

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-83389; File No. SR-ICEEU-2018-006)

June 6, 2018

Self-Regulatory Organizations; ICE Clear Europe Limited; Order Approving Proposed Rule Change Relating to the ICE Clear Europe CDS End-of-Day Price Discovery Policy

I. Introduction

On April 5, 2018, ICE Clear Europe Limited (“ICE Clear Europe”) 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-ICEEU-2018-006) to amend ICE Clear Europe’s CDS End-of-Day Price Discovery Policy (“Price Discovery Policy”) to implement a revised methodology used to determine bid-offer widths for credit defaults swap (“CDS”) contracts. The proposed rule change was published for comment in the Federal Register on April 25, 2018.³ The Commission did not receive comments regarding the proposed changes. For the reasons discussed below, the Commission is approving the proposed rule change.

II. Description of the Proposed Rule Change

As part of its pricing process, on a daily basis, ICE Clear Europe uses intraday quotes submitted by its CDS Clearing Members to determine the bid-offer width (“BOW”) for each eligible CDS instrument. The BOW is then used in ICE Clear Europe’s price discovery process as an input to determine, among other things, end-of-day price levels. These levels are, in turn, used for mark-to-market and risk management

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 34-83072 (April 19, 2018), 83 FR 18106 (April 25, 2018) (SR-ICEEU-2018-006) (“Notice”).

purposes.⁴ Under its current methodology, ICE Clear Europe begins its price discovery process by calculating a “consensus BOW” for each relevant CDS instrument based on specified averages of the quotes provided by CDS Clearing Members. ICE Clear Europe then compares this consensus BOW with three pre-defined BOWs that correspond to three specific market regimes, which ICE Clear Europe denotes as Regime 1, Regime 2, and Regime 3. The BOW for Regime 1 is the smallest, and the BOW for Regime 3 is the largest. Depending on where the consensus BOW falls in comparison to the three predefined market regime BOWs, ICE Clear Europe selects one of the market regime BOWs as the end-of-day BOW for a given risk factor based on that risk factor’s most actively traded instrument (“MATI”).⁵

ICE Clear Europe’s clearing risk department is permitted to make adjustments to the calculated end-of-day BOWs based on volatile or “fast-moving” market conditions that may cause BOWs, according to ICE Clear Europe, to be temporarily wider than those observed in intraday quotes.⁶ In order to systematically capture the volatile market conditions and obviate the need for ICE Clear Europe’s clearing risk department to make manual adjustments to the calculated BOWs, ICE Clear Europe proposes to revise its Price Discovery Policy to incorporate a new methodology that would automatically widen the selected BOWs based on observed market conditions. Specifically, ICE Clear Europe proposes to introduce a new “variability level” calculation.

⁴ Notice, 83 FR at 18106.

⁵ Id. at 18106-07.

⁶ Id. at 18106.

For index CDS instruments, this new calculation would take a time series of intraday mid-levels from member quotes and compare the last mid-level for the most actively traded instrument for a considered risk factor to the end-of-day level from the prior day.⁷ Under the proposed methodology, where the last mid-level of the time series for an index CDS instrument is below the prior day's end-of-day level by more than the pre-defined BOW for Regime 3 (i.e., by more than one Regime 3 BOW), ICE Clear Europe will calculate the variability level as the difference between the prior day's end-of-day level and the minimum mid-level of the time series, divided by the Regime 3 BOW. Where the last mid-level is above the prior day's end-of-day level by more than one Regime 3 BOW, ICE Clear Europe would calculate the variability level as the difference between the maximum mid-level of the time series and the prior day's end-of-day level, divided by the Regime 3 BOW. In cases where the last mid-level in the time series is within one Regime 3 BOW of the prior day's end-of-day level, then ICE Clear Europe will set the variability level based on the range of intraday mid-levels. Where the range of mid-levels is less than or equal to the Regime 3 BOW, the variability level would be set to 1. Where the range of mid-levels is greater than the Regime 3 BOW, ICE Clear Europe would set the variability level at 1.2.⁸

In addition to proposing to implement a new variability level calculation, ICE Clear Europe also proposes to group CDS risk factors into "market proxy groups." The market proxy groups for CDS index instruments would consist of CDX, which would cover North American Investment Grade and High Yield indices, and iTraxx, which

⁷ Id.

