

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-71920; File No. SR-ICEEU-2014-04)

April 9, 2014

Self-Regulatory Organizations; ICE Clear Europe Limited; Order Approving Proposed Rule Change to Clear New Sovereign Contracts

I. Introduction

On February 11, 2014, ICE Clear Europe Limited (“ICE Clear Europe”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change SR-ICEEU-2014-04 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> The proposed rule change was published for comment in the Federal Register on February 25, 2014.<sup>3</sup> The Commission did not receive any comments on the proposed rule change. This order approves the proposed rule change.

II. Description of the Proposed Rule Change

ICE Clear Europe proposes to adopt rules to provide for the clearance of new credit default swap (“CDS”) contracts that are Western European Sovereign CDS contracts referencing the Republic of Ireland, Italian Republic, Portuguese Republic, and Kingdom of Spain (the “New Sovereign Contracts”). ICE Clear Europe has identified Western European Sovereign CDS Contracts as a product that has become increasingly important for market participants to manage risk and express views with respect to the European sovereign credit markets. ICE Clear Europe believes clearance of the New Sovereign Contracts will benefit the markets for CDS on Western European sovereigns by offering to market participants the benefits of clearing, including

---

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

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

<sup>3</sup> See Exchange Act Release No. 34-71574 (Feb. 19, 2014), 79 FR 10578 (Feb. 25, 2014) (SR-ICEEU-2014-04).

reduction in counterparty risk and safeguarding of margin assets pursuant to clearing house rules. The terms of the New Sovereign Contracts will be governed by Paragraph 12 of ICE Clear Europe's CDS Procedures. ICE Clear Europe has stated that clearing of the New Sovereign Contracts will not require any changes to ICE Clear Europe's existing Clearing Rules and CDS Procedures, although ICE Clear Europe has updated its risk management framework (including relevant policies) and margin model as discussed herein.

ICE Clear Europe proposes to enhance its CDS risk management framework, including the margin methodology (the "CDS Model"),<sup>4</sup> to include several features designed to address particular risks of the New Sovereign Contracts. To address so-called general wrong way risk ("General Wrong Way Risk") involving correlation between the risk of default of an underlying sovereign and the risk of default of a clearing member that has written credit protection through a New Sovereign Contract on such sovereign, ICE Clear Europe proposes to establish additional jump-to-default requirements for initial margin for portfolios that present such risk.

ICE Clear Europe proposes to adopt a combination of qualitative and quantitative approaches to capture General Wrong Way Risk. Under the enhanced CDS Model, an additional contribution to initial margin will be required when the seller of protection exhibits a high degree of association with an underlying Western European Sovereign reference entity by virtue of domicile (qualitative approach) or high spread return correlation (quantitative approach). To address General Wrong Way Risk arising from clearing member domicile, ICE Clear Europe proposes to require full collateralization of the jump-to-default loss for a protection seller under a contract referencing the sovereign where the protection seller is domiciled.

---

<sup>4</sup> ICE Clear Europe has performed a variety of empirical analyses related to clearing of the New Sovereign Contracts under its margin methodology, including back tests and stress tests.

Under the proposed quantitative approach, which will apply where the protection seller is not domiciled in the jurisdiction of the underlying sovereign, two types of thresholds will be introduced: a loss threshold and a correlation threshold. Additional General Wrong Way Risk collateralization will be collected if both thresholds are exceeded. If the spread return correlation between the member and the sovereign is above the correlation threshold and the sovereign CDS jump-to-default loss is above the loss threshold, General Wrong Way Risk collateralization is assessed as a function of the spread return correlation and amount by which the loss threshold is exceeded. The charge becomes more conservative as the spread return correlation increases. The application of additional initial margin requirements under the quantitative approach is not subject to discretion, although the thresholds will be subject to review by the CDS Risk Committee as part of its periodic review of ICE Clear Europe's margin methodology.

ICE Clear Europe's proposal also addresses other forms of wrong way risk arising from currency risk. To mitigate the currency risk between a sovereign reference entity and a New Sovereign Contract involving that entity, and to facilitate greater market liquidity, the New Sovereign Contracts (and related margin and guaranty fund requirements) will be denominated in U.S. dollars, rather than Euro. In addition, ICE Clear Europe's rules contain prohibitions on self-referencing trades (i.e., trades where the clearing member is an affiliate of the underlying sovereign reference entity). Such trades may not be submitted for clearing, and if a clearing member subsequently becomes affiliated with the underlying reference entity, the rules applicable to New Sovereign Contracts provide for the termination of relevant positions.

ICE Clear Europe proposes to apply its existing margin methodology to the New Sovereign Contracts, with the enhancements to address General Wrong Way Risk discussed above. ICE Clear Europe believes that this model, including the additional initial margin that

may be required to address General Wrong Way Risk, will provide sufficient margin to cover its credit exposure to its clearing members from clearing such contracts. Furthermore, ICE Clear Europe believes that its CDS Guaranty Fund, under its existing methodology, will, together with the required margin, provide sufficient financial resources to support the clearing of New Sovereign Contracts.

