

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-80848; File No. SR-LCH SA-2017-003)

June 2, 2017

Self-Regulatory Organizations; LCH SA; Order Approving Proposed Rule Change Relating to Recovery Risk Margin

I. Introduction

On April 4, 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”)¹ and Rule 19b-4 thereunder,² a proposed rule change (SR-LCH SA-2017-003) to revise its margin methodology with respect to credit default swaps (“CDS”) in the Reference Guide: CDS Margin Framework (“Reference Guide”). The proposed rule change was published for comment in the Federal Register on April 19, 2017.³ The Commission received no comment letters regarding the proposed change. For the reasons discussed below, the Commission is approving the proposed rule change.

II. Description of the Proposed Rule Change

The proposed rule change seeks to amend the Reference Guide by eliminating the recovery rate risk charge as a component of the margin methodology, as it applies to index CDS. LCH SA, however, does not propose to alter the recovery rate risk charge as a component of the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 34-80450 (April 13, 2017), 82 FR 18488 (April 19, 2017) (SR-LCH SA-2017-003) (the “Notice”).

margin methodology, as it applies to single name CDS. The proposed rule change also seeks to make minor updates and clarifications to the Reference Guide.⁴

With respect to the portion of the proposed rule change that eliminates the recovery rate risk charge as a margin component for index CDS positions, LCH SA believes that recovery rate risk is irrelevant to index CDS in normal market conditions and it therefore should not need to charge margin to address it. In support, LCH SA represents that “[the] market convention is to assume a pre-defined recovery rate for pricing an index CDS, such as a CDS on iTraxx indices.”⁵ Therefore, according to LCH SA, there is no need to charge margin for an adverse recovery rate movement for an index CDS position because, pursuant to market convention for pricing an index CDS in normal market conditions, the rate will not move. Moreover, LCH SA characterizes any drop in the recovery rate for index CDS as a stress loss, and states that applying a margin charge to address this risk “would be trying to capture a stress loss incurred in a Clearing Member’s portfolio should the pre-defined recovery rate for these index CDS change, which is not consistent with market convention in normal market conditions.”⁶ Furthermore, while LCH SA does expect deviations from this market convention in extreme market conditions, LCH SA believes that these deviations – and any resultant recovery rate risk on the affected index CDS positions – should not be addressed through its margin framework but rather “would be captured by LCH SA’s stress scenarios used to size the Default Fund.”⁷ Therefore,

⁴ LCH SA has proposed changes to the Reference Guide to (i) correct a hyperlink and (ii) add a cross reference and hyperlink to the general inputs considered by LCH SA in constructing the CDS pricing for European and U.S. dollar denominated contracts. See Notice, 82 FR at 18489.

⁵ Id.

⁶ Id.

⁷ Id.

LCH SA maintains that elimination of recovery rate risk charge from its margin framework is appropriate and consistent with applicable provisions of the Exchange Act and Commission Rules promulgated thereunder.

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.⁸ Section 17A(b)(3)(F) of the Act requires,⁹ among other things, that the rules of a registered 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. Rule 17Ad-22(b)(2) requires that a registered clearing agency that performs central counterparty services shall 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.¹⁰ Rule 17Ad-22(e)(6) requires that a covered clearing agency¹¹ shall 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, calculates margin sufficient to cover its potential future exposure to participants in the interval between the last margin collection and the close out of positions following a participant default and uses an appropriate method for measuring credit exposure that accounts

⁸ 15 U.S.C. 78s(b)(2)(C).

⁹ 15 U.S.C. 78q-1(b)(3)(F).

¹⁰ 17 CFR 240.17Ad-22(b)(2).

¹¹ See 17 CFR 240.17Ad-22(a)(5) (defining “covered clearing agency”).

for relevant product risk factors and portfolio effects across products.¹² Rule 17Ad-22(e)(1) requires that a covered clearing agency shall establish, implement, maintain, and enforce written policies and procedures reasonably designed to provide for a well-founded, clear, transparent, and enforceable legal basis for each aspect of its activities in all relevant jurisdictions.¹³

The Commission finds that the proposed rule change is consistent with Section 17A of the Act and Rule 17Ad-22 thereunder. In particular, the Commission finds that the elimination of recovery rate risk charges is consistent with market convention for pricing index CDS, as represented by LCH SA and discussed above. Moreover, the Commission notes that the elimination of this component of LCH SA's margin is expected to have only a minor impact on the total amount of margin LCH SA collects with respect to index CDS. Furthermore, the Commission notes that LCH SA will continue to consider and address recovery rate risk on index CDS in its stress scenarios used to size its default fund. Based on these findings and considerations, the Commission believes that the proposed rule change is reasonably designed to use margin requirements to limit its credit exposures to participants under normal market conditions, calculate margin sufficient to cover its potential future exposure to participants in the interval between the last margin collection and the close out of positions following a participant default and use an appropriate method for measuring credit exposure that accounts for relevant product risk factors and portfolio effects across products, consistent with Section 17A(b)(3)(F) of the Exchange Act,¹⁴ and Rules 17Ad-22(b)(2), (e)(6)(iii), and (e)(6)(v) thereunder.¹⁵

¹² See 17 CFR 240.17Ad-22(e)(6)(iii), (e)(6)(v).

¹³ 17 CFR 240.17Ad-22(e)(1).

¹⁴ 15 U.S.C. 78q-1(b)(3)(F).

¹⁵ 17 CFR 240.17Ad-22(b)(2), (e)(6)(iii), and (e)(6)(v).

With respect to the portion of the proposed rule change that revises the Reference Guide to (i) correct a hyperlink and (ii) add a cross reference and hyperlink to the general inputs considered by LCH SA in constructing the CDS pricing for European and U.S. dollar denominated contracts, the Commission believes that correcting an erroneous hyperlink and providing an additional cross-reference and hyperlink would make the Reference Guide more clear to those who use it, consistent with Rule 17Ad-22(e)(1).¹⁶

IV. Conclusion

IT IS THEREFORE ORDERED pursuant to Section 19(b)(2) of the Act that the proposed rule change (SR-LCH SA-2017-003) be, and hereby is, approved.¹⁷

For the Commission by the Division of Trading and Markets, pursuant to delegated authority.¹⁸

Eduardo A. Aleman
Assistant Secretary

¹⁶ 17 CFR 240.17Ad-22(e)(1).

¹⁷ 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).

¹⁸ 17 CFR 200.30-3(a)(12).