

Via CFTC Portal

12 September 2022

**Mr Christopher J. Kirkpatrick**  
**Office of the Secretariat**  
**Commodity Futures Trading Commission**  
**Three Lafayette Centre**  
**1155 21<sup>st</sup> Street NW**  
**Washington, DC 20581**

**Re:** Proposed amendments to LCH SA CDS Clearing Rules – iTraxx® Asia ex Japan and CDX® Emerging Markets and Sovereigns

Dear Mr. Kirkpatrick,

Pursuant to CFTC regulation §40.6(a), LCH SA (“**LCH SA**”), a derivatives clearing organization (“**DCO**”) registered with the Commodity Futures Trading Commission (the “**CFTC**”), is submitting for self-certification the proposed amendments to its CDS Clearing framework to enhance and expand its clearing services to additional index and single name credit default swaps (“**CDS**”) (the “**Proposed Rule Change**”).<sup>1</sup>

The Proposed Rule Change is expected to be effective from mid-October, 2022 however, in no event, will either be implemented earlier than 10 business days after the proposed changes are filed with the CFTC.

The text of the Proposed Rule Change is attached hereto as Appendix.

**Part I: Explanation and Analysis**

LCH SA is proposing to provide clearing services with regard to Markit iTraxx® Asia ex Japan Indices and the associated single name constituents, Markit CDX® Emerging Markets Indices and the single names that comprise each index, as well as a list of additional sovereign single names which are not constituent of an index (all together the “**New Products**”).

**Part II: Description of Rule Changes**

To expand its clearing services in this way, LCH SA is proposing to amend its CDS Clearing Supplement (the “**Supplement**”) and Section 2 of the CDS Clearing Procedures (the “**Procedures**”) to accommodate

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<sup>1</sup> Capitalized terms used but not defined herein shall have the meaning specified in LCH SA’s existing CDS Clearing Rule Book or Clearing Supplement.

these additional indices and single names. LCH SA is further proposing to amend its CDS Margin Framework and Default Fund Methodology to reflect the addition of the New Products in the scope of instruments eligible for clearing by members of LCH SA CDS Clear service as follows :

**1. Proposed amendments to the CDS Clearing Rule Book**

**a) Amendments to the Clearing Supplement**

To accommodate the New Products, LCH SA is proposing to amend the following definitions set out in Section 1.2 of Part B of the Supplement: (i) "Compression Cut-off Date"; (ii) "Novation Cut-off Date"; (iii) "Index Cleared Transaction Confirmation"; and (iv) "Transaction Business Day".

Specifically, the definitions of "Compression Cut-off Date" and "Novation Cut-off Date" are each being amended to add two additional credit events that are taken into consideration in determining the "Compression Cut-off Date" and "Novation Cut-off Date": (i) the "Obligation Acceleration Credit Event"; and (ii) the "Repudiation/Moratorium Credit Event". These credit events, which are both standard under the 2014 ISDA Credit Derivatives Definitions, are not credit events that apply to any of the transaction types referenced by CDS that are currently eligible for clearing at LCH SA and, therefore, did not previously need to be addressed in the Supplement. These credit events apply to certain transaction types for sovereigns, and are proposed to be added as a result of index comprising of and single name CDS referencing sovereign reference entities becoming eligible for clearing.

In addition, the definition of "Index Cleared Transaction Confirmation" is proposed to be revised to provide that: (i) with regard to any index cleared transaction that references a Markit iTraxx ex Japan Index Series [27] or above, the confirmation will be the form of confirmation that incorporates the iTraxx Asia/Pacific Untranching Standard Terms Supplement; and (ii) with regard to any index cleared transaction that references a Markit CDX.EM Index Series [27] or above, the form of confirmation that incorporates the CDX Emerging Markets Untranching Transactions Standard Terms Supplement, in each case being the latest version in force as published by Markit North America, Inc.

The definition of a "Transaction Business Day" is currently defined to mean a "Business Day", as defined in the Index Cleared Transaction Confirmation or the Single Name Cleared Transaction Confirmation, as applicable. This term is proposed to be amended to take into account the situation where such confirmations could include different definitions of the term "Business Day" depending on the circumstances by providing that, "if the relevant Index Cleared Transaction Confirmation or Single Name Cleared Transaction Confirmation defines such term differently depending upon its use, such distinction shall also apply to the use of the term Transaction Business Day herein."

In Section 2 of Part B of the Supplement, LCH SA is proposing to amend Section 2.2 (*Index Cleared Transaction Confirmation*) which specifies the manner in which an Index Cleared Transaction Confirmation is amended, supplemented and completed depending on the index CDS that is cleared to include, in addition to the indices currently set out in the section, the iTraxx Asia ex Japan Index and the CDX.EM Index and provide for the necessary amendments to be made to the relevant confirmations depending on the index. Section 2.2. is also proposed to be amended to provide that "*The applicable Physical Settlement Matrix is the version of the Physical Settlement Matrix which is in force on the Clearing Day on which the Index Cleared Transaction is registered by LCH SA*" in a new indent (i) of paragraph (f). The purpose of this amendment is to ensure that the Additional Provisions for Certain

Russian Entities published by ISDA on March 25, 2022 will apply to the relevant cleared trades, including the trades submitted through the backloading cycle that could have been entered into before the implementation date of these Additional Provisions and updated Physical Settlement Matrix and for which one of the parties, or both, did not adhere to the ISDA 2022 Russia Additional Provisions Protocol published by ISDA on March 29, 2022.

