

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-95207; File No. SR-LCH SA-2022-004)

July 7, 2022

Self-Regulatory Organizations; LCH SA; Notice of Filing of Proposed Rule Change Relating to the Clearing of Markit iTraxx® Australia Indices and the Associated Single Name Constituents and Remediation of WWR Margin Instability

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act” or “Exchange Act”)¹ and Rule 19b-4 thereunder² notice is hereby given that on June 30, 2022, Banque Centrale de Compensation, which conducts business under the name LCH SA (“LCH SA”), filed with the Securities and Exchange Commission (“Commission” or “SEC”) the proposed rule change described in Items I, II, and III below, which Items have been prepared primarily by LCH SA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Clearing Agency’s Statement of the Terms of Substance of the Proposed Rule Change

(a) LCH SA is proposing to amend its CDS Clear Risk methodology and its CDS Clearing Supplement (the “**Clearing Supplement**”) to allow LCH SA to enhance and expand its clearing services as follows: LCH SA intends to (i) permit the clearing of Markit iTraxx® Australia indices and the associated single name constituents, (the “**iTraxx Change**”) and (ii) provide a remediation to one independent model validation recommendation regarding the Wrong Way Risk (WWR) margin instability (the “**WWR Change**”) (all together the “**Proposed Rule Change**”).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

The text of the Proposed Rule Change is in Exhibit 5.³

The implementation of the Proposed Rule Change will be contingent on LCH SA's receipt of all necessary regulatory approvals.

(b) Not applicable.

(c) Not applicable.

II. Clearing Agency's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, LCH SA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. LCH SA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of these statements.

A. Clearing Agency's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

The purpose of the Proposed Rule Change is to revise LCH SA's rules, procedures and supplement to (1) permit the clearing of Markit iTraxx® Australia indices and the associated single name constituents and (2) provide the remediation to the WWR margin instability.

³ All capitalized terms not defined herein have the same definition as in the CDS Clearing Rule Book, Supplement or Procedures, as applicable.

1) **Proposed amendments to permit the clearing of Markit iTraxx® Australia indices**

a) **Amendments to the Clearing Supplement**

The Clearing Supplement has been amended in order to include the relevant provisions to allow the clearing of the new Markit iTraxx® Australia indices.

In Part B of the Clearing Supplement, Section 1.2 (*Terms defined in the CDS Clearing Supplement*) has been amended to include a new sub-paragraph (a) to the definition of an “Index Cleared Transaction Confirmation” in order to make a reference to the form of confirmation which incorporates the iTraxx® Asia/Pacific Untranch Standard Terms Supplement. As a consequence, the sub-paragraphs (a), (b), (c), and (d) have been re-lettered as (b), (c), (d), (e), respectively.

Section 2.2 (*Index Cleared Transaction Confirmation*) of Part B of the Clearing Supplement has been also amended to make appropriate references to any Index Cleared Transaction that is a Markit iTraxx® Australia Index in paragraphs (a)(i), (b)(i), (c)(i) and (f)(i).

b) **Proposed amendments to the CDSClear Risk framework**

LCH SA is proposing to amend its Methodology Services Reference Guide: CDS Margin Framework (“**CDSClear Risk Methodology**”) under Section 2.1.1.1 (*Interest Rate Curve*) to proceed with the removal of the interest rate curve name used with the International Swaps and Derivatives Association, Inc. (ISDA) standard model pricer (used as a converter between upfront cash and quoted spread in basis points, as described on www.cdsmodel.com) that does not need to be clearly specified in such risk documentation. The objective now is to refer to the original website when the market

moves to the new Risk Free Rates, so that the CDSClear Risk Methodology always automatically refers to the latest state in the market without risking becoming outdated.

For clarity purposes only, LCH SA is proposing to remove “through a CDS index” under the provisions of Section 3.2 (*Self-referencing margin risk*) as the Self-Referencing Margin would apply as soon as the clearing member sells protection on itself whatever the financial instrument used.

The other proposed change specified under Section 3.4.5 (*Portfolio Margining*) is intended to add iTraxx® Australia to the list of indices on which index basis packages can be cleared.

