund/IM Modification incorporates into the initial margin risk model⁹ the single name that causes the greatest loss when entering a state of default (i.e., the single name that results in the greatest amount of loss when stress-tested to undergo a credit event). This change effectively collateralizes the loss that would occur from this single name upon default. Consequently, the amount of uncollateralized loss that would result from the three single names causing the greatest losses when entering a state of default is reduced, thereby reducing the amount of required contributions to the CDS Guaranty Fund.

ICE Clear Europe notes that the decrease in the CDS Guaranty Fund and the increase in initial margin requirements are not equivalent in terms of magnitudes. Instead, based on current portfolios, it is expected that for every \$1 decrease in the CDS Guaranty Fund requirement there will be a corresponding increase of approximately \$5 in initial margin requirements.

The IM Recovery Rate Modification modifies the initial margin risk model by removing the conditional recovery rate stress scenarios and adding a new recovery rate sensitivity component that is computed by considering changes in the recovery rate assumptions and their impact on the net asset value of the CDS portfolio. This modification will make it easier for market participants to replicate their initial margin requirements.

⁹ The modification applies to the jump-to-default requirements component of IM.

The IM Concentration Charge Modification defines concentration charge thresholds in terms of NNA as well as 5Y ENA and takes the more conservative concentration requirement based on either notional amount. The current concentration charge approach only takes into account 5Y ENA. This modification captures the risk of large directional CDS positions that may not be captured by the calculation based on the 5Y ENA. For example, a set of large NNA positions, whose maturity date is close to the current date, may not be subject to concentration charges based on 5Y ENA if the estimated 5Y ENA is below the established threshold. The alternative NNA-based concentration charge computations may yield significant additional initial margin requirements as the NNA exceeds the established threshold.

As index-derived single-name positions and outright single-name positions are offset, an additional basis risk requirement is introduced to account for the fact that the index instruments are more actively traded than single-name instruments and thus are the preferred instruments to express changing views about the credit market as a whole, or even about specific single-name components of the indices. The IM Basis Risk Modification captures the risk associated with differences between outright single-name CDS positions and index-derived single-name CDS positions. In other words, a “perfectly hedged” portfolio consisting of an index CDS position and opposite index replicating single-name CDS positions will still attract an initial margin requirement due to the basis risk that exists.

Currently, ICE Clear Europe estimates separate guaranty fund sizes for index CDS positions and single-name positions. The Guaranty Fund Modification takes into account the portfolio benefits between index and single-name positions, and incorporates the worst 2-member uncollateralized losses coming from the jump-to-default, spread response, basis and

interest rate stress scenario considerations. As noted above, the Decomp Model also extends the jump-to-default calculation to index CDS as well as single-name CDS.

III. Comments

The Commission received one comment on the proposed rule change.¹⁰ The commenter queried whether the Commission's exemptive order permitting ICE Clear Europe to commingle customer positions in index CDS and single-name CDS carried through FCM/BD Clearing Members in a single account is in compliance with generally accepted accounting principles and is in the best interest of customers.¹¹ The commenter also queried whether customers are aware of the commingling and whether such commingling is industry standard.¹² The comment is not directly applicable to the proposed rule change, which relates to ICE Clear Europe's implementation of an enhanced margin methodology designed to address the risk of clearing both index and single-name credit default swaps.¹³

IV. Discussion

Section 19(b)(2)(C) of the Act¹⁴ 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

¹⁰ See supra note 5.

¹¹ See supra note 7.

¹² Id.

¹³ The Commission notes that such commingled positions would be held in a segregated account established and maintained in accordance with Section 4d(f) of the Commodity Exchange Act, and the CFTC has adopted rules requiring that cleared swaps customer collateral be held separately from the FCM's own property and be accounted for on a customer-by-customer basis (i.e., the collateral of one cleared swaps customer may not be used to satisfy the losses of the FCM or any other customer). See Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, Final Rule, 77 FR 6336 (February 7, 2012).

¹⁴ 15 U.S.C. 78s(b)(2)(C).

organization. Section 17A(b)(3)(F) of the Act¹⁵ requires, among other things, that the rules of a clearing agency be designed to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible.

The Decomp Model would implement a number of Margin Methodology Enhancements for index CDS instruments, as described above, which are already in place for single-name CDS. The decomposition of index CDS also would permit ICE Clear Europe to incorporate jump-to-default risk as a component of the risk margin associated with index CDS. The Commission believes that the Margin Methodology Enhancements and the incorporation of jump-to-default risk as a component of the index CDS margin methodology would result in better measurement of the risk associated with clearing index CDS.

The proposed rule change also includes modifications to ICE Clear Europe's initial margin and CDS Guaranty Fund methodologies. The Guaranty Fund/IM Modification would incorporate into the initial margin risk model the single name that causes the greatest loss when entering a state of default, thus requiring Clearing Members to collateralize a greater portion of the loss resulting from their default. The IM Recovery Rate Modification would facilitate the ability of market participants to replicate their initial margin requirements and evaluate the risk of their CDS clearing portfolio. The IM Concentration Charge Modification would allow for a potentially more conservative concentration requirement for large directional CDS positions. The IM Basis Risk Modification would capture the risk associated with differences between outright single-name CDS positions and index-derived single-name CDS positions, such that even "perfectly hedged" portfolios will still attract an initial margin requirement due to the basis risk that exists. Finally, the Guaranty Fund Modification would combine a single guaranty fund

¹⁵ 15 U.S.C. 78q-1(b)(3)(F).

calculation for index CDS and single-name CDS positions, which takes into account the portfolio benefits between index and single-name positions and incorporates the worst 2-member uncollateralized losses coming from the jump-to-default, spread response, basis and interest rate stress scenario considerations. The Commission believes that these modifications, and the enhancements described above, would facilitate the safeguarding of securities and funds in the custody or control of ICE Clear Europe or for which it is responsible.

After considering the proposed changes, including each of the representations made by ICE Clear Europe in the filing, the Commission believes that these changes are consistent with the requirements of Section 17A(b)(3)(F) of the Act,¹⁶ including ICE Clear Europe's obligation to ensure that its rules are designed to assure the safeguarding of securities and funds in the custody or control of the clearing agency or for which it is responsible.

¹⁶ 15 U.S.C. 78q-1(b)(3)(F).

V. Conclusion

On the basis of the foregoing, the Commission finds that the proposal is consistent with the requirements of the Act and in particular with the requirements of Section 17A of the Act¹⁷ and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁸ that the proposed rule change (File No. SR-ICEEU-2012-11), as modified by Amendment No. 1, be, and hereby is, approved.¹⁹

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁰

Kevin M. O'Neill
Deputy Secretary

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¹⁷ 15 U.S.C. 78q-1.

¹⁸ 15 U.S.C. 78s(b)(2).

¹⁹ 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).

²⁰ 17 CFR 200.30-3(a)(12).