ICE Clear Europe believes it will have the operational and managerial capacity to clear the New Sovereign Contracts as of the commencement of clearing, and that its existing systems are appropriately scalable to handle the additional New Sovereign Contracts, which are generally similar from an operational perspective to the CDS contracts currently cleared by ICE Clear Europe.

ICE Clear Europe has stated that the revised margin methodology operates without the need for the CDS Risk Committee, ICE Clear Europe Board or management to exercise discretion concerning particular clearing members or the margin levels applicable to them. ICE Clear Europe has also stated that the qualitative and quantitative components to the methodology do not contain discretionary elements, and once the relevant threshold is exceeded, the clearing house is required under the policy to assess an additional initial margin charge based on the margin methodology. ICE Clear Europe believes this approach should minimize any potential conflicts of interest.

### III. Discussion and Commission Findings

Section 19(b)(2)(C) of the Act<sup>5</sup> 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

---

<sup>5</sup> 15 U.S.C. 78s(b)(2)(C).

organization. Section 17A(b)(3)(F) of the Act<sup>6</sup> requires, among other things, that the rules of a clearing agency are designed to promote the prompt and accurate clearance and settlement of securities transactions and, to the extent applicable, derivative agreements, contracts, and transactions, 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, and in general, to protect investors and the public interest.

After careful review, the Commission finds that the proposed rule change is consistent with Section 17A of the Act<sup>7</sup> and the rules thereunder applicable to ICE Clear Europe. Specifically, the Commission believes that ICE Clear Europe's proposal to clear the New Sovereign Contracts in accordance with its existing Clearing Rules and procedures applicable to CDS contracts is designed to promote the prompt and accurate clearance and settlement of securities transactions and 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, consistent with Section 17A(b)(3)(F) of the Act.<sup>8</sup>

Additionally, the Commission believes that the proposed enhancements to ICE Clear Europe's CDS risk management framework to address the General Wrong Way Risks associated with clearing New Sovereign Contracts, including the correlation and currency risks discussed above, are 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, and in general, to protect investors

---

<sup>6</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>7</sup> 15 U.S.C. 78q-1.

<sup>8</sup> 15 U.S.C. 78q-1(b)(3)(F).

and the public interest, consistent with Section 17A(b)(3)(F) of the Act.<sup>9</sup> The proposal will require additional contributions to initial margin when the seller of protection exhibits a high degree of association with an underlying Western European Sovereign reference entity by virtue of domicile (qualitative approach) or high spread return correlation (quantitative approach). These proposed margin model enhancements will provide additional resources to ICE Clear Europe to address the potential risks associated with the correlation between the risk of default of an underlying sovereign and the risk of default of a clearing member that has written credit protection through a New Sovereign Contract on such sovereign. The Commission also believes that the enhanced risk management framework, in combination with ICE Clear Europe's existing rules and procedures related to margin and guaranty fund, is reasonably designed to meet the requirements of Rules 17Ad-22(b)(1) - (3)<sup>10</sup> related to the measurement and management of credit exposures, margin requirements, and the maintenance of sufficient financial resources required for a registered clearing agency acting as a central counterparty for security-based swaps.

As noted above, ICE Clear Europe's proposed revised margin methodology operates without the need for the CDS Risk Committee, ICE Clear Europe Board, or management to exercise discretion concerning particular clearing members or the margin levels applicable to them. ICE Clear Europe has stated that the qualitative and quantitative components to the methodology do not contain discretionary elements, and once the relevant thresholds are exceeded, the clearing house is required under the policy to assess an additional initial margin charge based on the margin methodology. The Commission does not believe that these proposed

---

<sup>9</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>10</sup> 17 CFR 240.17Ad-22(b)(1) - (3).

changes will result in unfair discrimination among clearing members within the meaning of Section 17A(b)(3)(F) of the Act<sup>11</sup> and believes that these proposed changes are consistent with the requirements of Rule 17Ad-22(d)(8).<sup>12</sup>

Finally, the Commission believes that ICE Clear Europe's proposal to clear New Sovereign Contracts in accordance with its existing rules, procedures, and operational framework is reasonably designed to identify sources of operational risk and minimize them through the development of appropriate systems, controls, and procedures, and to implement systems that are reliable, resilient and secure, and have adequate, scalable capacity consistent with Rule 17Ad-22(d)(4).<sup>13</sup>

---

<sup>11</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>12</sup> 17 CFR 240.17Ad-22(d)(8).

<sup>13</sup> 17 CFR 240.17Ad-22(d)(4).

IV. 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 Act<sup>14</sup> and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>15</sup> that the proposed rule change (SR-ICEEU-2014-04) be, and hereby is, approved.<sup>16</sup>

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

Kevin M. O'Neill  
Deputy Secretary

---

<sup>14</sup> 15 U.S.C. 78q-1.

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

<sup>16</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>17</sup> 17 CFR 200.30-3(a)(12).