As there are financial single name constituents in the iTraxx® Australia index family, positions on this index will be subject to the Wrong Way Risk margin, a margin that aims at capturing the potential contagion effect off the default of a clearing member (that is a financial institution) on instruments with open positions in the defaulter’s portfolio. Here, it would be the risk that Australian financials credit spreads may widen following the default of a clearing member, to an extent that goes beyond the spread move already covered by the spread margin. This requirement, coupled with the need to address a recommendation raised by the independent risk model validation on the instability of the Wrong Way Risk margin component, result in LCH SA also proposing to amend the provisions under Section 3.8 of the CDSClear Risk Methodology about the Wrong Way Risk margin to introduce the following updates:

- the introduction of the shocks applied to Australian entities in Section 3.8.1.1 (*Spread parallel moves*), alongside the shocks applied to existing products.

- a generalisation of the calculation to all indices under Section 3.8.1.4 (*Index Shocks*) instead of just referring to Senior Financial or its parent index Main as it was previously in Section 3.8.1.3.
- a description of the way the shocks on indices are defined in Section 3.8.1.4 (*Index Shocks*), being derived directly from the shocks applied on constituents as a spread and CS01 weighted average. This would apply to iTraxx® Australia as well as other indices containing financial names, although no financial impact is expected since index shocks are currently already calibrated as the average shock of their constituents.
- As required to address the recommendation raised by the Independent Model Validation, a specification that the contribution to the spread margin used to derive the spread_SM under Sections 3.8.1.5 (*Wrong-Way/Right-Way P&L*) and 3.8.1.6 (*Instrument level Expected Shortfall*) would now consider the contribution of a single tenor, instead of the joint contribution of all tenors on a given product, to address the WWR margin instability observed with curve trades.
- the introduction of iTraxx® Australia alongside other regions under Section 3.8.1.8 (*Trigger*) when aggregating Wrong way and Right way across regions.
- Some of the existing provisions under Sections 3.8.2 (*Offsets inter-region*) and 3.8.3 (*Final WWR Margin*) have been moved to the general Section 3.8.1 explaining the overall WWR calculation. The shocks defined when extending to CDX products are now part of the table inside Section 3.8.1.1 (*Spread parallel moves*) and the relevant provision has been moved at the end of this

same section. The provision about Sub Financials has been moved to the Section 3.8.1.2 (Sub Financials) as a subsection of 3.8.1 (WWR: Parallel Move).

Further, the provisions of Section 4 on Additional Margin are proposed to be updated for the Liquidity and Concentration Risk Margin under paragraphs 4.1.2 (*Macro Hedging Phase*) and 4.1.4.1 (*Diversification Ratio*) to specify that iTraxx® Australia index would be used for hedging and would define an additional sub-portfolio when considering liquidation costs.

Finally, LCH SA is also taking this opportunity to propose changes for consistency purposes by removing from its CDSClear Risk methodology documentation any reference to IBOR curves in Section 2.1.1.1, and refer instead to the cdsmodel.com website which details the pricer used by all market participants to convert from quoted spreads to upfronts in parallel to the cessation of IBOR and the transition to Risk Free Rates, and also clarify in Section 1, Introduction that the short charge can cover 1 or 2 credit events, as the CDX.HY component does cover 2 defaults and was not correctly reflected in the introduction.

(b) Statutory Basis

LCH SA believes that the Proposed Rule Change is consistent with the requirements of Section 17A of the Act⁴ and regulations thereunder applicable to it, including Commission Rule 17Ad-22(e).⁵ In particular, Section 17A(b)(3)(F) of the Act requires, *inter alia*, that the rules of a clearing agency be designed to “promote the prompt and accurate clearance and settlement of . . . derivatives agreements, contracts,

⁴ 15 U.S.C. 78q-1.

⁵ 17 C.F.R. §240.17Ad-22.

and transactions”.⁶ By proposing to amend its CDS Clearing Supplement to authorize the acceptance of the new iTraxx® Australia transactions, on the terms and conditions set out in the Proposed Rule Change, LCH SA considers that this would encourage Clearing Members to clear additional indices and single name CDS through its CDSClear service, which, in turn, should promote the prompt and accurate clearance and settlement of those instruments within the meaning of Section 17A(b)(3)(F) of the Act.⁷

By improving the stability of the WWR margin in order for LCH SA CDSClear to collect the appropriate level of margin amount required for any clearing member portfolio, the proposed WWR Change is also consistent with the SEC requirement for accurate clearance and settlement of transactions cleared by LCH SA.

