

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-99423; File No. SR-LCH SA-2023-008)

January 24, 2024

Self-Regulatory Organizations; LCH SA; Order Approving Proposed Rule Change, as Modified by Partial Amendment No. 1, Relating to Recovery and Resolution

I. Introduction

On November 24, 2023, 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 to amend its CDS Clearing Rule Book (“Rule Book”) to make amendments relating to recovery and resolution. On December 5, 2023, LCH SA filed Partial Amendment No. 1 to the proposed rule change to make certain changes to the Exhibit 5 to File No. LCH SA-2023-008.³ The proposed rule change, as modified by Partial Amendment No. 1 (hereinafter, the “Proposed Rule Change”) was published for comment in the *Federal Register* on December 13, 2023.⁴ The Commission has not received any comments on the Proposed Rule Change. For the reasons discussed below, the Commission is approving the Proposed Rule Change.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Partial Amendment No. 1 updates the pagination throughout Exhibit 5 to File No. LCH SA-2023-008 and the Table of Contents in Exhibit 5 to File No. LCH SA-2023-008 to reflect the revised pagination. Partial Amendment No. 1 would also remove two references to field codes in Chapter 1 of Exhibit 5 to File No. LCH SA-2023-008.

⁴ Securities Exchange Act Release No. 99109 (Dec. 7, 2023), 88 FR 86389 (Dec. 13, 2023) (File No. SR-LCH-2023-008).

II. Description of the Proposed Rule Change

LCH SA is a clearing agency that offers clearing of, among other things, credit-default swaps (“CDS”).⁵ LCH SA is registered with the Commission for clearing CDS that are security-based swaps (“SBS”) and with the Commodity Futures Trading Commission (“CFTC”) for clearing CDS that are swaps. In addition to being registered with the Commission and CFTC, LCH SA is authorized to offer clearing services in the European Union pursuant to rules established under European Markets Infrastructure Regulation (“EMIR”) for Central Counter Parties (“CCP”). LCH SA is required to amend its rules to remain in compliance with the CCP Recovery and Resolution Regulation under EMIR.⁶ The goal of the CCP Recovery and Resolution Regulation is to ensure that both CCPs and national authorities in the European Union have the means to act decisively in a crisis scenario. LCH SA is proposing to amend its Rule Book to comply with Article 9(6) and Article 9(14) of the CCP Recovery and Resolution Regulation.⁷ The Proposed Rule Change would amend Title I, Title II, Title IV, and Appendix 1 of the Rule Book.

Article 9(14) of the CCP Recovery and Resolution Regulation requires that, following a default event in respect of a clearing member, each CCP shall use an additional amount of its pre-funded, dedicated own resources (the “second skin-in-the-game”) prior to the requirement of non-defaulting clearing members to make a contribution in cash to the CCP amounting to at least each clearing member’s contribution to the default fund. This second skin-in-the-game is required in addition to the prefunded resources required in accordance with EMIR (the “first

⁵ Capitalized terms used but not defined herein have the meanings specified in the LCH CDS Rule Book as applicable.

⁶ Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade reporting, Title III, Chapter 1, Section 1, Article 9.

⁷ *Id.*

skin-in-the-game”),⁸ which will be used by the CCP before the use of each non-defaulting clearing member’s initial contribution to the default fund.⁹ On November 25, 2022, the European Commission adopted a delegated act specifying the methodology for calculation and maintenance of the second skin-in-the-game to be used in accordance with Article 9(14) of the CCP Recovery and Resolution Regulation (the “Commission-Delegated Regulation”).¹⁰ Separately, Article 9(6) of the CCP Recovery and Resolution Regulation requires that CCPs provide in their rules that they may deviate from their recovery plan measures and, in such circumstances, they shall notify their competent authority designated in accordance with EMIR.¹¹

A. *Defined Terms*

Title I of LCH SA’s Rule Book addresses general provisions and legal framework, including a set of defined terms in Chapter 1. LCH SA proposes to add two new defined terms to Chapter 1. First, LCH SA would add the term “CCP Recovery and Resolution Regulation,” which would be defined as Regulation (EU) 2021/23 of the European Parliament and of the Council of 16 December 2020 on a framework for the recovery and resolution of central counterparties. Second, LCH SA would add the term “ACPR,” which would be defined as the

⁸ Article 9(14) of Regulation (EU) 2021/23 of the European Parliament and of the Council of 16 December 2020 on a framework for the recovery and resolution of central counterparties.
<http://data.europa.eu/eli/reg/2021/23/oj>.

⁹ Regulation (EU) 2021/23 of the European Parliament and of the Council of 16 December 2020 on a framework for the recovery and resolution of central counterparties, *Article 9(14)*.
<http://data.europa.eu/eli/reg/2021/23/oj>.

