

**VIA CFTC Portal**

30 November 2020

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

**Re:** Clearing of options on index credit default swaps in respect of North American indices

Dear Mr Kirkpatrick,

Pursuant to CFTC regulation 39.5(b), LCH SA (“**LCH**”), a derivatives clearing organization registered (“**DCO**”) with the Commodity Futures Trading Commission (the “**CFTC**”), is making the present submission for determination of whether mandatory clearing should apply.

**CDX Swaptions initiative**

LCH intends to add to the list of eligible instruments swaptions on CDX Investment Grade and High Yield indices.

**Eligibility to clear swaps and ability to maintain compliance under a mandatory clearing determination**

LCH is launching CDX.NA.IG and CDX.NA.HY index options as part of its CDSClear service, as an extension to its current product offering on [...] 2020 subject to any relevant regulatory review or approval process duly completed. Under CFTC regulation § 39.5(a)(1), LCH is eligible to clear these swaps and will be able to maintain compliance with section 5b(c)(2) of the Commodity Exchange Act in the event.

**Factors for determination**

**The existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data.**

This index options are currently heavily traded but not yet cleared by any CCP.

Swaptions eligible for clearing will include physically delivered European style Swaptions with maturities up to 3 months on the following underlying CDX index CDS.

- On-The-Run 5 Year CDX.NA.IG and CDX.NA.HY
- On-The-Run-1 5 Year CDX.NA.IG and CDX.NA.HY

There are always three option maturities available for clearing on the On-The-Run index Series (1, 2 and 3 months) and there are three option maturities available for clearing on the On-The-Run-1 index Series (1, 2 and 3 months) just after the roll, but no new maturities are made available on that index Series after that (which is the same framework as for iTraxx Swaptions).

As of June 2020, the outstanding notional of trades eligible for clearing amongst all our market participants is \$1.7 Billion in CDX.NA.HY Swaptions and \$37.08 Billion in CDX.NA.IG Swaptions. Because the US entities are the most active on the CDX Swaptions and we currently only have one US member, these numbers represent only a fraction of the overall liquidity in this instrument. Additionally it is important to note that due to Credit Swaptions' short expiry cycle (3 months being the most active), open interest is not a good gauge for the actual trading. It is also estimated that 80% of traded volumes are transactions executed between clients and dealers.

Pricing data is available from Markit and other standard price sources. However, to ensure that LCH always has access to the best prices, even on illiquid products, we have implemented a process whereby members of the CDSClear service (with open interest in a product) contribute prices on a daily basis. These prices are aggregated to create our settlement prices.

**The availability of rule framework, capacity, operational expertise and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded**

LCH already has a well-developed rule framework and support infrastructure for clearing Index Swaptions. LCH intends to leverage this existing operational capability when extending its offering to cover the CDX Swaptions.

In order to prepare for the launch of these Swaptions, LCH has performed testing to ensure that it is able to clear CDX Swaptions in a manner that is consistent with the terms on which these contracts are traded.

As for the other Index Swaptions currently cleared through LCH, the clearing documentation applicable to the CDX Swaptions is based on the market standard documentation.

**The effect on the mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the derivatives clearing organization available to clear the contract**

The CCP's default management protocols, processes and technology are modified to allow clearing of the new product.

The CCP's risk management framework has been calibrated to handle an expected volume of activity.

**The effect on competition, including appropriate fees and charges applied to clearing**

To the best of our knowledge, Swaptions on CDX.NA.HY and CDX.NA.IG are not yet offered to clearing by any other CCP in the US or in Europe, although it is likely to be in the short term, and therefore LCH's early engagement in offering clearing on these instruments will foster competition on this market.

The fees applicable to the clearing of CDX Swaptions are \$15 per million gross notional cleared for General Members, \$18 per million gross notional cleared for Select Members and \$20 per million gross notional cleared for Clients. The Introductory and Unlimited Tariff schemes, alongside the Discounted rates will be applicable to the cumulative iTraxx and CDX Swaption volumes. The current fees for CDX Swaptions have been already rule certified with the CFTC.<sup>1</sup>

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<sup>1</sup>[https://www.lch.com/system/files/media\\_root/CDSClear\\_CIO%20Fee%20Rebate\\_CFTC%20SelfCert\\_Formal\\_1%20April%202019.pdf](https://www.lch.com/system/files/media_root/CDSClear_CIO%20Fee%20Rebate_CFTC%20SelfCert_Formal_1%20April%202019.pdf)

**The existence of reasonable legal certainty in the event of insolvency of the relevant derivatives clearing organization or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds and property**

The level of legal certainty around the clearing of CDX Swaptions is the same as that of any other Credit instrument currently cleared by LCH.

Insofar as legal certainty in the event of the insolvency of the DCO is concerned, LCH would be wound up under French law and has provided opinions on the treatment of cleared swaps customer funds as part of its DCO registration in 2013.

**Product specifications, including copies of any standardized legal documentation, generally accepted contract terms, standard practices for managing any life cycle events associated with the swap, and the extent to which the swap is electronically confirmable.**

The clearing documentation applicable to the CDX Swaptions is based on the market standard CDX Untranchured Transactions Swaptions Standard Terms Supplement published by Markit. This covers the standardized legal documentation and generally accepted contract terms.

Standard practices for managing any life cycle events are based on the credit events as defined under the 2014 ISDA Credit Derivatives Definitions as applicable, and as determined by the ISDA Americas Determination Committee.

Only standardized CDS are eligible to clearing and as a result, they are all electronically confirmable.

**Participant eligibility standards, if different from the derivatives clearing organization's general participant eligibility standards**

The participant eligibility standards have not been modified.

**Pricing sources, models, and procedures, demonstrating an ability to obtain sufficient price data to measure credit exposures in a timely and accurate manner, including any agreements with clearing members to provide price data and copies of executed agreements with third party price vendors, and information about any price reference index used, such as the name of the index, the source that calculates it, the methodology used to calculate the price reference index and when and where it is published publicly**

LCH will continue using a price contribution process as described under Section 5.18 of the CDS Clearing Procedures. All members are required to contribute on contracts on which they have open interest.

**Risk management procedures including measurement and monitoring of credit exposures, initial and variation margin methodology, methodologies for stress testing and back testing, settlement procedures, and default management procedures**

No changes to the current framework for Swaptions were required, but a change to the vega margin calculation has been introduced. Instead of relying on shocks applied to unobservable parameters of a model, a new methodology focusing on the observable changes in volatilities has been developed.

**Applicable rules, manuals, policies or procedures**

- LCH has made some amendments to the CDS Clearing Documentation to take into account the clearing of Swaptions on CDX Investment Grade and High Yield indices: Part C of the CDS Clearing Supplement has been updated mainly to refer to the applicable documentation to CDX Swaptions;
- Section 5.18 of the Procedures has been updated, extending the scope of the price contribution process to CDX Swaptions; and
- A new Clearing Notice regarding the creation of matched pairs will include the applicable maximum notional amounts for CDX swaptions.

**A description of the manner in which the derivatives clearing organization has provided notice of the submission to its members and a summary of any views on the submission expressed by the members**

The proposed amended CDS Clearing Documentation has been provided to the legal working group of the CDSClear clearing members.

Clearing members have also been informed via the notice attached in Appendix.

No specific comments have been expressed by the clearing members.

Yours sincerely



**Francois Faure**  
Chief Compliance Officer  
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**APPENDIX**

- Notice sent to CDSClear members

# Memo

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To	Clearing Members
From	CDSClear
Date	08 October 2020
Subject	<b>CFTC Clearing Mandate Determination for Swaptions on North American index CDS</b>

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## **Introduction**

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