⁸ Id.

could cover the iTraxx Main, Crossover, Senior Financial, Sub Financials, and High Volatility indices. In connection with establishing these market proxy groups, ICE Clear Europe also proposes to implement “variability bands” that would apply to the market proxy groups and correspond to specified ranges of variability level determined by the new variability level calculation described above. Under the proposed changes, the variability band applicable to a market proxy group would be equal to the largest variability band of the individual risk factors within the group. Depending on the market proxy group variability band, ICE Clear Europe would adjust the selected market Regime BOW by increasing it either one or two Regimes (i.e., from Regime 1 to Regime 2, from Regime 2 to Regime 3, or from Regime 1 to Regime 3), with larger variability bands corresponding to the larger adjustment.⁹ The resulting Regime BOW (i.e., Regime 1, Regime 2, or Regime 3) will serve as the end-of-day BOW.

With respect to single name CDS instruments, ICE Clear Europe proposes to adopt a new scaling factor, denoted the “SN variability factor,” that would be applied to the consensus BOW for single name CDS instruments. The SN variability factor applied to the consensus BOW is determined using the same new variability calculation methodology described above, and the variability factor for single name instruments will range from 1 to 1.5 depending on the applicable market proxy variability band. As with the index instruments, ICE Clear Europe proposes to group single name instruments into market proxy groups (the CDX market proxy group for Standard North American Corporate Single Names, and the iTraxx market proxy group for European Corporate and Standard Western European Sovereign Single Names). ICE Clear Europe would then

⁹ Id. at 18106-07.

apply variability bands to the market proxy groups for single names in the same way that such variability bands are determined for index instruments.¹⁰

ICE Clear Europe also proposes to make certain typographical corrections, as well as updates to cross-references, and other minor clarifications.¹¹

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.¹² For the reasons given below, the Commission finds that the proposed rule change is consistent with Section 17A(b)(3)(F),¹³ and Rules 17Ad-22(e)(6)(iv) and (e)(17)(i).¹⁴

A. Consistency with Section 17A(b)(3)(F)

Section 17A(b)(3)(F) of the Act requires, among other things, that the rules of a registered clearing be designed to promote the prompt and accurate clearance and settlement of securities transactions and, to the extent applicable, derivatives agreements, contracts and 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.¹⁵ The

¹⁰ Id. at 18107.

¹¹ Id.

¹² 15 U.S.C. 78s(b)(2)(C).

¹³ 15 U.S.C. 78q-1(b)(3)(F).

¹⁴ 17 CFR 240.17Ad-22(e)(6)(iv) and (e)(17)(i).

¹⁵ 15 U.S.C. 78q-1(b)(3)(F).

Commission believes that the proposed changes, taken as a whole, should improve ICE Clear Europe's ability to determine appropriate end-of-day BOWs for its CDS instruments in a number of ways, including but not limited to (i) incorporating a new systematic method for evaluating market variability and automatically widening the selected BOWs for index CDS instruments; and (ii) incorporating a new variability scaling factor for single name instruments to account for greater variability in end-of-day BOWs than that which appears in intraday quotes.

By automating the process for widening BOWs through applying pre-determined and well-defined criteria for evaluating and responding to market volatility that will be consistently applied over time for each CDS instrument that ICE Clear Europe clears, the Commission believes that the proposed rule changes will reduce the risk of human error associated with ICE Clear Europe's determination of BOWs. As a result of the likely reduction in human error and the more consistent application over time and across CDS instruments of the BOW widening process, the Commission believes the proposed rule change will promote the prompt and accurate clearance and settlement of CDS instruments by ICE Clear Europe.

