

**SUBMISSION COVER SHEET**

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

Registered Entity Identifier Code (optional): 16-354

Organization: Chicago Mercantile Exchange Inc.

Filing as a:  DCM  SEF  DCO  SDR

Please note - only ONE choice allowed.

Filing Date (mm/dd/yy): 08/31/16 Filing Description: Addition of Portfolio Gains Haircuts, Tear-Ups, and Limited Recourse to the Financial Safeguards Package for Base

**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:** see filing.

August 31, 2016

**VIA ELECTRONIC PORTAL**

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(a) Submission Regarding Addition of Portfolio Gains Haircuts, Tear-Ups, and Limited Recourse to the Financial Safeguards Package for Base, CME Submission No. 16-354/ Amendments to CME Rules 802 and 818 and definitions in Chapter iii**

Dear Mr. Kirkpatrick:

Chicago Mercantile Exchange Inc. (“CME”) hereby provides advance notice to the Commodity Futures Trading Commission (“CFTC”) of proposed changes to the rules of the CME (the “Rulebook”) applicable to Base<sup>1</sup> products on the earlier of October 31, 2016 or the receipt of regulatory approval or non-objection.<sup>2</sup> CME is a systemically important derivatives clearing organization (“SIDCO”)<sup>3</sup> and its clearing division (the “Clearing House”) offers clearing for all products traded on the Exchanges as well as other cleared products and provides clearing services to third parties.

The clearing services and operations CME provides are critical to CME’s clearing members, the customers of CME’s clearing members, the smooth functioning of the markets CME serves and

---

<sup>1</sup> As used herein, “Base” means relating to products other than interest rate swap (“IRS”) products, credit default swap (“CDS”) products, or any positions comingled with IRS contracts.

<sup>2</sup> Each of CME, the Board of Trade of the City of Chicago, Inc., the New York Mercantile Exchange, Inc., and the Commodity Exchange, Inc. (each, an “Exchange” and collectively, the “Exchanges”), in its capacity as a designated contract market, will make a filing with the CFTC under CFTC Regulation 40.6(a) with conforming rule changes before CME implements the rule changes proposed herein.

<sup>3</sup> On July 18, 2012, CME Inc. was designated as a systemically important financial market utility under Title VIII of the Dodd-Frank Act.

the maintenance of financial stability.<sup>4</sup> The Rulebooks provide for a robust financial safeguards package for Base products that would be used to address losses that arise from the default of one or more clearing members on obligations to the Clearing House with respect to Base Contracts (as defined in the proposed rules). Under the Rulebooks, in the unlikely event that the losses arising from the default of one or more clearing members on obligations to the Clearing House with respect to Base Contracts exceed the financial safeguards package for Base, CME would likely become subject to a bankruptcy proceeding that is subject to the commodity broker liquidation provisions of the US Bankruptcy Code.<sup>5</sup> This would constitute a Bankruptcy Event (as defined in Rule 818.A) and would result in the close out and netting of all contracts cleared by CME (including IRS and CDS) pursuant to Rule 818. Through this close out and netting, Rule 818 provides certainty and provides for the return of assets to clearing members and their customers in a manner that enables clearing members to measure and manage their exposures to CME. Chapter 7 of the Bankruptcy Code requires liquidation—rather than reorganization—of a commodity broker, which is defined to include the Clearing House. CME’s bankruptcy would end the critical services and operations of the Clearing House.

CME proposes rule changes to add the following recovery tools to facilitate the continuity of CME’s clearing services and operations in the unlikely event that the losses arising from the default of one or more Base Clearing Members (as defined in the proposed rules) exceed the financial safeguards package for Base: (i) portfolio gains haircuts;<sup>6</sup> (ii) mandatory tear-ups;<sup>7</sup> (iii) voluntary contributions by Base Clearing Members (and their customers);<sup>8</sup> (iv) voluntary tear-ups by Base Clearing Members (and their customers);<sup>9</sup> and (v) limited recourse for Base (collectively, the “Recovery Tools”).<sup>10</sup> Each of these tools is described in detail below.<sup>11</sup> The intent of these proposed rules is to avoid a Bankruptcy Event driven by the default of one or

---

<sup>4</sup> See CPMI-IOSCO, Board of the International Organization of Securities Commissions report, Recovery of Financial Market Infrastructures (October 2014) (“CPMI-IOSCO Report”) at 8, <http://www.bis.org/cpmi/publ/d121.pdf> (defining “critical” services).

<sup>5</sup> 11 U.S.C. §§ 761–767 (2012).

<sup>6</sup> See proposed rule 802.B.7(b)(v).

<sup>7</sup> See proposed rules 802.B.8(b) and 802.B.8(c).

<sup>8</sup> See proposed rule 802.B.7(b)(v)(A).

<sup>9</sup> See proposed rule 802.B.8(a).

<sup>10</sup> See proposed rules 802.B.9, 802.B.10 and 802.B.11.

<sup>11</sup> As discussed below, pursuant to the proposed amendments to Rule 802, (i) portfolio gains haircuts; (ii) mandatory tear-ups; (iii) voluntary contributions and voluntary tear-ups by Base Clearing Members (and their customers); and (iv) limited recourse may be used only if a Base Clearing Member defaults and at any time following the default of the Base Clearing Member, (i) the assets available to cover the default under the preceding sections of Rule 802 are insufficient to satisfy the obligations of the Clearing House as a result of such default; (ii) a default of the Exchange occurs, as described in Rule 818.B; or (iii) a Bankruptcy Event of the Exchange occurs, as defined in Rule 818.A.

more Base Clearing Members. As noted, a Bankruptcy Event would result in the close out and netting of all contracts cleared by CME (including IRS and CDS) pursuant to Rule 818.

CME also proposes a rule change to Rule 802.E to clarify that if CME uses non-defaulted Base Clearing Members' guaranty fund contributions, its assessment powers, voluntary contributions and/or gains haircuts and subsequently recovers any portion of those amounts from the defaulted clearing member's estate, CME will reimburse Base Clearing Members and, if applicable, their customers pro rata first for voluntary contributions and then for the remainder of these resources in the reverse order of the utilization of these resources.<sup>12</sup>

None of the Recovery Tools rely upon public or government support.