¹⁰ Commission Delegated Regulation (EU) 2023/840 of 25 November 2022 supplementing Regulation (EU) 2021/23 of the European Parliament and of the Council with regard to regulatory technical standards specifying the methodology for calculation and maintenance of the additional amount of pre-funded dedicated own resources to be used in accordance with Article 9(14) of that Regulation.
http://data.europa.eu/eli/reg_del/2023/840/oj.

¹¹ Regulation (EU) 2021/23 of the European Parliament and of the Council of 16 December 2020 on a framework for the recovery and resolution of central counterparties, *Article 9(6)*.
<http://data.europa.eu/eli/reg/2021/23/oj>.

Autorité de Contrôle Prudentiel et de Résolution and any successor organization. The ACPR is one of LCH SA's national competent authorities.¹² LCH SA also proposes to replace each reference to Autorité de Contrôle Prudentiel et de Résolution in the Rule Book with the new defined term ACPR.

B. *Recovery Plan*

Title I of LCH SA's Rule Book includes provisions related to membership in LCH SA, including terms related to the suspension and termination of membership in Chapter 4 of Title II. LCH SA proposes to add a new section 2.4.4 to Chapter 4 that pertains specifically to recovery. LCH SA maintains a recovery plan. The recovery plan includes certain quantitative and qualitative indicators to identify the circumstances under which LCH SA may take specific measures, which are also specified in the recovery plan, in the case of a default or non-default event. The goal of such measures is the restoration of LCH SA's financial resources so it can continue providing critical functions in all relevant scenarios. As required by Article 9(6), proposed Article 2.4.4 would provide for an additional scenario in which LCH SA either takes measures provided for in its recovery plan despite the fact that the relevant indicators have not been met, or refrains from taking measures provided for in the recovery plan despite the fact that the relevant indicators have been met. In either event, the proposed rule change would require any such proposal to be submitted to the LCH SA board of directors for approval, and LCH to submit to the ACPR without delay any subsequent decision taken by the board of directors.

C. *Default Waterfall*

¹² EMIR requires that each EU member state designate the competent authority responsible for, *inter alia*, supervision of CCPs established in its territory. See Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, Title III, Chapter 2, Section 1, Article 22 (Competent Authority).

Title IV of LCH SA's Rule Book includes provisions related to risk management, including terms related to events of default in Chapter 3 of Title IV. LCH SA proposes to amend the default waterfall provisions in Article 4.3.3.1 of Chapter 3. Article 4.3.3.1 defines the waterfall of resources that LCH SA would apply to cover losses arising out of a member default. LCH SA proposes to add LCH SA's second skin-in-the-game as a new loss mitigation resource to its default waterfall.¹³ The second skin-in-the-game would be applied immediately before the collateral deposited by the non-defaulting clearing members. The proposed amendment to the waterfall provisions will also provide that, in accordance with Article 9(14) of the CCP Recovery and Resolution Regulation and Article 1 of the Commission-Delegated Regulation, the LCH SA additional dedicated own resources, as determined from time to time, will be (a) up to the amount of such dedicated own resources allocated to the CDS Default Fund in proportion to the size of the CDS Default Fund; and (b) in the case of an Event of Default occurring after a previous Event of Default, but before LCH SA has reinstated such dedicated own resources in accordance with Article 3(2) of the Commission Delegated Regulation, up to the residual amount of such dedicated own resources in the CDS Default Fund.

In the penultimate paragraph of Article 4.3.3.1, LCH SA proposes to clarify that the LCH SA second skin-in-the-game could be up to the amount of LCH SA's own resources allocated to the CDS Default Fund.¹⁴

¹³ The new resource would be added as the sixth resource on the list, requiring LCH SA to renumber items (vi) and (vii) of the current list.

¹⁴ LCH SA also proposes conforming edits in Section 7 of Appendix 1 to the Rule Book, which deals with loss distributions in the context of the CDS default management process. Specifically, LCH SA proposes to add a reference in Section 7 of the appendix to section 4.3.3.1 as well as language consistent with the amended language of 4.3.3.1.

III. Discussion and Commission Findings

Section 19(b)(2)(C) of the Act requires the Commission to approve a proposed rule change of a self-regulatory organization if it finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to the organization.¹⁵ For the reasons given below, the Proposed Rule Change is consistent with Section 17A(b)(3)(F) of the Act¹⁶ and Rule 17Ad-22(e)(2)¹⁷ thereunder.

A. *Consistency with Section 17A(b)(3)(F) of the Act*

Section 17A(b)(3)(F) of the Act requires, among other things, that the rules of LCH SA be designed to assure the safeguarding of securities and funds which are in the custody or control of LCH SA or for which it is responsible.¹⁸ As discussed in more detail below, the Proposed Rule Change is consistent with Section 17A(b)(3)(F) of the Act.¹⁹

The Commission continues to regard skin-in-the-game as a potential tool to align the various incentives of a covered clearing agency's stakeholders, including management and clearing members.²⁰ LCH SA proposes to add a second skin-in-the-game as a resource to be used to cover the losses resulting from the implementation of the CDS Default Management Process before the collateral deposited by the non-defaulting clearing members as an additional contribution to the CDS Default Fund. Adding a second skin-in-the-game resource would create additional incentive for LCH SA to maintain the appropriate amount of resources to manage

¹⁵ 15 U.S.C. 78s(b)(2)(C).

