



8011-01p  
SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-81056; File No. SR-LCH SA-2017-005)

June 30, 2017

Self-Regulatory Organizations; LCH SA; Order Approving Proposed Rule Change, as Amended by Amendment No. 1 thereto, to add Rules Related to the Clearing of CDX.NA.HY CDS

I. Introduction

On April 28, 2017, 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”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change (SR-LCH SA-2017-005) to amend LCH SA’s CDS Margin Framework and CDSClear Default Fund Methodology in order to permit LCH SA to clear CDS contracts on the CDX.NA.HY index. On May 5, 2017, LCH SA filed Amendment No. 1.<sup>3</sup> The proposed rule change was published in the Federal Register on May 17, 2017.<sup>4</sup> The Commission received no comment letters regarding the proposed change. For the reasons discussed below, the Commission is approving the proposed rule change.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> LCH SA filed Amendment No. 1 to replace the initial filing in its entirety in order to clarify certain changes to the CDSClear Margin Framework.

<sup>4</sup> Securities Exchange Act Release No. 34-80666 (May 11, 2017), 82 FR 22699 (May 17, 2017) (SR-LCH SA-2017-005) (“Notice”).

## II. Description of the Proposed Rule Change

LCH SA has proposed various changes to its CDS Margin Framework and CDSClear Default Fund Methodology for the purpose of permitting LCH SA to clear CDS contracts on the CDX.NA.HY index.

### A. Changes to CDS Margin Framework

With respect to the CDS Margin Framework, LCH SA proposed to amend the short charge component of its margin methodology to provide a description of the purpose of the short charge, noting that it is intended to account for the probability of a credit event occurring during the period from the default of a Clearing Member to liquidation of the defaulting Clearing Member's portfolio, as well as to adjust the method for calculating the short charge to account for CDX.NA.HY index contracts. Under its current CDS Margin Framework, LCH SA calculates the short charge component by taking the larger of (1) a "Global Short Charge," derived from the Clearing Member's top net short exposure with respect to any CDS contract and its top net short exposure among the three "riskiest" reference entities (of any type), i.e. those that are most likely to default, in the Clearing Member's portfolio, and (2) the top two net short exposures with respect to CDS contracts on senior financial entities.<sup>5</sup> LCH SA believes that high yield entities are riskier than senior financial entities, and as a result it proposed to introduce a "High Yield Short Charge" that would replace the top two net short exposures to CDS on senior financial entities in its approach to calculating the short charge.<sup>6</sup> Consequently,

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<sup>5</sup> Notice, 82 FR at 22700.

<sup>6</sup> Id.

the short charge under the proposed rule change would be the greater of (1) the “Global Short Charge,” as described above, and (2) a “High Yield Short Charge,” calculated from a member’s top net short exposure (with respect to high yield CDS) and its top two net short exposures among the three “riskiest” reference entities in the high yield category in the Clearing Member’s portfolio.<sup>7</sup>

LCH SA also proposed to make certain conforming changes throughout Section 4.1.1 of the CDS Margin Framework, which describes the “net short exposure” calculation, to refer to CDX.NA.HY contracts, as well as to clarify that in order to calculate margin in Euros, all US dollar denominated variables are converted to Euros utilizing the current USD/Euro foreign exchange rate and calibrated haircut based upon historical data. Furthermore, LCH SA proposed conforming changes to Section 4.1.2 of the CDS Margin Framework, which describes the “top exposure” component of the short charge and Section 4.1.3 of the CDS Margin Framework, which describes the process by which LCH SA identifies the “riskiest” entities (of any type) in determining the short charge, to incorporate terms for CDX.NA.HY index contracts and to clarify the calculation as it applies to high yield indices. LCH SA also proposed clarifying changes to Section 4.1.4 of the CDS Margin Framework to summarize the calculation for the short charge amount.<sup>8</sup>

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<sup>7</sup> Id.

<sup>8</sup> Id.

LCH SA proposed to amend the CDS Margin Framework by deleting Section 4.3 in its entirety because the substance of that section would be contained in other sections of the CDS Margin Framework as a result of the proposed changes described above.<sup>9</sup>

In addition, LCH SA also proposed to amend Section 5.1 of the CDS Margin Framework, which sets forth the wrong way risk (“WWR”) component of LCH SA’s margin methodology. According to LCH SA, the current approach leverages the short charge framework by calculating the top two net short exposures of financial entities in a Clearing Member’s portfolio following the calculation described above for the short charge margin. LCH SA then compares these top two net short exposures of financial entities to the Global Short Charge and imposes the greater of those two as the short charge, which addresses the WWR arising from the correlation between a Clearing Member default and the default(s) of the top two financial entities in the Clearing Member’s portfolio.<sup>10</sup> The proposed rule change amends Section 5.1 of the CDS Margin Framework to make the WWR component more explicit, such that, when the top two net short exposures in respect of financial entities exceeds the short charge margin, as amended to equal the greater of the Global Short Charge and the High Yield Short Charge, LCH SA will charge the incremental amount that is attributable to the top two financial entities as part of the WWR Margin.<sup>11</sup>

LCH SA further proposed to amend a heading in Section 3 and a table in Section 3.1.1 to clarify that the summary of the margin framework also applies to CDX HY

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<sup>9</sup> Id.

<sup>10</sup> Id.