### **CFTC Regulatory Requirements**

CME proposes to add portfolio gains haircuts and voluntary contributions to the Rulebooks in connection with CFTC Regulation 39.35 (Default rules and procedures for uncovered credit losses or liquidity shortfalls (recovery) for SIDCOs). CFTC Regulation 39.35(a) requires a SIDCO to "adopt explicit rules and procedures that address *fully* any loss arising from any individual or combined default relating to any clearing members' obligations to the [SIDCO]"(emphasis added). These proposed recovery tools for Base specifically address how CME would allocate losses that exceed the financial resources available to CME, as required by CFTC Regulation 39.35(a)(1).

CME proposes to add the Recovery Tools to the Rulebooks for Base in connection with CFTC Regulation 39.39. CFTC Regulation 39.39(b)(1) requires a SIDCO to maintain viable plans for recovery or orderly wind-down necessitated by uncovered credit losses or liquidity shortfalls. These proposed rules are designed to allocate uncovered credit losses<sup>13</sup> and restore a matched book.<sup>14</sup>

CFTC Regulation 39.39(a)(3) defines recovery to include "the actions of a [SIDCO], consistent with its rules . . . to address any uncovered credit loss . . . as necessary to maintain the [SIDCO's] viability as a going concern." The proposed rules adding portfolio gains haircuts and voluntary contributions are designed to enable CME to address any uncovered credit loss as necessary to maintain CME's viability as a going concern. Thus, these proposed rules are designed to enable CME's recovery, as required by CFTC Regulation 39.39(a)(3).

---

<sup>12</sup> The proposed conforming rule changes are discussed below.

<sup>13</sup> Uncovered credit losses are losses arising from the default of one or more Base Clearing Members on obligations to CME that exceed the Base financial safeguards package.

<sup>14</sup> CME's book is matched when there is a solvent clearing member standing behind every transaction.

## **Background**

On October 30, 2014, the Exchanges provided advance notice to the CFTC that they intended to add limited recourse and a portfolio gains haircut settlement cycle followed by contract extinguishment to the financial safeguards package for Base.<sup>15</sup> Since then, the Exchanges have engaged with government regulators, clearing members, customers of clearing members and other stakeholders. Based on that feedback, the Exchanges have contemporaneously withdrawn their original proposal and CME proposed the revised rules herein.

In formulating the revised rules, the Exchanges considered the recommendations of the Committee on Payments and Market Infrastructures and the Board of the International Organization of Securities Commissions (“CPMI-IOSCO”) set forth in the October 2014 “Recovery of Financial Market Infrastructures.”<sup>16</sup> Additionally, on March 19, 2015, the CFTC held a roundtable with industry stakeholders to discuss the recovery and wind-down of derivatives clearing organizations (“DCOs”). The roundtable specifically addressed gains haircuts and tear-ups, providing a unique opportunity for the Exchanges to hear a variety of perspectives and share the Exchanges’ points of view on the design and use of those recovery tools. Furthermore, the Exchanges discussed their proposed rule changes with clearing members, customers of clearing members and the Futures Industry Association during the second half of 2015.

The proposed rules are a product of such guidance, industry forums and discussions with clearing members and customers of clearing members.

## **Overview of Proposed Changes**

In accordance with CFTC Regulation 40.10, CME specifically describes below: (i) the nature of the rule changes and expected effects on risks to the Clearing House, its clearing members, and the market; and (ii) how the Clearing House plans to manage any identified risks.

Before using any of the Recovery Tools, CME would conduct its default management processes,<sup>17</sup> which may include entering into potential hedging transactions and the liquidation of the defaulter’s portfolio through market or auction mechanisms.<sup>18</sup> As CME’s default management process is continuous; CME would continue working to reduce the amount of

---

<sup>15</sup> See Regulation 40.10 Submission Regarding Addition of Limited Recourse and Portfolio Gain Haircut Settlement Cycles to the Financial Safeguards Package for Base Products. CME Submission No. 14-462 (October 30, 2014).

<sup>16</sup> See CPMI-IOSCO Report.

<sup>17</sup> See rules 802.A and 802.B.1–5 (describing the default management process).

<sup>18</sup> See proposed rule 802.B.6 (describing the process for liquidating open positions of the defaulted clearing member).

uncovered credit losses and restore a matched book while using the Recovery Tools. CME conducts its default management process to protect non-defaulted clearing members, customers of clearing members and the stability of the broader U.S. financial market.<sup>19</sup>

### *Portfolio Gains Haircuts*

CFTC Regulation 39.35(a) requires CME to address *fully* any loss arising from any individual or combined default relating to any clearing members' obligations to it. While CME and Base Clearing Members—through the CME's corporate contribution, the Base Guaranty Fund (as defined in Rule 802.A) and Base Assessments (as defined in the proposed rules)—are responsible for mitigating losses that exceed the defaulter's collateral and its guaranty fund deposit, such amounts are finite and CFTC Regulation 39.35(a) requires CME to allocate any remaining losses.

Portfolio gains haircuts is a recovery tool that provides for the allocation of losses following complete utilization of the Base financial safeguards resources. This tool is designed to extinguish (or "haircut") a portion of amounts due to Base Clearing Members and their customers with a net portfolio gain<sup>20</sup> for a settlement cycle while collecting the full amount from Base Clearing Members and their customers with a net portfolio loss for the settlement cycle. The amount of the haircut is based on the amount received from Base Clearing Members and their customers with net portfolio losses applied on a pro rata basis across the Base Clearing Members and their customers with net portfolio gains for the relevant account class for the settlement cycle.<sup>21</sup> The haircut amount will be increased by any necessary payments to liquidation counterparties and winners of the auctions of defaulters' positions. Such liquidation and auction payment amounts may not exceed the amount determined by the Clearing House Oversight Committee ("CHOC")<sup>22</sup> to be appropriate to mitigate further disruptions to the

---

<sup>19</sup> As discussed below, CME would not accept bids at prices that the resources available cannot support. The suggestion that a clearing house should accept *any* bid received in an auction is not appropriate and would not protect market stability.

<sup>20</sup> For the avoidance of doubt, the proposed rules would not haircut performance bonds. CME strongly opposes haircuts of performance bonds for the reasons discussed below on pages 8–9.

<sup>21</sup> Haircuts would be determined at the proprietary account level of each Base Clearing Member, the segregated futures customer account level of each Base Clearing Member and at the beneficial owner level for each cleared swaps customer of each Base Clearing Member.