¹⁶ 15 U.S.C. 78q-1(b)(3)(F).

¹⁷ 17 CFR 240.17Ad-22(e)(2).

¹⁸ 15 U.S.C. 78q-1(b)(3)(F).

¹⁹ 15 U.S.C. 78q-1(b)(3)(F).

²⁰ Securities Exchange Act Release No. 78961 (Sep. 28, 2016), 81 Fed. Reg. 70786, 70806 (Oct. 13, 2016) (S7-03-14) ("Covered Clearing Agency Standards").

clearing member default because failure to do so would result in a direct cost to LCH SA. Creating additional incentive for LCH SA to maintain an appropriate amount of resources, in turn, could reduce the potential losses charged to the CDS Default Fund contributions of non-defaulting clearing members in the event of a clearing member default, which in turn would help assure the safeguarding of the CDS Default Fund contributions of non-defaulting clearing members.

As discussed above, LCH SA proposes to change its Rule Book so that it can either take measures provided for in its recovery plan even if relevant indicators have not been met, or refrain from taking measures provided for in the recovery plan even though the relevant indicators have been met, provided it obtains board approval and promptly notifies the ACPR of the board's decision. This too would provide LCH SA with additional flexibility to take actions to safeguard funds for which it is responsible.

Based on the foregoing, the Commission finds that the Proposed Rule Change is consistent with the requirements of Section 17A(b)(3)(F) of the Act.²¹

B. Consistency with Rule 17Ad-22(e)(2) under the Act

Rule 17Ad-22(e)(2) under the Act requires that a covered clearing agency establish, implement, maintain, and enforce written policies and procedures reasonably designed to provide for governance arrangements that, among other things, support the public interest requirements of the Act.²² In adopting Rule 17Ad-22(e)(2), the Commission stated that “the proper alignment of incentives is an important element of a covered clearing agency’s risk management practices,” and noted that skin-in-the-game “may play a role in those risk management practices in many

²¹ 15 U.S.C. 78q-1(b)(3)(F).

²² 17 CFR 240.17Ad-22(e)(2)(iii).

instances.”²³ And, as noted above, the Commission continues to regard skin-in-the-game as a potential tool to align the various incentives of a covered clearing agency’s stakeholders, including management and clearing members.²⁴

As described above, LCH SA proposes to amend its Rule Book so that the second skin-in-the-game will be used to cover the losses resulting from the implementation of the CDS Default Management Process immediately before the collateral deposited by the non-defaulting clearing members. This would mean that, following a default event in respect of a clearing member, LCH SA would apply its own resources to mitigate losses before applying resources provided by non-defaulting clearing members. As discussed above, adding a second skin-in-the-game resource would help to create incentive for LCH SA to mitigate, manage, and maintain the appropriate amount of resources to manage clearing member default because failure to do so would result in a direct cost to LCH SA. Such mitigation of risk in the clearance and settlement of securities would be consistent with supporting the public interest because it helps reduce market disruptions. Accordingly, the Commission finds that that the Proposed Rule Change is consistent with Rule 17Ad-22(e)(2) under the Act.²⁵

IV. Conclusion

On the basis of the foregoing, the Proposed Rule Change is consistent with the requirements of the Act, and in particular, Section 17A(b)(3)(F) of the Act²⁶ and Rule 17Ad-22(e)(2)²⁷ thereunder.

²³ Covered Clearing Agency Standards, 81 FR at 70806.

²⁴ Securities Exchange Act Release No. 78961 (Sep. 28, 2016), 81 Fed. Reg. 70786, 70806 (Oct. 13, 2016) (S7-03-14) (“Covered Clearing Agency Standards”).

²⁵ 17 CFR 240.17Ad-22(e)(2).

²⁶ 15 U.S.C. 78q-1(b)(3)(F).

²⁷ 17 CFR 240.17Ad-22(e)(2).

IT IS THEREFORE ORDERED pursuant to Section 19(b)(2) of the Act that the proposed rule change (SR-LCH SA-2023-008), as modified by Partial Amendment No. 1, be, and hereby is, approved.²⁸

For the Commission by the Division of Trading and Markets, pursuant to delegated authority.²⁹

Sherry R. Haywood,

Assistant Secretary.

²⁸ In approving the Proposed Rule Change, the Commission considered the proposal's impacts on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

²⁹ 17 CFR 200.30-3(a)(12).