SUBMISSION COVER SHEET

***IMPORTANT*: Check box if Confidential Treatment is requested** ☐

Registered Entity Identifier Code (optional): 19-302

Organization: Chicago Mercantile Exchange Inc. ("CME")

Filing as a: ☐ **DCM** ☐ **SEF** ☒ **DCO** ☐ **SDR**

Please note - only ONE choice allowed.

Filing Date (mm/dd/yy): 08/01/19 Filing Description: Enhancements to the Margin Model for Interest Rate Swaps and Commingled Contracts.

SPECIFY FILING TYPE

Please note only ONE choice allowed per Submission.

Organization Rules and Rule Amendments

☒	Certification	§ 40.6(a)
☐	Approval	§ 40.5(a)
☐	Notification	§ 40.6(d)
☐	Advance Notice of SIDCO Rule Change	§ 40.10(a)
☐	SIDCO Emergency Rule Change	§ 40.10(h)

Rule Numbers:

New Product **Please note only ONE product per Submission.**

☐	Certification	§ 40.2(a)
☐	Certification Security Futures	§ 41.23(a)
☐	Certification Swap Class	§ 40.2(d)
☐	Approval	§ 40.3(a)
☐	Approval Security Futures	§ 41.23(b)
☐	Novel Derivative Product Notification	§ 40.12(a)
☐	Swap Submission	§ 39.5

Product Terms and Conditions (product related Rules and Rule Amendments)

☐	Certification	§ 40.6(a)
☐	Certification Made Available to Trade Determination	§ 40.6(a)
☐	Certification Security Futures	§ 41.24(a)
☐	Delisting (No Open Interest)	§ 40.6(a)
☐	Approval	§ 40.5(a)
☐	Approval Made Available to Trade Determination	§ 40.5(a)
☐	Approval Security Futures	§ 41.24(c)
☐	Approval Amendments to enumerated agricultural products	§ 40.4(a), § 40.5(a)
☐	"Non-Material Agricultural Rule Change"	§ 40.4(b)(5)
☐	Notification	§ 40.6(d)

Official Name(s) of Product(s) Affected:

Rule Numbers:

Christopher Bowen
Managing Director and Chief Regulatory Counsel
Legal Department

August 1, 2019

VIA ELECTRONIC PORTAL

Mr. Christopher J. Kirkpatrick
Office of the Secretariat
Commodity Futures Trading Commission
3 Lafayette Center
1155 21st Street NW
Washington, DC 20581

Re: CFTC Regulation 40.6(a) Certification. Notification Regarding Enhancements to the Margin Model for Interest Rate Swaps and Commingled Contracts.
CME Submission No. 19-302

Dear Mr. Kirkpatrick:

Pursuant to Commodity Futures Trading Commission ("CFTC" or "Commission") Regulation 40.6(a), Chicago Mercantile Exchange Inc. ("CME"), in its capacity as a derivatives clearing organization ("CME Clearing"), hereby notifies the Commission that it intends to implement enhancements to the margin model used to margin swaps that are supported by CME's IRS Guaranty Fund deposits ("Margin Model"). The proposed enhancement would also apply to exchange-listed contracts when commingled with such swaps (collectively, "Interest Rate Products").[1] CME Clearing proposes to implement the enhancements on or after August 19, 2019.[2]

CME Clearing's Margin Model for Interest Rate Products leverages a filtered historical value at risk ("VaR") methodology. The Margin Model is designed to achieve a 99 percent margin coverage standard while incorporating measures designed to promote stability. In order to further refine the Margin Model's application, CME Clearing proposes to implement enhancements that (i) facilitate stability within the Margin Model's market risk component, (ii) augment CME Clearing's risk management capabilities for responding to various known events, and (iii) further align margin performance with historical movements with respect to specific risk profiles.[3]

- Refining the Market Risk Component

CME Clearing proposes to include additional unscaled scenarios within the market risk component of the Margin Model. More specifically, the Margin Model's final market risk component would be calculated as the weighted average sum of the existing filtered historical VaR (H) and the VaR obtained from applying the unscaled scenarios (V). As illustrated in the formula below, variable α, a number between 0 and 1, is

[1] CME Rulebook Chapters 8G, 900, 901 and 902 codify the rules CME Clearing administers in connection with clearing Interest Rate Products. CME Rule 8G831 authorizes the commingling of qualifying exchange-listed contracts with swaps in cleared swaps accounts.

[2] This certification is accompanied by supporting documentation and analysis for which confidential treatment has been requested.

[3] The impact of the proposed enhancements has been subjected to extensive analysis which demonstrated the Margin Model's continuous adherence to the 99 percent regulatory coverage standard.

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the weight given to the H component. Therefore, the margins collected for a portfolio's market risk(M) would be calculated as follows:

$$M = \alpha * H + (1 - \alpha) * V$$

When prudent, the unscaled scenarios can reflect historical periods from longer lookbacks and facilitate the injection of hypothetical countercyclical scenarios, both of which inherently support stability. With regard to unscaled historical scenarios with longer lookbacks, for example, including the additional unscaled scenarios in calculating margin requirements can be applied to affect the stability of margin levels (*i.e.* the speed of change of margin levels) as opposed to aggregate margin levels over time.

In addition to promoting stability, introducing this change synchronizes the Margin Model's methodology with the most effective stability attributes of CME Clearing's other Commission-reviewed VaR margin models.[4]

- <u>Enhancing Capabilities for Responding to Various Known Events</u>

CME Clearing proposes an enhancement to the Margin Model that will serve as an additional tool to apply precisely expert judgement in response to unique events when required under Part 39 of the Commission's regulations. As part of actively managing risk in accordance with its regulatory responsibilities, CME Clearing routinely monitors upcoming events that may potentially and meaningfully impact returns and volatility that in turn may impact certain portfolios' risk profile. CME Clearing then acts as necessary and appropriate to manage the potential risks of such events.