<sup>22</sup> On May 17, 2016, the Board of Directors of Chicago Mercantile Exchange Inc. approved the establishment of the CHOC, a Committee of the Board of Directors. The purpose of the CHOC is to provide oversight of the risk management activities (excluding operational risk) of the Clearing House. Pursuant to the charter of the CHOC, in fulfilling its responsibilities, the CHOC "shall prioritize the safety and efficiency of the Clearing House, generally support the stability of the broader financial system and consider legitimate interests of clearing members and customers of clearing members taking into account prudent risk management standards (including systemic risk mitigation) and best practices in the industry."

markets, after considering the then existing facts and circumstances and any recommendation made by the Emergency Financial Committee (as defined in Rule 975).<sup>23</sup>

CME proposes Rule 802.B.7(b)(v) to provide for portfolio gains haircuts for Base products (“Base Gains Haircuts”) in connection with a settlement cycle for which CME has not received all payments for Base products due to the default of one or more Base Clearing Members.

Base Gains Haircuts is expected to act as an incentive to motivate Base Clearing Members and their customers with positions in the affected contracts to participate in the default auctions in order to protect their gains from Base Gains Haircuts. Base Gains Haircuts thus promote recovery by incentivizing auction participation.

Base Gains Haircuts would be distributed broadly to minimize their impact on market participants.

Base Gains Haircuts would distribute remaining losses associated with the default of a Base Clearing Member pro-rata across all market participants with net portfolio gains in Base Contracts. During each Base Gains Haircuts settlement cycle, a haircut would be applied pro rata to the net portfolio gains for such settlement cycle of each proprietary account of each Base Clearing Member, the segregated futures customer account of each Base Clearing Member<sup>24</sup> and at the beneficial owner level for each cleared swaps customer of each Base Clearing Member.<sup>25</sup>

Certain market participants have raised concerns with respect to the application of Base Gains Haircuts to their accounts noting that their account should be exempt from the application of this haircutting tool. CME proposes haircuts across all market participants, as outlined above, to ensure that the remaining losses are distributed in a manner that is comprehensive and fair. If certain market participants were exempt from Base Gains Haircuts, other participants would need to absorb such losses in order for Base Gains Haircuts to fully allocate the loss to the benefit of those exempted.<sup>26</sup> As any application of Base Gains Haircuts is expected during a time of severe market stress, the broad dispersion resulting from this tool should minimize the impact across market participants.

Base Gains Haircuts would have no impact on accounts with net portfolio losses for the relevant settlement cycle. While the holders of accounts with net portfolio gains in Base Contracts would

---

<sup>23</sup> Proposed rule 802.B.7(b)(ii).

<sup>24</sup> CME would allocate a haircut pro rata to any net portfolio gains of each Base Clearing Member’s segregated futures customer account. Base Clearing Members would then allocate any haircuts to their segregated futures customer account pro rata to customers in such account with net portfolio gains.

<sup>25</sup> Proposed rule 802.B.7(v)(B).

<sup>26</sup> See CPMI-IOSCO Report at 13 (stating “Once a loss or liquidity shortfall materialises, if it is not allocated to one entity it will necessarily be allocated to another entity....”).

be exposed to losses, such holders would still likely recover more of the amounts owed to them (and on a more expedient basis) through Base Gains Haircuts than would likely be realized if a Bankruptcy Event were to occur and Rule 818 were triggered as a result of losses from the default of one or more Base Clearing Members on obligations to the Clearing House exceeding the financial safeguards package for Base.

The proposed rules would establish a period of Base Gains Haircuts.

Proposed rule 802.B.7(b)(v) provides for three Business Days of Base Gains Haircuts and a mechanism to shorten or extend the duration of Base Gains Haircuts depending upon the then existing facts and circumstances (as discussed below). In contemplating the number of Base Gains Haircuts settlement cycles, CME aimed to allow for a sufficient amount of time for CME to reestablish the matched book, for Base Clearing Members and customers of Base Clearing Members to measure and manage their exposures. By providing certainty on the number of Base Gains Haircuts settlement cycles (while enabling adjustments to be made pursuant to the process discussed below), the proposed rule minimizes the market uncertainty that would be associated with an unlimited number of Base Gains Haircuts settlement cycles, thereby allowing Base Clearing Members and customers of Base Clearing Members to measure and manage this risk.

Pursuant to proposed rule 802.B.7(b)(v)(C), the CHOC<sup>27</sup> may extend or reduce the number of days during which Base Gains Haircuts are applied by one or two Business Days, such that the maximum number of days with Base Gains Haircuts is five Business Days.

Proposed rule 802.B.7(b)(v)(C) provides that in order for the CHOC to make a determination to extend or reduce, as appropriate, the CHOC must make such determination: (i) based upon the then existing facts and circumstances; (ii) in furtherance of the integrity of the Clearing House and stability of the financial system; and (iii) by taking into consideration the legitimate interests of clearing members and customers of clearing members.<sup>28</sup>

Before making any adjustments to the duration of Base Gains Haircuts, the CHOC would consider the recommendation(s)—if any—made by the Emergency Financial Committee. Pursuant to proposed CME rule 802.B.7(b)(v)(C), any recommendation by the Emergency Financial Committee regarding whether to extend or reduce the duration of Base Gains Haircuts must similarly (i) be based on the then existing facts and circumstances; (ii) be in furtherance of

---

<sup>27</sup> See *supra* note 22 (discussing the purpose and priorities of the CHOC).

<sup>28</sup> See CFTC Regulation 39.32(a)(1)(iv) (requiring each SIDCO to have governance arrangements that explicitly support the stability of the broader financial system and other relevant public interest considerations of clearing members, customers of clearing members, and other relevant stakeholders); CFTC Regulation 39.32(a)(2) (requiring the board of directors of a SIDCO to make certain that the SIDCO's design, rules, overall strategy, and major decisions appropriately reflect the legitimate interests of clearing members, customers of clearing members, and other relevant stakeholders).



the integrity of the Clearing House and stability of the financial system; and (iii) take into consideration the legitimate interests of clearing members and customers of clearing members.<sup>29</sup>

Proposed rule 802.B.7(b)(v) thus enables CME to extend the Base Gains Haircuts settlement cycles by one or two additional Business Days to allow for the completion of the default management process if warranted by the then existing facts and circumstances, such that the maximum number of days with Base Gains Haircuts is five Business Days. Similarly, proposed rule 802.B.7(b)(v) enables CME to reduce the duration of Base Gains Haircuts settlement cycles by one or two Business Days if warranted by the then market conditions. It is anticipated that the CHOC would exercise its discretion to reduce the duration of Base Gains Haircuts settlement cycles if the CHOC believed that (i) additional days of haircuts would not result in the disposition of the defaulter's remaining open positions in Base Contracts and (ii) it would be imprudent to conduct additional haircut cycles.