Further, from the perspective of financial risk management and margin requirements, the clearing of the proposed new iTraxx® Australia index and the associated single name constituents would not require changes to LCH SA’s existing margin methodology, default management policies and procedures and operational process, as the proposed products do not include any new risk factor compared to the Corporates and Financials indices or single names already cleared by the LCH SA CDSClear service. The iTraxx® Australia transactions would be cleared pursuant to LCH SA’s existing clearing arrangements and related financial safeguards, protections and risk management procedures which are consistent with Exchange Act Rule 17Ad-22(e)(17),⁸ requiring a covered clearing agency to establish, implement, maintain and

⁶ 15 U.S.C. 78q-1(b)(3)(F).

⁷ 15 U.S.C. 78q-1(b)(3)(F).

⁸ 17 CFR 240.17Ad-22(e)(17).

enforce written policies and procedures reasonably designed to manage the covered clearing agency's operational risks by, among other things, identifying the plausible sources of operational risk, both internal and external, and mitigating their impact through the use of appropriate systems, policies, procedures, and controls.

Adopting rules to facilitate the clearing of the iTraxx® Australia transactions would also be consistent with other relevant requirements of Rule 17Ad-22(e),⁹ as set forth in the following discussion.

Margin Requirements. Rule 17Ad-22(e)(4)¹⁰ requires LCH SA to establish, implement, maintain and enforce written policies and procedures reasonably designed to effectively identify, measure, monitor, and manage its credit exposures to participants and those arising from its payment, clearing, and settlement processes, among other requirements. In terms of financial resources, LCH SA would apply its existing margin methodology – including its Wrong Way Risk margin framework – to the new iTraxx® Australia Index, which are similar to the European indices currently cleared by LCH SA. LCH SA believes that the proposed rules that would apply this risk model to the new iTraxx® Australia Index will provide sufficient margin requirements to cover its credit exposure to its clearing members from clearing such contracts, consistent with the requirements of Rule 17Ad-22(e)(4).¹¹

Financial Resources. Rule 17Ad-22(e)(4)(i)¹² requires LCH SA to establish, implement, maintain and enforce written policies and procedures reasonably designed to

⁹ 17 CFR 240.17Ad-22(e).

¹⁰ 17 CFR 240.17Ad-22(e)(4).

¹¹ 17 CFR 240.17Ad-22(e)4.

¹² 17 CFR 240.17Ad-22(e)(4)(i).

effectively identify, measure, monitor, and manage its credit exposures to participants and those arising from its payment, clearing, and settlement processes by maintaining sufficient financial resources to cover its credit exposure to each participant fully with a high degree of confidence. To the extent not already maintained pursuant to paragraph (e)(4)(i), Rule 17Ad-22(e)(4)(ii)¹³ requires LCH SA's policies and procedures be reasonably designed to maintain 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. As explained in the above paragraph on Margin Requirements, LCH SA also believes its Default Fund, under its existing methodology, will, together with the required margin, provide sufficient financial resources to support the clearing of the new iTraxx® Australia Index contracts, consistent with the requirements of Rules 17Ad22(e)(4)(i) and (ii).

Operational Resources. Rule 17Ad-22(e)(3)¹⁴ requires LCH SA to establish, implement, maintain and enforce written policies and procedures reasonably designed to maintain a sound risk management framework for comprehensively managing legal, credit, liquidity, operational, general business, investment, custody, and other risks that arise in or are borne by the covered clearing agency. LCH SA believes that its existing operational and risk management resources will be sufficient for clearing of the iTraxx Australia transactions, consistent with the requirements of Rule 17Ad-22(e)(3)¹⁵, as this

¹³ 17 CFR 240.17Ad-22(e)(4)(ii).

¹⁴ 17 CFR 240.17Ad-22(e)(3).