Moreover, by systematically taking into account market variability and automatically widening BOWs in response, the Commission believes that the proposed changes will enhance ICE Clear Europe's ability to more consistently and efficiently determine appropriate end-of-day BOWs for the CDS instruments it clears. This improvement in determining end-of-day BOWs for CDS instruments, in turn, should improve ICE Clear Europe's ability to determine more accurate end-of-day price levels for the purposes of mark-to-market and risk management of positions it clears in CDS

instruments, thereby improving ICE Clear Europe's ability to safeguard the securities and funds which are in its custody or control or for which it is responsible. Therefore, the Commission finds that the proposed rule changes are consistent with the requirements of Section 17A(b)(3)(F) of the Act.

B. Consistency with Rule 17Ad-22(e)(6)(iv)

Rule 17Ad-22(e)(6)(iv) requires, in relevant part, that a covered clearing agency establish, implement, maintain and enforce written policies and procedures reasonably designed to cover, if the covered clearing agency provides central counterparty services, its credit exposures to its participants by establishing a risk-based margin system that uses reliable sources of timely price data and uses procedures and sound valuation models for addressing circumstances in which pricing data are not readily available or reliable.¹⁶ As described above, ICE Clear Europe currently uses intra-day quotes to determine end-of-day BOWs for the CDS instruments that it clears. However, under certain volatile or fast moving market conditions BOWs may be wider than observed in intraday quotes.¹⁷ To address this issue, ICE Clear Europe proposes to implement a systematic approach for evaluating market volatility and automatically widening the selected end-of-day BOWs such that the end-of-day BOWs more reliably reflect current market conditions. As a result, the Commission finds that the proposed rule change is consistent with the requirements of Rule 17Ad-22(e)(6)(iv).

¹⁶ 17 CFR 240.17Ad-22(e)(6)(iv).

¹⁷ Notice, 83 FR at 18106.

C. Consistency with Rule 17Ad-22(e)(17)(i)

Rule 17Ad-22(e)(17)(i) requires a covered clearing agency, in relevant part, to establish, implement, maintain and enforce written policies and procedures reasonably designed to manage the covered clearing agency's operational risk 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.¹⁸ As described above, ICE Clear Europe's clearing risk department currently is tasked with monitoring market conditions in order to assess volatility and, if appropriate, manually adjust the selected end-of-day BOWs to reflect such volatility. As described above, by implementing a systematic approach to assessing volatility and an automatic widening of BOWs in appropriate instances, the Commission believes that the proposed rule change will reduce the level of operational risk in ICE Clear Europe's end-of-day pricing methodology because it will establish pre-determined and well-defined criteria that can be quickly and consistently applied to widen the BOWs with minimal human intervention. As a result, the Commission believes that the risk of error associated with observation of market volatility and manual adjustment of the end-of-day BOWs will be mitigated. Therefore the Commission finds that the proposed rule change is consistent with the requirements of Rule 17Ad-22(e)(17)(i).

¹⁸ 17 CFR 240.17Ad-22(e)(17)(i).

IV. Conclusion

On the basis of the foregoing, the Commission finds that the proposed rule change is consistent with the requirements of Section 17A of the Act,¹⁹ and Rules 17Ad-22(e)(6)(iv) and (e)(17)(i)²⁰ thereunder.

IT IS THEREFORE ORDERED pursuant to Section 19(b)(2) of the Act²¹ that the proposed rule change be, and hereby is, approved.²²

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

Eduardo A. Aleman
Assistant Secretary

¹⁹ 15 U.S.C. 78q-1.

²⁰ 17 CFR 240.17Ad-22(e)(6)(iv) and (e)(17)(i).

²¹ 15 U.S.C. 78s(b)(2).

²² 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).

²³ 17 CFR 200.30-3(a)(12).