At the conclusion of the Base Gains Haircuts settlement cycles, either: (i) CME will have completed the default management process and restored the matched book, thereby allowing CME to provide for continuity of clearing services, or (ii) CME will extinguish certain open Base positions through a tear-up process pursuant to proposed rule 802.B.8(b), as discussed below.

The proposed rules would not haircut performance bonds (also known as initial margin).

Consistent with feedback from clearing members and their customers, performance bonds (which are sometimes referred to as initial margin) will not be subject to haircuts under the proposed rules. CME does not consider haircutting clearing member and/or customer performance bonds ("PB") to be an alternative to Base Gains Haircuts. CME is strongly opposed to haircutting PB, whether during recovery or wind-down. Haircutting PB of customers is unlawful under Section 4d of the Commodity Exchange Act ("CEA"). Furthermore, haircutting PB would have a destabilizing impact on markets by (i) increasing the risk that the clearing house is under-protected against a future default of a Base Clearing Member and (ii) creating a procyclical liquidity requirement for all Base Clearing Members and their customers to reestablish their full amount of margin, which could increase the likelihood that a clearing house would enter recovery and/or wind-down.

Haircutting customer PB would likely precipitate clearing member failures or defaults as customers withdraw funds from their clearing members for protection or in fulfillment of contractual or fiduciary duties. Further clearing member defaults would increase the odds of a clearing house entering recovery and/or wind-down. Furthermore, in a scenario where PB has been haircut, the clearing house would be under-protected and thus, have even greater exposure to future clearing member defaults because those clearing members would no longer be fully

---

<sup>29</sup> *See id.*

collateralized, which would also increase the odds of a clearing house entering recovery and/or wind-down. Finally, haircutting PB would also limit the effectiveness of a clearing house's default management plan. In particular, the prospect of PB haircutting would incentivize clearing members not to take part in the auction process due to the potential for increased losses if a haircut of PB occurs after a portfolio has been acquired. Any tool that would increase the chances of a clearing house entering recovery and/or wind-down presents risk to all stakeholders, including regulators, clearing members, customers of clearing members and potentially even tax payers. Those risks make haircutting PB an inappropriate recovery tool.

### *Base Partial Tear-Ups and Base Full Tear-Up*

CME proposes to introduce mandatory tear-ups as a recovery tool to reestablish the matched book.<sup>30</sup> If CME's default management process is unsuccessful in fully liquidating or transferring the defaulter's positions and reestablishing a matched book and the Base financial safeguard resources have been completely utilized, CME would likely become subject to a bankruptcy proceeding that is subject to the commodity broker liquidation provisions of the US Bankruptcy Code.<sup>31</sup> If CME becomes subject to a bankruptcy proceeding, all contracts cleared by CME (including IRS and CDS) would be closed out and netted pursuant to Rule 818. Rule 818 thus provides certainty and for the return of assets to clearing members and their customers in a manner that enables clearing members to measure and manage their exposures to CME, but it does not promote the continuity of clearing. CME thus proposes to add a mandatory tear-up process to reestablish a matched book and promote continuity of clearing.

CME designed the mandatory tear-up process to reestablish a matched book in a manner that, to the extent possible, localizes the impact of a failure to the markets in which defaulters' positions have not been fully transferred or liquidated and avoids impacting properly functioning markets. The proposed rules refer to the proprietary and customer positions in Base Contracts of the defaulted Base Clearing Member(s) that remain open as the "Remaining Open Base Positions."<sup>32</sup> In connection with the last settlement cycle conducted in connection with Base Gains Haircuts, the Clearing House would extinguish all Remaining Open Base Positions through a partial tear-up process ("Base Partial Tear-Up") or through a full tear-up process of all Base Contracts ("Base Full Tear-Up") of proprietary and customer positions of non-defaulted Base Clearing Members and non-defaulted customers of the defaulted Base Clearing Member.<sup>33</sup> On days when Base Gains Haircuts are occurring, the Clearing House could extinguish a portion of the Remaining Open Base Positions through a Base Partial Tear-Up of proprietary and customer

---

<sup>30</sup> While Base Gains Haircuts allocate actual losses of the defaulter's portfolio that exceed remaining financial resources, Base Gains Haircuts do not assist with the disposition of the defaulter's positions that have generated such losses.

<sup>31</sup> 11 U.S.C. §§ 761–767 (2012).

<sup>32</sup> See proposed rule 802.B.8(b).

<sup>33</sup> See proposed rule 802.B.8(b).

positions of non-defaulted Base Clearing Members and non-defaulted customers of the defaulted Base Clearing Member.<sup>34</sup> In either case, the CHOC would determine the appropriate scope of tear-ups as described below.

Tear-Ups Would Occur In Connection with the Last Settlement Cycle with Base Gains Haircuts.

In connection with the final Base Gains Haircuts settlement cycle, the CHOC<sup>35</sup> would determine either the appropriate scope of each Base Partial Tear-Up or that a Base Full Tear-Up is appropriate.<sup>36</sup> The CHOC would make this determination (i) based upon then existing facts and circumstances; (ii) in furtherance of the integrity of the Clearing House and stability of the financial system; (iii) by taking into consideration the legitimate interests of clearing members and customers of clearing members;<sup>37</sup> and (iv) with the aim of extinguishing all of the Remaining Open Base Positions and any additional positions in Base Contracts deemed necessary to mitigate further disruptions to the markets affected by the Remaining Open Base Positions.<sup>38</sup>

Before making such determination, the CHOC would consider the recommendation(s)—if any—made by the Emergency Financial Committee.<sup>39</sup> Any such Emergency Financial Committee recommendation would similarly (i) be based on the then existing facts and circumstances; (ii) be in furtherance of the integrity of the Clearing House and stability of the financial system; (iii) take into consideration the legitimate interests of clearing members and customers of clearing members;<sup>40</sup> and (iv) aim to extinguish all of the Remaining Open Base Positions and any additional positions in Base Contracts deemed necessary to mitigate further disruptions to the markets affected by the Remaining Open Base Positions.<sup>41</sup>

Potential forms of Base Partial Tear-Ups in connection with the final Base Gains Haircuts settlement cycle include, but are not limited to: (a) proportionately extinguishing Base Contracts held by non-defaulted Base Clearing Members, their non-defaulted customers and the non-

---

<sup>34</sup> See proposed rule 802.B.8(c).

