



Jason Silverstein
Executive Director and Associate General Counsel
Legal Department

September 4, 2014

VIA E-MAIL

Mr. Christopher J. Kirkpatrick
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

RE: Regulation 40.10 Submission Regarding the Acceptance of Swaptions for Clearing, CME Submission No. 14-327

Dear Mr. Kirkpatrick:

The clearing house division of Chicago Mercantile Exchange Inc. (“CME Clearing”), in its capacity as a registered derivatives clearing organization (“DCO”), hereby notifies the Commodity Futures Trading Commission (“CFTC”) that it intends to accept for clearing options on USD-denominated, European style, fixed vs. float swaps (“Swaptions”) on the earlier of November 3, 2014, or the receipt of regulatory approval. CME Clearing is proposing enhancements to its interest rate swaps (“IRS”) margin model to account for Swaptions and is proposing certain eligibility rules and requirements for clearing members that are approved to clear Swaptions as further described herein. CME Clearing’s acceptance of Swaptions for clearing could materially affect the nature or level of risks presented by CME Clearing. Pursuant to CFTC Regulation 40.10, CME Clearing hereby submits this notice in which CME Clearing addresses the nature of the acceptance of Swaptions for clearing and its expected effects on risks and explains how it plans to manage such identified risks.¹

To be eligible to clear Swaptions, a clearing member must satisfy CME Clearing's standard criteria applicable to clearing members that clear any IRS products pursuant to CME Rule 8G04 (a member satisfying such criteria, an “IRS Clearing Member”). An IRS Clearing Member must satisfy additional criteria pursuant to proposed CME Rule 8G18.A, attached hereto in Exhibit 1, to be approved by CME Clearing as eligible to clear Swaptions (a member satisfying such criteria, an “IRS Swaptions Clearing Member”).

Swaptions Background

Swaptions offer protection against adverse movements in interest rates. Market participants use Swaptions to hedge future interest rate exposures, manage borrowing costs, and increase risk management flexibility. While central clearing of Swaptions provides several important risk management benefits, including transparency in prices, at least daily mark-to-market and systemic risk reduction, CME Clearing does not believe that this product should become subject to the clearing mandate.

¹ On July 18, 2012, Chicago Mercantile Exchange Inc. was designated a systemically important derivatives clearing organization (“SIDCO”) by the Financial Stability Oversight Council.

The buyer of a Swaption will pay a premium (which will be denominated in USD) to the seller of the Swaption for the right, but not the obligation, to cause the underlying swap to become effective. When entering into a Swaption, the buyer of the Swaption can act as the floating rate payer (and receive the fixed rate) or the fixed rate payer (and receive the floating rate) if the Swaption is exercised on the expiration date. Any fixed rate may be specified for the strike price. Upon exercise, the Swaption will become a cleared IRS on T + n as a result of this life cycle event. The float leg of the swap that becomes effective will reference the underlying swap index (*e.g.*, Libor 3M) as the floating rate. For the initial launch of the offering, CME Clearing is planning to accept European style Swaptions denominated in US Dollars with a maximum expiration date of two years after acceptance for clearing by CME Clearing and maturities of the underlying swap up to thirty years.²

By accepting Swaptions for clearing, CME Clearing would provide market participants the opportunity to manage risk associated with IRS and Swaptions on a portfolio basis by combining cleared IRS and Swaptions portfolios, which would mitigate risks and inefficiencies present in the over-the-counter (“OTC”) Swaptions market due to mandatory clearing of IRS. Swaptions and IRS demonstrate strongly correlated responses to changes in interest rate levels. For this reason, prior to the Dodd-Frank Wall Street Reform and Consumer Protection Act, IRS and Swaptions were risk managed on a portfolio basis, with IRS hedging the risk of changing interest rates (“delta”). One negative consequence of IRS transitioning from OTC to clearing is that as IRS have become centrally cleared, these IRS delta hedges have been separated from Swaptions. This separation complicates portfolio-based risk management, leads to mismatched risk profiles, and potentially increases risk during default situations. Without portfolio risk management, market participants post margins for their cleared IRS and uncleared Swaptions without any offsetting benefits.

Compliance with Core Principles

When CME Clearing accepts Swaptions for clearing, CME Clearing will continue to be able to maintain compliance with the DCO core principles set forth in section 5b(c)(2) of the Commodity Exchange Act (“CEA”) and the regulations promulgated thereunder. The following discusses risks identified by CME Clearing associated with accepting Swaptions for clearing, how CME Clearing plans to manage any such risks, and the sufficiency of the DCO's financial resources.