In Section 4 of Part B of the Supplement, LCH SA is proposing to amend Section 4.1(b) to add a “Repudiation/Moratorium Extension Notice” to the types of notices that neither LCH SA nor a clearing member is entitled to deliver with regard to an M(M)R Restructuring in accordance with the terms of any Restructuring Cleared Transaction. As above, a “Repudiation/Moratorium Extension Notice” is standard under the 2014 ISDA Credit Derivatives Definitions and is being proposed to be added as a result of index comprising of and single name CDS referencing sovereigns becoming eligible for clearing.<sup>2</sup>

In Section 6 of Part B of the Supplement, Section 6.5(c) is proposed to be amended to add “Package Observable Bond” to the types of asset packages that can be identified in a Notice of Physical Settlement (“NOPS”) or a NOPS Amendment Notice. The Package Observable Bond provisions in the 2014 ISDA Credit Derivatives Definitions only apply to transactions referencing sovereigns. As a result, they did not previously need to be referenced in the Supplement.

LCH SA is also proposing to add a new section 6.8(c) entitled “Buy-in of Bonds – Cap on Settlement” for the purposes of clarifying how the “60 Business Day Cap on Settlement”, which is relevant for transactions derived from the CDX EM Index amongst others, will apply to CCM Client Transactions in respect of the Matched Contracts of a Settlement Matched Pair. This proposed amendments consist in making an adjustment as to the manner in which Section 9.10 of the 2014 ISDA Credit Derivatives Definitions works between Matched Buyer and Matched Seller to ensure that the extension of the Termination Date provided for by Section 9.10 will apply when there has been a notice delivered to Matched Seller by its client under a CCM Client Transaction. This is to ensure that the Termination Date of the Cleared Transactions and related CCM Client Transaction is the same.<sup>3</sup>

**b) Amendments to Section 2 of the Procedures**

LCH SA is also proposing to make one minor technical amendment to Section 2 of the Procedures (*Margin, NPV Payment and Price Alignment*). Specifically, the initial sentence of Section 2.7(c) currently provides, *inter alia*, that, where a Clearing Member is acting as a CDS Seller, Short Charge Margin will be required to cover the risk that the Clearing Member is subject to an event of default at the same time that a credit event occurs “with respect to a Reference Entity”. Recognizing that a credit event may

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<sup>2</sup> For the same reason, “Repudiation/Moratorium Extension Notice” is proposed to be added to Section 5(b) of Appendix XIII of Part B of the Supplement (*CCM Client Transaction Requirements*).

<sup>3</sup> For the same reason, the provisions of section 6.8(c) are effectively repeated in Section 7.8 and Section 7.18 of Appendix XIII of Part B of the Supplement (*CCM Client Transaction Requirements*). Separately, Section 7.15 of Appendix XIII, Alternative Procedures relating to Loans in respect of Matched Contracts, and Section 7.17 of Appendix XIII, Alternative Procedures relating to Assets Not Delivered, are proposed to be amended to remove as unnecessary the phrase “for the purposes of the Matched Contracts of the related Settlement Matched Pair” and also to use the correct defined term “Settlement Matched Pair”.

occur with respect to more than one Reference Entity, this sentence is proposed to be revised to refer to “one or more Reference Entities”.

**2. Proposed amendments to the CDSClear Risk methodology documentation**

**a) Amendments to the Reference Guide: CDS Margin Framework**

LCH SA is proposing to amend the Margin Framework to reflect the addition of the new single names. For example, Section 3.4.5, Portfolio Margining, which, *inter alia*, lists the various combinations of instruments that can constitute an index basis package, is proposed to be revised to add to the list (i) the CDX.EM Index vs All Single Names Constituents of the index and (ii) the iTraxx Asia ex Japan vs All Single Names Constituents of the index. In addition, LCH SA is proposing to amend Section 3.5.1, Recovery Rate for Short Charge to note that the recovery rate for state-owned enterprises (“SOE”) is 70 percent. LCH is also proposing to move the provisions of current Section 3.5.2, Short Charge Calculation, to a new Section 3.5.3. A new Section 3.5.2, Sovereign Exposures, is proposed to be added, which notes the high level of correlation between SOEs and their sovereign entities. As a result, an SOE that is more than 50 percent owned by a sovereign entity would be defaulted jointly with its sovereign entity when the positions are not risk reducing. Further, exposures for SOEs will be calculated using a fixed 70 percent recovery rate.