<sup>35</sup> As noted above, the CHOC is a Committee of the Board of Directors. See *supra* note 22 (discussing the purpose and priorities of the CHOC).

<sup>36</sup> See proposed rule 802.B.8(b)(i).

<sup>37</sup> See *supra* note 28.

<sup>38</sup> See proposed rule 802.B.8(b)(i). The CHOC would consider the legitimate interests of clearing members and customers of clearing members by assessing the relevant facts and circumstances and the impact of the scope of tear-ups on such interests.

<sup>39</sup> See *id.*

<sup>40</sup> See *supra* note 28.

<sup>41</sup> See proposed rule 802.B.8(b)(i).

defaulted customers of the defaulted Base Clearing Member that are opposite to, and relative to the size of, the Remaining Open Base Positions; and (b) extinguishing all open positions in Base Contracts for a particular product or combination of products.<sup>42</sup> The type of Base Partial Tear-Up utilized at any time would depend on the then existing facts and circumstances.

A Base Full Tear-Up would involve extinguishing all open positions in Base Contracts.<sup>43</sup>

#### Tear-Ups Could Occur While Settlement Cycles with Base Gains Haircuts Are Ongoing.

While Base Gains Haircuts settlement cycles are ongoing, the CHOC could determine to extinguish a portion of the Remaining Open Base Positions through a Base Partial Tear-Up of proprietary and customer positions of non-defaulted Base Clearing Members and non-defaulted customers of the defaulted Base Clearing Member.<sup>44</sup> The CHOC would make this determination by using the same four factors that the CHOC would use to determine the appropriate scope of tear ups conducted in connection with the final Base Gains Haircuts settlement cycle, except with a narrower aim of extinguishing a portion of the Remaining Open Base Positions and any additional positions in Base Contracts deemed necessary to mitigate further disruptions to the markets affected by the portion of the Remaining Open Base Positions.<sup>45</sup> The CHOC would only determine to tear-up a portion of the Remaining Open Base Positions if the CHOC believed that the Clearing House could not properly default manage such positions, but that the Clearing House may be able to successfully default manage the Remaining Open Base Positions not being torn up.

Before determining the appropriate scope of each Base Partial Tear-Up to conduct while Base Gains Haircuts settlement cycles are ongoing, the CHOC would consider the recommendation(s)—if any—made by the Emergency Financial Committee.<sup>46</sup> Any such Emergency Financial Committee recommendations would be based upon the same four factors as an Emergency Financial Committee recommendation regarding tear ups conducted in connection with the final Base Gains Haircuts settlement cycle, except with a narrower aim of extinguishing a portion of the Remaining Open Base Positions and any additional positions in

---

<sup>42</sup> See proposed rule 802.B.8(b)(ii).

<sup>43</sup> See proposed rules 802.B.8(b)(iii). Base Full Tear-Ups could only be conducted in connection with the final Base Gains Haircuts settlement cycle and could not be conducted while Base Gains Haircuts settlement cycles are ongoing.

<sup>44</sup> See proposed rule 802.B.8(c).

<sup>45</sup> See proposed rules 802.B.8(b)(i) and (c). The CHOC would consider the legitimate interests of clearing members and customers of clearing members by assessing the relevant facts and circumstances and the impact of the scope of tear-ups on such interests.

<sup>46</sup> See *id.*

Base Contracts necessary to mitigate further disruptions to the markets affected by the portion of Remaining Open Base Positions.<sup>47</sup>

Potential forms of Base Partial Tear-Ups that may be conducted while Base Gains Haircuts settlement cycles are ongoing include, but are not limited to: (a) proportionately extinguishing Base Contracts held by non-defaulted Base Clearing Members, their non-defaulted customers and the non-defaulted customers of the defaulted Base Clearing Member that are opposite to, and relative to the size of, a portion of the Remaining Open Base Positions; and (b) extinguishing all open positions in Base Contracts for a particular product or combination of products.<sup>48</sup> The type of Base Partial Tear-Up utilized at any time would depend on the then existing facts and circumstances.

### The Effects of Base Partial Tear-Ups

Base Partial Tear-Ups are designed to enable CME to re-establish a matched book, avoid a Bankruptcy Event and provide for continuity of clearing services and operations to clearing members and their customers. CME does not propose to use Base Partial Tear-Ups as a loss allocation measure as such tear-ups will occur as soon as practicable after the settlement cycle and at the price of such settlement price.<sup>49</sup> Any torn-up position would still be subject to any applicable Base Gains Haircut for that settlement cycle as the tear-up is occurring following, and at the price of, the settlement cycle conducted immediately prior.

As a result of Base Partial Tear-Ups, Base Clearing Members and customers of Base Clearing Members would lose the positions that were torn up. Base Clearing Members and customers of Base Clearing Members that elect to reestablish such market positions could incur replacement costs in doing so. Because Base Partial Tear-Ups enable CME to tear up only those contracts necessary to reestablish a matched book (as compared to all contracts cleared by CME as a result of a Bankruptcy Event), the utilization of Base Partial Tear-Ups as a recovery tool should reduce the number of contracts torn up, which should, in turn, reduce the costs of reestablishing torn up positions. Base Partial Tear-Ups are thus designed to reduce the number of contracts torn up, enable CME to re-establish a matched book and allow CME to provide for continuity of clearing services and operations to clearing members and their customers. After CME reestablishes a matched book and following the Base Cooling Off Period, CME and non-withdrawing Base

---

<sup>47</sup> See proposed rules 802.B.8(b)(i) and (c).

<sup>48</sup> See proposed rules 802.B.8(b)(ii) and (c).

<sup>49</sup> The price for the contracts that are torn up would be determined in connection with the current Base Gains Haircuts settlement cycle. All contracts being torn up would be marked to market during the current Base Gains Haircuts settlement cycle, thereby valuing these contracts at the market price as of the time the contracts are extinguished. CME believes this approach is preferable to tearing up contracts in between settlement cycles, which would require valuing the contracts being extinguished by reverting to the price determined at the previous Base Gains Haircuts settlement cycle and thus potentially allocating the loss to the beneficial owner of the contract being extinguished.