Financial Resources

In accordance with CFTC Regulations 39.11 and 39.33, CME Clearing maintains financial resources for IRS products (including Swaptions) sufficient to enable it to meet its financial obligations to its IRS Clearing Members notwithstanding a default by the two IRS Clearing Members (and their affiliates that are IRS Clearing Members) creating the largest combined loss to CME Clearing in extreme but plausible market conditions. CME Clearing maintains such financial resources for IRS products (including Swaptions) through its IRS financial safeguards, which include IRS performance bonds, the CME IRS Contribution, the IRS Guaranty Fund, and IRS Assessments (each as defined in Chapter 8G of the CME Rules). CME Clearing is keeping the structure of the IRS Guaranty Fund unchanged, as the existing framework for constructing an appropriate safeguards package is flexible and can accommodate additional products, including Swaptions. CME Clearing will include Swaptions related stress scenarios

² A ten day buffer is added to the expiration and maturity to account for date adjustments related to weekends and holidays.

in the IRS Guaranty Fund sizing methodology. Confidential and proprietary information will be submitted to the CFTC in connection with this filing (such materials, the “Confidential Supplemental Materials”). The Confidential Supplemental Materials contain details regarding CME Clearing's financial safeguards.

Participant and Product Eligibility

In accordance with CFTC Regulation 39.12(a), CME Clearing will establish objective, publicly disclosed, and risk-based admission and continuing participation requirements for IRS Swaptions Clearing Members. To become an IRS Swaptions Clearing Member, a clearing member must be an IRS Clearing Member and satisfy the additional criteria in proposed CME Rule 8G18.A, attached hereto in Exhibit 1. These additional criteria include: a demonstration of operational capabilities to clear Swaptions; the ability, commitment, and expertise to manage risk associated with clearing Swaptions; a requirement to provide traders to the IRS Default Management Committee; and other questionnaires and diligence. Pursuant to proposed CME Rule 8G18.B, attached hereto in Exhibit 1, IRS Swaptions Clearing Members will also be required to submit Swaptions pricing data on a daily basis to CME Clearing and will be subject to certain penalties for failure to provide the required submission as further described in proposed CME Rule 8G18.B.

As required by CFTC Regulation 39.12(b), CME Clearing has established appropriate requirements for determining the eligibility of products submitted to the DCO for clearing. These requirements take into account CME Clearing's ability to manage the risks associated with those products as further described herein.

Settlement Procedures

Pursuant to CFTC Regulation 39.14(b), CME Clearing effects a settlement with each IRS Clearing Member, and will effect a settlement with each IRS Swaptions Clearing Member, at least once each business day and has the authority and operational capacity to effect a settlement with each IRS Clearing Member on an intraday basis either routinely, when specified thresholds are breached, or in times of extreme market volatility. CME Clearing will settle Swaptions using a proprietary model based on the Swaptions market information provided by IRS Swaptions Clearing Members pursuant to proposed CME Rule 8G18.B. This proprietary model will calibrate a settlement price for Swaptions of different expiries, tenors, and moneyness. On a day that CME Clearing does not receive adequate Swaptions market information from IRS Swaptions Clearing Members, it will supplement with third party data and run the proprietary model. Additional detail regarding the settlement model and the processes that will be used to price Swaptions is provided in the Confidential Supplemental Materials.

Risk Management

CFTC Regulation 39.13(g)(2)(i) requires a DCO to establish initial margin requirements that are commensurate with the risks of each product and portfolio. Consistent with this regulation, CME will enhance its existing Historical Value at Risk (HVar) based performance bond and liquidity/concentration add-on models for IRS to cover the additional risk factors presented by the clearing of Swaptions and will margin existing IRS and Swaptions on a portfolio basis.

CME Clearing's Swaptions margin model generates performance bond requirements that are sufficient to cover CME Clearing's potential future exposures to clearing members based on price movements in the interval between the last collection of settlement variation and the liquidation time in accordance with

CFTC Regulation 39.13(g)(2)(ii). CME Clearing will continue to use a minimum liquidation time that is five days for IRS portfolios that include Swaptions. CME Clearing's Swaptions margin model is designed to meet an established confidence level of at least ninety-nine percent as required by CFTC Regulation 39.13(g)(2)(iii). A description of the Swaptions enhancements to the IRS margin model is provided in the Confidential Supplemental Materials.

As described earlier, the existing IRS financial safeguards will be utilized to cover exposures from IRS Swaptions Clearing Members and will include stressed volatility scenarios to size the IRS Guaranty Fund (which will not require any model changes). The IRS financial safeguards will continue to provide protection beyond daily settlement variation and performance bonds.

Default Rules and Procedures

To ensure proper management of defaulted Swaptions portfolios, CME Clearing will follow an approach to the default management process currently in place for IRS under the IRS Default Management Guidelines, with appropriate modifications such that portfolios of IRS and Swaptions across different risk profiles can be successfully closed out within the margin period of risk. The default management process that will be used for Swaptions is discussed in the Confidential Supplemental Materials. As required by CFTC Regulation 39.16(c), CME Clearing's default management procedures—including the default management procedures applicable to Swaptions—permit it to take timely action to contain losses and liquidity pressures and to continue to meet its obligations in the event of a clearing member default. CME Clearing has adopted rules that set forth its default procedures and makes these rules publicly available. CME Clearing will require an IRS Swaptions Clearing Member to provide prompt notice to CME Clearing if it becomes the subject of a bankruptcy petition, receivership proceeding, or the equivalent as detailed in CFTC Regulation 39.16(d).