LCH SA is also proposing to amend Section 3.8.1, Offsets inter-region, to expand the regional pairs that LCH SA will consider in calculating wrong way risk to include: (i) Europe/US; (ii) Europe/Australia; (iii) Europe/Asia; (iv) US/Australia; (v) US/Asia; and (vi) Asia/Australia.

LCH SA is proposing to amend Section 4.1.1, Liquidity Charge for Linear Portfolio, to note that the liquidation cost of a sub-portfolio composed of a single 5 year position in the principal on the run index is simply the sum of the macro hedging cost. Further, single names without a parent index are considered a sub-portfolio for which LCH SA charges the cost of unwinding a non-hedged sub-portfolio.

Section 4.1.2, Macro Hedging Phase, which, *inter alia*, sets out a list of sub-portfolios corresponding to indices and their components is proposed to be revised to add: (i) the CDX.EM sub-portfolio; (ii) the iTraxx Asia ex Japan IG sub-portfolio, and (iii) the No parent index sub-portfolio.

Finally, LCH SA is proposing to amend Section 4.1.7 to update the existing thresholds and include more cleared indexes in the table for volume thresholds based on calibrations done in December 2021. A dedicated liquidity grid has also been added for sovereign single names in order to reflect their tighter bid-ask spreads and higher liquidity profiles.

**b) Amendments to the CDS Default Fund Methodology**

LCH SA is also proposing to amend its CDS Default Fund Methodology (Guide Stress testing) in a number of sections, to reflect the extension of the product offer as well as to introduce a Sovereign Stressed Short Charge component aimed to capture a potential joint default of a member and its country:

- the last paragraph of section 2.2 adds to the list of index families covered to reflect the addition of CDX.EM and iTraxx Asia. It also adds iTraxx Australia, as this should have been updated when introducing that index.

- section 2.4.1 details how State-Owned Entities' exposures should be added to the exposure on the sovereign name only if risk increasing
- section 2.4.2 introduces a Sovereign Stressed Short Charge, considering jointly the top exposure across the portfolio and if relevant the exposure on the sovereign name corresponding to the member's jurisdiction
- section 2.4.3. and 2.7.2 describe the same Sovereign Stressed Short Charge with formulas instead of plain text
- section 2.6.1. and 2.6.3 extend the logic of exercise decisions to consider the Sovereign Stressed Short Charge when relevant.

### **Part III: Core Principle Compliance**

LCH SA has reviewed the Proposed Rule Changes against the requirements of Commission' regulations and DCO Core Principles, and finds that these changes will continue to comply with all the requirements and standards therein and in particular with the following principles and Commission's regulations including, but not limited to § 30.13 and 39.27.

**DCO Core Principle D – Risk management.** CFTC Regulation 39.13 requires a DCO to ensure that it possesses the ability to manage the risks associated with discharging the responsibilities of the derivatives clearing organization through the use of appropriate tools and procedures. If we except the relevant update, from the perspective of financial risk management and margin requirements, the clearing of the New Products would not require changes to LCH SA's existing margin methodology, default management policies and procedures and operational process, as LCH SA determined that the current margin framework for its CDSClear service already appropriately captures the risk associated to the New Products. The New Products would be cleared pursuant to LCH SA's existing clearing arrangements and related financial safeguards, protections and risk management procedures in accordance with the requirements of Core Principle D and § 39.13.

**DCO Core Principle R – Legal risk considerations.** LCH SA has determined that the Proposed Rule Changes are consistent with the requirements of CFTC Regulation 39.27 to remain in good standing at all times in the relevant jurisdictions and to operate pursuant to a well-founded, transparent, and enforceable legal framework that addresses each aspect of its activities. As described above, the CDSClear risk and legal framework for indices and single names CDS was modified to take into account the New Products and provide for a clear and transparent legal basis for LCH SA's CDS Clearing rules which is fully consistent with the requirements of Core Principle R and § 39.27.

### **Part IV: Public Information**

LCH SA has posted a notice of pending certifications with the CFTC and a copy of the submission on LCH's website at: <https://www.lch.com/resources/rulebooks/proposed-rule-changes>

### **Part V: Opposing Views**

There were no opposing views expressed to LCH SA by governing board or committee members, members of LCH SA that were not incorporated into the rule.

**Certification**

LCH SA hereby certifies to the CFTC, pursuant to the procedures set forth in the Commission regulation § 40.6, that attached changes submission complies with the Commodity Exchange Act, as amended, and the regulations promulgated there under.

Should you have any questions please contact me.

A handwritten signature in blue ink, appearing to read 'Faure', is written over a horizontal line.

**Francois Faure**  
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## **APPENDIX**

Proposed Rule changes to LCH SA CDS Clearing framework:

- 1) CDS Clearing Supplement and Section 2 of the CDS Clearing Procedures
  
- 2) LCH SA Reference Guide: CDS Margin Framework (V3.14) and CDS Default Fund Methodology (V1.9) **(to be filed separately with the CFTC under Confidential Treatment request)**