Clearing Members would replenish their contributions to the Base guaranty fund, allowing for the continued functioning of the markets.<sup>50</sup>

### The Effects of Base Full Tear-Up

Base Full Tear-Up is designed to enable CME to re-establish a matched book, avoid a Bankruptcy Event and provide for continuity of clearing services and operations. As discussed above in Base Partial Tear-Ups, CME does not propose to use Base Full Tear-Up as a loss allocation measure as such tear-ups will occur as soon as practicable following a settlement cycle and at the price of such settlement cycle.<sup>51</sup> Any torn-up position would still be subject to any applicable Base Gains Haircut for that settlement cycle.

As a result of a Base Full Tear-Up, Base Clearing Members and customers of Base Clearing Members would lose all open positions in Base Contracts through the extinguishment of such contracts. Base Clearing Members and customers of Base Clearing Members that elect to reestablish such market positions could incur replacement costs in doing so.

As noted above, a determination by the CHOC that a Base Full Tear-Up is appropriate must be in furtherance of the integrity of the Clearing House and the stability of the financial system.<sup>52</sup> Given the systemic importance of CME and the systemic impact that the Base Full Tear-Up may have on the stability of the financial system, the CHOC would not determine to conduct a Base Full Tear-Up if it determined that a Base Partial Tear-Ups would be equally or more effective to mitigate the then existing facts and circumstances.

The extinguishment of all Base Contracts cleared by CME through a Base Full Tear-Up—as compared to a Bankruptcy Event (which would trigger application of Rule 818<sup>53</sup>)—would provide for continuity of clearing as CME would not become subject to a mandatory liquidation under the provisions of the Bankruptcy Code. Avoiding a Bankruptcy Event would (i) permit Base Clearing Members and customers of Base Clearing Members to elect to reestablish their positions in Base Contracts upon the replenishment of the Base guaranty fund<sup>54</sup> and (ii) prevent CDS and IRS contracts from being closed out under Rule 818 as a result of a Bankruptcy Event.

---

<sup>50</sup> See Rules 802.H (describing the Base Cooling Off Period) and 802.F (regarding Base Clearing Members' obligations to replenish their contributions to the Base Guaranty Fund).

<sup>51</sup> See *supra* note 49.

<sup>52</sup> See proposed rules 802.B.8(b)(i). See also CFTC Regulations 39.32(a)(1)(iv) and 39.32(a)(2).

<sup>53</sup> The application of Rule 818 would result in the extinguishment of all open positions in Base, CDS and IRS Contracts.

<sup>54</sup> Base Clearing Members and customers of Base Clearing Members that elect to reestablish such market positions could incur replacement costs in doing so.

Base Full Tear-Up is thus designed to enable CME to re-establish a matched book and allow CME to provide for continuity of clearing services and operations to clearing members and their customers. CME expects that a number of clearing members could withdraw their memberships after a Base Full Tear-Up. After CME reestablishes a matched book and following the Base Cooling Off Period, CME and any Base Clearing Members that elect to remain would replenish their contributions to the Base guaranty fund. Replenishment of the Base financial safeguards would allow Base Clearing Members and their customers to reestablish positions and thus provide for the continued functioning of the markets.

The addition of a Base Full Tear-Up is designed to incentivize participation in auctions by Base Clearing Members and their customers as poor or no bidding in auctions could increase the likelihood of a Base Full Tear-Up.

#### *Voluntary Actions by Clearing Members and/or Their Customers*

Pursuant to proposed rule 802.B.7(b)(v)(A), if, following a default of a Base Clearing Member, the Clearing House has exhausted the financial safeguards package for Base but not yet recovered, the Clearing House will provide Base Clearing Members and their customers an opportunity to make voluntary contributions to assist in curing remaining losses. The incentive for Base Clearing Members and their customers to provide voluntary contributions to the Clearing House is to avoid Base Gains Haircuts, Base Partial Tear-Ups and/or a Base Full Tear-Up.

Pursuant to proposed rule 802.B.8(a), at any time, the Clearing House could notify Base Clearing Members and provide an opportunity for Base Clearing Members to voluntarily agree to have their proprietary Base positions or, with a customer's consent, to agree to have each such customer's Base positions, extinguished by the Clearing House. CME would quickly identify and approach Base Clearing Members whose positions, or whose customer's positions, are on the opposite side of defaulter positions that remain open. Such Base Clearing Members, or their customers, could agree voluntarily to tear-up such positions in part or in full in a manner that would reestablish a matched book. The incentive for Base Clearing Members and their customers to agree to take a loss and participate in a voluntary partial tear-up is to help CME reestablish a matched book and avoid the consequences of Base Gains Haircuts, Base Partial Tear-Ups and/or a Base Full Tear-Up. By participating in voluntary contributions and/or voluntary partial tear-ups, Base Clearing Members and their customers may control how they manage and measure their exposures to CME.

It is expected that voluntary contributions and/or voluntary partial tear-ups would only occur if the amount of contribution and/or the universe of positions marked for voluntary partial tear-up are in the aggregate sufficient to fully mitigate all losses and would restore a fully matched book.

#### *Limited Recourse, No Claims Against the Exchange or Clearing House, and Non-Petition*

CME proposes to add limited recourse as a component of the financial safeguards package for Base to promote continuity of clearing for market participants with Base Contracts in the unlikely event losses exceed the financial safeguards package for Base. If losses arising from the default of one or more clearing members on obligations to the Clearing House for Base products exceed the financial resources available to the Clearing House and the limited recourse, Base Gains Haircuts, Base Partial Tear-Ups and Base Full Tear-Up features are not yet in place for Base, CME would likely become subject to a bankruptcy proceeding that is subject to the commodity broker liquidation provisions of the US Bankruptcy Code.<sup>55</sup> If CME becomes subject to a bankruptcy proceeding, all contracts cleared by CME (including IRS and CDS) would be closed out and netted pursuant to Rule 818. Rule 818 thus provides certainty and provides for the return of assets to clearing members and their customers in a manner that enables clearing members to measure and manage their exposures to CME. Chapter 7 of the Bankruptcy Code requires liquidation, rather than reorganization, of a commodity broker, which is defined to include the Clearing House. CME's bankruptcy would end the critical services and operations of the Clearing House.