Under the proposed enhancement, in case of any known forthcoming market event (*e.g.* the imminent governmental introduction of capital controls), CME Clearing may prudently add one additional VaR component which consists of some targeted scenarios to ensure there is a sufficient margin buffer for potentially impacted risk profiles. As amended, the final market risk margin would be the larger of either the calculated value as highlighted above or the weighted VaR of this new component β.

This component can consist of historical or hypothetical scenarios that are relevant to the upcoming event. The weighting of this new component is used to introduce this additional calculation smoothly in the case that this event brings a meaningful margin increase for risk profiles with exposure to the risk event. The additional event risk accounting in this manner allows CME Clearing to transparently introduce risk measures that are specific to the event without impacting any other product risk factors. This accounting is applicable only when facing significantly impactful market events and will have no impact on margin level otherwise.

- <u>Further Aligning Margin Performance with Historical Returns</u>
    - Enhanced Volatility Floor Application:

CME Clearing intends to enhance the manner in which it applies a volatility floor. Currently CME Clearing's Margin Model leverages a volatility floor to prevent margin levels from chasing volatility to the bottom during extended periods of low volatility. In the current framework, the application of the volatility floor is conducted at the risk factor level.

CME Clearing intends to implement a minor change that will apply the volatility floor at the margin level. The volatility floor will continue to prevent margin levels from imprudently bottoming during extended

[4] Refining the Margin Model's market risk component in this manner aligns with CME's margin methodology for OTC FX swaps. *See* Changes to the OTC FX Risk Model for OTC FX Options, CME Submission No. 17-053 (February 9, 2017). The proposal also aligns with CME Clearing's new margin framework for futures and options on futures, which will be implemented in 2020. *See* Adoption of a New Framework for Initial Margin Calculations, CME Submission No. 19-213R (May 28, 2019, revised July 5, 2019).

periods of low volatility. However, applying the volatility floor at the margin level as opposed to the risk factor level introduces beneficial margin calculation efficiencies and demonstrably better aligns the value of margins with historical moves.

- Risk Factor Enhancement:

Currently, risk factors for different but related futures and swaps products held by a portfolio are calculated independently. CME Clearing proposes to utilize spreads between such risk factors for modeling a portfolio's risk exposure.

Modelling interconnected risk factors independently could under certain circumstance possibly result in margin requirements that are not aligned with the historical market movements. Synchronizing related risk factors through spreads can better align margins with historical market movements.

By way of example and to place the usage of this approach in proper context, the proposal would be applicable to a portfolio with Eurodollar futures that are commingled with LIBOR interest rate swaps. CME Clearing currently calculates margins for the portfolio's Eurodollars by modeling Eurodollar futures prices ("Eurodollar Prices") and margins for related LIBOR swaps by modelling forecasted LIBOR 3-month curves ("LIBOR Curves"). As proposed, CME Clearing would calculate margins for Eurodollar futures by modeling the forecasted LIBOR Curves plus the spread between the Eurodollar Price and LIBOR Curve.

This proposal will enhance the risk management of specific portfolios that are extremely sensitive to the dynamics between two highly interconnected products, like a convexity trade between swaps and futures that are based on the same underlying financial commodity. CME Clearing will apply this risk factor enhancement beyond Eurodollar futures only after consultation with Commission staff and pursuant to the appropriate regulatory procedures.

Core Principle Review

CME Clearing reviewed the derivatives clearing organization core principles ("DCO Core Principles") as set forth in the Commodity Exchange Act ("CEA" or "Act") and identified that the proposed amendment may have some bearing on the following principles:

- DCO Core Principle B – Financial Resources. DCO Core Principle B requires CME Clearing to maintain financial resources sufficient to enable CME Clearing to meet its financial obligations to clearing members notwithstanding a default by the two (2) clearing members creating the largest exposure to CME Clearing ("Cover 2 Shortfall"). CME Clearing will continue to maintain sufficient resources to meet the Cover 2 Shortfall. The Margin Model enhancements will have no impact on CME Clearing's responsibility in connection with the compliance of this Core Principle.
- DCO Core Principle D – Risk Management. DCO Core Principle D requires that CME Clearing utilize margin and other risk controls to limit the exposures of both CME Clearing and its members and participants in the event of default. CME Clearing will continue to employ a vast array of tools to limit such exposures, while improving its risk management practices by targeting portfolios that pose the highest potential risks to CME Clearing and market participants.
- DCO Core Principle L – Public Information. DCO Core Principle L requires that CME Clearing to provide information to market participants with information related to the risks and costs associated with its services. CME Clearing will release a Clearing House Advisory Notice ("CHAN") to the marketplace regarding the implementation of the Margin Model enhancements in advance of the effective date. The CHAN will also be publicly available on the CME Group website.

CME Clearing certifies that proposed changes comply with the Act and regulations thereunder. There were no substantive opposing views to this action

CME Clearing certifies that this submission has been concurrently posted on the CME website at http://www.cmegroup.com/market-regulation/rule-fillings.html.

Should you have any questions concerning the above, please contact the undersigned at (212) 299-2200 or CMEGSubmissionInquiry@cmegroup.com.

Sincerely,

/s/ Christopher Bowen
Managing Director and Chief Regulatory Counsel

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