<sup>11</sup> Id.

contracts. Additional conforming changes in the CDS Margin Framework were proposed with respect to Sections 5, 6, 8, 10, and 11 of the CDS Margin Framework to clarify that the those sections also apply to high yield indices.<sup>12</sup>

#### B. Changes to CDSClear Default Fund Methodology

LCH SA also proposed changes to its CDSClear Default Fund Methodology. Specifically, LCH SA proposed to amend Section 2.3 of the CDSClear Default Fund Methodology to modify the existing stressed short charge. Under its current approach, LCH SA calculates a stressed short charge, which equals the greater of (1) the top net short exposure plus the top two net short exposures among the three entities most likely to default in the Clearing Member's portfolio, and (2) the top two net short exposures which are senior financial entities plus the top net short exposures among the three riskiest senior financial entities in the Clearing Member's portfolio. Under the proposed rule change, LCH SA will take the default of high yield entities into account and add a third prong to the stressed short charge calculation which will take the greater of (1) and (2) as described above in this paragraph, or (3) the top two net short exposures which are high yield entities plus the top two net short exposures among the three high yield entities most likely to default in the Clearing Member's portfolio.<sup>13</sup>

Finally, LCH SA also proposed to amend Section 3.8 of the CDSClear Default Fund Methodology, which describes the correlation between index families and series, to reflect that additional data will be used.<sup>14</sup>

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<sup>12</sup> Id.

<sup>13</sup> Id.

<sup>14</sup> Id.

### III. Discussion and Commission Findings

Section 19(b)(2)(C) of the Act<sup>15</sup> directs the Commission to approve a proposed rule of a self-regulatory organization if the Commission finds that such proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to such organization. Section 17A(b)(3)(F) of the Act<sup>16</sup> requires, in relevant part, 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. Rule 17Ad-22(b)(2)<sup>17</sup> requires, in relevant part, a registered clearing agency that performs central counterparty services to establish, implement, maintain and enforce written policies and procedures 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. Rule 17Ad-22(b)(3)<sup>18</sup> requires, in relevant part, a registered clearing agency that performs central counterparty services to establish, implement, maintain and enforce written policies and procedures reasonably designed to maintain additional financial resources sufficient to withstand, at a minimum, a default by the two participant families to which it has the largest exposures in extreme but plausible market conditions where such registered clearing agency acts as a central counterparty for

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<sup>15</sup> 15 U.S.C. 78s(b)(2)(C).

<sup>16</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>17</sup> 17 CFR 240.17Ad-22(b)(2).

<sup>18</sup> 17 CFR 240.17Ad-22(b)(3).

security-based swaps. Rule 17Ad-22(e)(4)(i) and (ii)<sup>19</sup> require a covered clearing agency to establish, implement, maintain and enforce written policies and procedures reasonably designed to maintain sufficient financial resources to cover its credit exposure to each participant fully with a high degree of confidence, and for a covered clearing agency involved in activities with a more complex risk profile,<sup>20</sup> maintaining additional financial resources at the minimum to enable it to cover a wide range of foreseeable stress scenarios that include, but are not limited to, the default of the two participant families that would potentially cause the largest aggregate credit exposure for the covered clearing agency in extreme but plausible market conditions. Finally, Rule 17Ad-22(e)(6)(i)<sup>21</sup> requires a covered clearing agency that provides central counterparty services to 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.

The Commission finds that the proposed rule change, which amends LCH SA's CDS Margin Framework and CDSClear Default Fund Methodology to permit LCH SA to clear CDS contracts on the CDX.NA.HY index, is consistent with Section 17A of the Act and the applicable provisions of Rule 17Ad-22 thereunder. By amending its CDS

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<sup>19</sup> 17 CFR 240.17Ad-22(e)(4)(i) and (ii).

<sup>20</sup> Rule 17Ad-22(a)(4)(i) defines a covered clearing agency involved in activities with a more complex risk profile as a clearing agency registered with the Commission under Section 17A of the Act that provides central counterparty services for security-based swaps. See 17 CFR 240.17Ad-22(a)(4)(i).

<sup>21</sup> 17 CFR 240.17Ad-22(e)(6)(i).

Margin Framework, LCH SA amends the approach to its short charge component of its margin methodology to consider the specific risks associated with, and incorporate parameters addressing the risks, associated with clearing contracts on the CDX.NA.HY index, and as a result, LCH SA will be able to calculate margin requirements to cover its exposures associated with clearing contracts on the CDX.NA.HY index. Therefore, the Commission finds that the proposed rule changes are consistent with Rule 17Ad-22(b)(2), 17Ad-22(e)(4)(i), and 17Ad-22(e)(6)(i).

Additionally, by amending its CDSClear Default Fund Methodology to change the manner in which it calculates its short charge to consider the risks introduced by clearing contracts on the CDX.NA.HY index, the Commission believes that LCH SA will be able to more appropriately calculate and maintain the financial resources necessary to cover the default of by the two participant families to which it has the largest exposures in extreme but plausible market conditions. Therefore, the Commission finds that the proposed rule change is consistent with the requirements of Rule 17Ad-22(b)(3) and Rule 17Ad-22(e)(4)(ii).

Because the proposed rule change amends LCH SA's CDS Margin Framework and CDSClear Default Fund Methodology in such a manner as to allow LCH SA to more appropriately take into consideration the risks associated with clearing contracts on the CDX.NA.HY index, and to collect margin and other financial resources that reflect such risks, the Commission believes that the proposed changes are designed to promote the prompt and accurate clearance and settlement of such contracts. As a result, the Commission finds that the proposed rule changes are consistent with Section 17A(b)(3)(F) of the Act.



#### IV. Conclusion

IT IS THEREFORE ORDERED pursuant to Section 19(b)(2) of the Act that the proposed rule change (SR-LCH SA-2017-005), as amended by Amendment No. 1, be, and hereby is, approved.<sup>22</sup>

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

Brent J. Fields  
Secretary

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<sup>22</sup> 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).

<sup>23</sup> 17 CFR 200.30-3(a)(12).