Legal Risk

CME Clearing provides a well-founded, transparent, and enforceable legal framework for clearing Swaptions in accordance with CFTC Regulation 39.27. CME Clearing's legal framework provides for netting arrangements, interests in collateral, steps to address a default of an IRS Clearing Member, the settlement of funds transfers, operational requirements, and risk management procedures in accordance with CFTC Regulation 39.27(b). Pursuant to CFTC Regulation 39.27(a), CME Clearing is duly organized, legally authorized to conduct business, and remains in good standing at all times in any relevant jurisdiction.

CME certifies that CME Clearing's acceptance of Swaptions for clearing complies with the CEA and the regulations thereunder. There were no substantive opposing views.

Notice of this submission has been concurrently posted on CME Group's website at
<http://www.cmegroup.com/market-regulation/rule-filings.html>

If you require any additional information regarding this submission, please contact Udes Jha at 312-930-3398 or Udes.Jha@cmegroup.com or me at 212-299-2228 or Jason.Silverstein@cmegroup.com. Please reference our CME Submission No. 14-327 in any related correspondence.

Sincerely,

/s/ Jason Silverstein
Executive Director & Associate General Counsel

Enclosures

EXHIBIT 1: PROPOSED RULES

CME Rule 8G18 IRS Swaptions³ Membership

CME Rule 8G18.A IRS Swaptions Eligibility

- 1. An IRS Clearing Member interested in clearing IRS Swaptions must demonstrate to CME Clearing it has the ability, commitment and expertise to risk manage IRS Swaptions and has the operational capability to clear IRS Swaptions.**
- 2. IRS Clearing Members interested in clearing IRS Swaptions are required to respond to a questionnaire and are subject to CME Clearing diligence for assessment that such IRS Clearing Member has sufficient internal market risk, credit risk and operational risk processes and management frameworks to clear IRS Swaptions, including the ability to properly measure, monitor and limit risks associated with clearing IRS Swaptions.**
- 3. Each IRS Swaptions Clearing Member shall submit to ongoing diligence reviews by CME Clearing.**
- 4. Each IRS Swaptions Clearing Member shall nominate IRS Swaptions trader(s) to the IRS Default Management Committee.**
- 5. "IRS Swaptions Clearing Member" means an IRS Clearing Member that has been approved by the Clearing House as eligible to clear IRS Swaptions.**

CME Rule 8G18.B IRS Swaptions Information Submissions

- 1. Each IRS Swaptions Clearing Member shall submit the IRS Swaptions Information Submission File on each Business Day at the time specified by the Clearing House for each IRS Swaptions currency it is eligible to clear. The information submitted by an IRS Swaptions Clearing Member in the IRS Swaptions Information Submission File shall be consistent with the information used by the IRS Swaptions Clearing Member for its internal valuation of IRS Swaptions.**
"IRS Swaptions Information Submission File" means the file containing the requested market data, internal price levels and such other information as specified by the Clearing House for each moneyness/expiry/tenor combination.
- 2. "Failed IRS Swaptions Submission" means a failure to submit (i) all or a portion of an IRS Swaptions Information Submission File at or prior to the time designated by the Clearing House or (ii) the IRS Swaptions Information Submission File in the proper format.**
- 3. During a calendar month that is not during an IRS Cooling Off Period, an IRS Swaptions Clearing Member will be assessed a penalty per Failed IRS Swaptions Submission based on the following table:**

³ CME Clearing will define the term "IRS Swaptions" in a rule that will be proposed in connection with a filing pursuant to CFTC Regulation 39.5(b).

<u># of Failed IRS Swaptions Submissions for that month</u>	<u>Penalty per Failed IRS Swaptions Submission</u>
<u>1</u>	<u>0</u>
<u>2</u>	<u>\$10,000</u>
<u>3</u>	<u>\$50,000</u>
<u>4+</u>	<u>\$100,000</u>

During an IRS Cooling Off Period, an IRS Swaptions Clearing Member will be assessed a penalty per Failed IRS Swaptions Submission based on the following table:

<u># of Failed IRS Swaptions Submissions for that month</u>	<u>Penalty per Failed IRS Swaptions Submission</u>
<u>1</u>	<u>0</u>
<u>2</u>	<u>\$30,000</u>
<u>3</u>	<u>\$150,000</u>
<u>4+</u>	<u>\$300,000</u>

Penalties shall be assessed monthly and payable with the IRS Guaranty Fund payment cycle. In addition, the IRS Swaptions Clearing Member may be referred to the IRS Risk Committee for further discipline. Penalties from Failed IRS Swaptions Submissions shall become part of the IRS Priority of Payments as additional CME IRS Contribution to the IRS Priority of Payments pursuant to CME Rule 8G802 and shall be applied to IRS Losses on a pro rata basis with other CME IRS Contribution.