¹⁵ 17 CFR 240.17Ad-22(e)(3).

new index contract is substantially the same from an operational and risk management perspective as the existing index contracts.

LCH SA will also apply its existing default management policies and procedures for the iTraxx® Australia transactions. As with current CDSClear products with similar risk profile, LCH SA believes that these procedures allow for it to take timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of clearing member insolvencies or defaults in respect of the additional single names, in accordance with Rule 17Ad-22(e)(3).¹⁶

Exchange Act Rule 17Ad-22(e)(1)¹⁷ requires that a covered clearing agency 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. As described above, the proposed iTraxx Change is also modifying the CDSClear framework for indices and single names CDS to take into account the new product iTraxx® Australia indices and the associated single name constituents and provide for a clear and transparent legal basis for LCH SA's CDS Clearing rules consistent with the requirements of Exchange Act Rule 17Ad-22(e)(1)¹⁸.

Following the recommendation raised by the LCH SA CDSClear Risk model validation, the proposed WWR Change is improving the stability and accuracy of the WWR margin so that LCH SA can determine and duly collect the full margin amount required for the level of risk exposure of any clearing member portfolio. Therefore LCH

¹⁶ 17 CFR 240.17Ad-22(e)(3).

¹⁷ 17 CFR 240.17Ad-22(e)(1).

¹⁸ 17 CFR 240.17Ad-22(e)(1).

SA believes it is consistent with Rule 17Ad-22(e)(6)(i),¹⁹ requiring a covered clearing agency 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.

Credit default swap (CDS) is an over-the-counter (OTC) market on which participants can be active at any time in the context of market stress. The LCH SA CDS Clear risk model is considering 5-d moves of unhedged portfolios and the back testing results confirmed that the margins were sufficient to cover the exposure in the interval between the last margin collection and the close out of the portfolio a defaulting clearing member which is consistent with the requirements of SEC Rule 17Ad-22(e)(6)(iii)²⁰.

For all these reasons, LCH SA believes that the Proposed Rule Change is consistent with the requirements of Section 17A of the Act and the regulations thereunder, including the standards under Rule 17Ad-22²¹ as discussed above.

B. Clearing Agency's Statement on Burden on Competition.

Section 17A(b)(3)(I) of the Exchange Act requires that the rules of a clearing agency not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.²²

¹⁹ 17 CFR 240.17Ad-22(e)(6).

²⁰ 17 CFR 240.17Ad-22(e)(6)(iii).

²¹ 17 CFR 240.17Ad-22.

²² 15 U.S.C. 78q-1(b)(3)(I).

LCH SA does not believe that its proposed clearing of Markit iTraxx® Australia indices and the associated single name constituents will adversely affect competition in the trading market for those contracts or CDS generally. By allowing LCH SA to clear Markit iTraxx® Australia indices and the associated single name constituents, market participants will have additional choices on where to clear and which products to use for risk management purposes, which, in turn, will promote competition and further the development of CDS for risk management.

In addition, LCH SA will continue to apply its existing fair and open access criteria to the clearing of these additional products and will apply the same criteria to every clearing member or client who proposes to enter into this clearing activity.

Further, as explained above, the WWR Change is proposed to improve the stability and accuracy of the WWR margin so that LCH SA can collect the full margin amount as duly and equally required for any CDSClear market participant.

Accordingly, LCH SA does not believe that the Proposed Rule Change would impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Clearing Agency's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

Written comments relating to the proposed rule change have not been solicited or received. LCH SA will notify the Commission of any written comments received by LCH SA.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period up to 90 days (i) as the Commission may designate if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-LCH SA-2022-004 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-LCH SA-2022-004. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The

Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549 on official business days between the hours of 10:00 am and 3:00 pm. Copies of the filing also will be available for inspection and copying at the principal office of LCH SA and on LCH SA's website at:

<https://www.lch.com/resources/rulebooks/proposed-rule-changes>. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-LCH SA-2022-004 and should be submitted on or before [Commission to insert date 21 days from publication in the Federal Register].

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

J. Matthew DeLesDernier,
Assistant Secretary.

²³ 17 CFR 200.30-3(a)(12).