Once the limited recourse structure is added to Base, proposed rule 802.B.9 provides that Base Clearing Members and any other holders of Base Contracts whose gains are haircut through Base Gains Haircuts and/or positions are extinguished through Base Partial Tear-Ups and/or a Base Full Tear-Up will have no claim against any other guaranty fund established by the Clearing House, any other funds, or any other entity (including CME Inc., CME Group Inc. or any of its affiliates) with respect to those haircut gains and/or extinguished positions other than amounts recovered from the defaulter's estate as described in proposed rule 802.E. Proposed rule 802.B.10(a) reinforces this limited recourse structure by providing that Base Clearing Members will have no claim to any other guaranty fund established by CME to cover losses suffered in connection with a Base default. Proposed rule 802.B.10(b) further provides that a beneficial holder of a Base Contract shall have no claim against its non-defaulted Base Clearing Member as a result of the application of this Rule 802.B other than any amounts recovered as described in Rule 802.E.

The addition of limited recourse for Base products, together with the other Recovery Tools, promotes the continuity of clearing for Base, IRS and CDS products by providing that CME's usage of Recovery Tools is final and not subject to further challenge. Limited recourse is designed to prohibit any additional claims with respect to the haircut gains or torn up positions and to thus provide certainty and finality with respect to these actions. This certainty and finality should enable CME and remaining Base Clearing Members to replenish their Base Guaranty Fund contributions following the Base Cooling Off Period (as defined in Rule 802) without concern that such replenishment would be used to reimburse the prior haircut gains or holders of torn up positions as limited recourse should protect such contributions against any claims or

---

<sup>55</sup> 11 U.S.C. §§ 761–767 (2012).



challenges in connection with such haircut gains or torn up positions. CME would similarly replenish its CME Contribution (as defined in Rule 802.B).

Furthermore, by avoiding a Bankruptcy Event and the close out and netting procedures under Rule 818 through the addition of limited recourse for Base Contracts, limited recourse should protect clearing members' and clearing members' customers' IRS and CDS positions and facilitate CME's continuity of clearing for IRS and CDS.

Limited recourse should limit the impact of a Base Clearing Member default on clearing members and customers of clearing members to those clearing members and customers of clearing members that clear and trade Base products.

Pursuant to proposed rule 802.B.11, no clearing member and no customer of a clearing member shall institute against, or join any other person in instituting against, CME any bankruptcy, reorganization or other similar proceedings under U.S. federal or state bankruptcy laws or other applicable law arising out of any claimed default by the Clearing House on a Base Contract as a result of the extinguishment of such Base Contract and related payments in accordance with these Rules. Proposed rule 802.B.11 should provide certainty and finality with respect to Base Partial Tear-Ups and Base Full Tear-Up and should enable CME to avoid a Bankruptcy Event. Thus, proposed rule 802.B.11 should promote continuity of clearing. Although CME received comments that proposed rule 802.B.11 was not necessary to preserve close-out rights, CME believes the addition of this rule is necessary to provide legal certainty and promote continuity of clearing and, thus, the stability of the financial system.

#### *Rights of Exchange for Recovery of Loss*

If a Base Clearing Member, Participating Exchange<sup>56</sup> or Partner Clearinghouse<sup>57</sup> defaults on its obligations to the Clearing House, the Clearing House may use Base guaranty fund contributions of non-defaulted Base Clearing Members, Base Assessments of non-defaulted Base Clearing Members and Aggregate Base Gains Haircuts (as defined in proposed rule 802.B.10(b)) to address losses caused by such default. Rule 802.E currently provides that CME shall take commercially reasonable steps to recover amounts so used. CME proposes amendments to Rule 802.E to set forth the order in which distributions would be made if CME subsequently recovers any funds from the defaulter (or its estate).

Pursuant to proposed rule 802.E, the net amount of any portion of recovered funds would be credited to non-defaulted Base Clearing Members on a pro rata basis in the amount of: (i) their (and their customers', if applicable) voluntary contributions with respect to such default; (ii) their (and their customers', if applicable) Aggregate Base Gains Haircuts with respect to such default;

---

<sup>56</sup> As defined in the Rulebook.

<sup>57</sup> As defined in the Rulebook.

(iii) their Base Assessments utilized by the Clearing House with respect to such default; and (iv) their Base Guaranty Fund contributions utilized by the Clearing House with respect to such default, each in the order listed, and then to CME for the amount of the CME Contribution utilized by the Clearing House with respect to such default.

### *Rule 818*

The proposed rules also make conforming changes to set forth how positions would be valued in connection with close out and netting pursuant to Rule 818 if a clearing member defaults and the Clearing House has not fully liquidated or ported all of the defaulted clearing member's proprietary and customer positions when a Bankruptcy Event occurs.

The proposed amendments to Rule 818.B make clear that any modification made by CME to any Base Contract, IRS contract or CDS contract pursuant to Rules 802.B.7, 8G802.B.3 or 8H802.B.3, respectively, shall not be considered a failure by CME to comply with an obligation to pay money or deliver property. Thus, in the event CME haircuts gains pursuant to such Rule(s), the lack of payment by CME of the haircut amount(s) shall not be considered a failure by CME to deliver such funds.

The proposed amendments to Rule 818.D provide that if a clearing member defaults and the Clearing House has not fully liquidated or ported all of the defaulted clearing member's proprietary and customer positions when a Bankruptcy Event occurs, CME shall value open positions subject to close-out by using the prices that were determined pursuant to the final settlement cycle that was conducted pursuant to Rules 802.B, 8G802.B and 8H802.B, as appropriate.

### **Comments/Opposing Views:**

In developing the Recovery Tools, the Exchanges held discussions with clearing members, customers of clearing members and the Futures Industry Association during the second half of 2015. The following is a description of the substantive opposing views received during this process, in addition to those discussed above, that were not incorporated in the proposed rules:

#### *Tear-Ups*

The Exchanges received an opposing view that the use of tear-ups should only be used where there is no available market price (either through auction or on exchange) for the defaulter's positions and that CME should have no discretion to decide that it will tear up trades because it lacks sufficient resources to complete the default management process. The commenter also suggested that CME should not implement tear-ups unless a substantial majority of the portfolio has been successfully auctioned (with a proposed estimate of approximately 90%). CME did not limit the use of tear-ups based on the comments as the tear-up tool is necessary to reestablish a matched book regardless of the amount of remaining positions and is designed to extinguish positions where the Base financial resources have been exhausted and the default management

actions have been unsuccessful. While the Exchanges expect the amount of positions subject to tear-up to be a small percentage of open positions, the tear-up tool needs to be comprehensive to address all remaining defaulter positions and thus could be a large percentage or even a full tear-up based on the existing circumstances.

The Exchanges also received an opposing view that it should not invoke tear-ups to resolve or manage any defaulted position if it has received even a single bid from clearing members for those defaulted positions. The Exchanges did not accept the comment that it should accept bids at any price. Bidders could seek windfall gains in the form of larger premiums than the available resources would support. Accepting bids at such prices would incentivize some market participants to game the system and provide windfall gains to the winning bidder at the expense of resources from non-defaulting Base Clearing Members and residual portfolio gains from market participants. This would not favor systemic stability.

#### *CME Equity:*

A commenter provided an opposing view to the removal of remaining CME equity through the addition of the limited recourse tool and requested that CME add a senior tranche (also known as additional skin in the game) following the use of Base assessments and prior to requests for voluntary contributions. CME did not include the additional senior skin in the game tranche in the proposed as CME already maintains a significant amount of skin in the game, which will be used before any non-defaulting clearing member's money, including guaranty fund contributions. CME believes that the commenter's suggestion is more appropriate for the broader skin in the game conversation. Further, CME does not believe that inclusion of the tranche will affect CME's risk management decisions.

#### *Governance*

The Exchanges received a request that the use of any loss-allocation measures or tear-ups require approval by CME's clearing members, with guidance from an impartial authority. However, CME does not believe that a clearing member vote would be timely or prudent. Clearing members may not be properly representative of all impacted market participants. Additionally, clearing members would likely be incentivized to vote in a manner that best affects their market positions. Furthermore, it is not possible for all market participants to vote. Thus, to address this request, the proposed rules adding Base Gains Haircuts, Base Partial Tear-Ups and Base Full Tear-Up would require the CHOC to consider, among other things, the legitimate interests of clearing members and customers of clearing members and any recommendation of the Emergency Financial Committee, when deciding whether to curtail or extend the duration of Base Gains Haircuts and/or when determining the appropriate scope of tear-ups. The proposed rules would further require the Emergency Financial Committee to consider, among other things, the legitimate interests of clearing members and customers of clearing members when making any recommendations to the CHOC regarding the duration of Base Gains Haircuts and/or the appropriate scope of tear-ups.

### *Compensation for Haircuts:*

The Exchanges received a comment that participants affected by haircuts and tear-ups should be “compensated by receiving a pro-rata share in (i) CCP’s claims against the estate(s) of the defaulting CM(s) and (ii) future CCP revenues/profits for replacement costs of trades torn up and cash paid-in/ gains haircut.” CME has included Rule 802.E to address the request that clearing members and, if applicable, their customers be compensated if the Clearing House is successful in recovering from the estate(s) of the defaulted clearing members. If CME recovers from the estate(s) of the defaulted clearing members, CME will reimburse clearing members and, if applicable, their customers pro rata first for voluntary contributions and then for the remainder of these resources in the reverse order of the utilization of these resources.

The proposed rules do not include a share in future CME revenues or profits. The incentives of the Clearing House, clearing members and customers of clearing members are better aligned if early participation in auctions is encouraged. The absence of an expectation of receiving compensation for haircuts and torn-up positions would incentivize clearing members and their customers to participate early in the auctions when CME first commences its default management process. As discussed above, as Base Partial Tear-Ups and a Base Full Tear-Up would occur contemporaneously with the settlement cycle and at the settlement price, the proposed rules do not include any further compensation.

### **Analysis of the Proposed Rules under DCO Core Principles**

CME reviewed the derivatives clearing organization core principles (“Core Principles”) as set forth in the CEA. During the review, CME identified the following Core Principles as potentially being impacted.

- **Core Principle E – Settlement Procedures:** If losses remain after exhausting the performance bonds of the defaulted Base Clearing Member, the CME Contribution, the Base Guaranty Fund, and Base Assessments, CME will conduct up to three days of Base Gains Haircuts settlement cycles for Base products. CME will collect from the Base Clearing Members with net portfolio losses, and CME will make payments to non-defaulting Base Clearing Members with net portfolio gains. CME’s payments to non-defaulting Base Clearing Members would be haircut to reflect the shortage of payments collected by the Clearing House during the settlement cycle. As noted above, the CHOC may instruct the Clearing House to extend or reduce the duration of Base Gains Haircuts settlement cycles by one or two Business Days after considering the recommendation(s)—if any—of the Emergency Financial Committee, such that the maximum number of days with Base Gains Haircuts is five Business Days.
- **Core Principle G – Default Rules And Procedures:** Consistent with CFTC Regulation 39.35, adding Base Gains Haircuts and voluntary contributions to the Rulebooks specifically addresses how CME would allocate losses that exceed the financial resources available to CME under the Rulebooks.

- Core Principle L – Public Information: The proposed rules will be added to CME’s publicly available rulebook, permitting clearing members to account for the proposed rules’ potential impact in the event that losses associated with the default of a Base Clearing Member exceed the financial safeguards package for Base.
- Core Principle O – Governance Fitness Standards: The proposed rules provide that the Board of Directors, through a Committee of the Board (the CHOC), will determine: (i) whether to extend or reduce the duration of Base Gains Haircuts; (ii) whether to conduct Base Partial Tear-Ups while settlement cycles with Base Gains Haircuts are ongoing (and if so, the appropriate scope of such tear-ups); and (iii) the appropriate scope of Base Partial Tear-Ups or that a Base Full Tear-Up is appropriate in connection with the last settlement cycle conducted in connection with Base Gains Haircuts. Such determinations would each be based on the then existing facts and circumstances, be in furtherance of the integrity of the Clearing House and the stability of the financial system, and take into consideration the legitimate interests of clearing members and customers of clearing members.<sup>58</sup> The proposed rules provide that the CHOC must also consider any recommendation of the Emergency Financial Committee. When making such recommendations to the CHOC, the proposed rules provide that the Emergency Financial Committee must also take into consideration the legitimate interests of clearing members and customers of clearing members. The proposed rule also provide that the CHOC would determine, after considering any recommendation of the Emergency Financial Committee, the maximum amount of liquidation and auction payment amounts that may be factored in when conducting Base Gains Haircuts.

CME certifies that the proposed rules comply with the CEA and the regulations thereunder.

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

Should you have any questions concerning the above, please contact the undersigned at (212) 299-2200 or via e-mail at [MEGSubmissionInquiry@cmegroup.com](mailto:MEGSubmissionInquiry@cmegroup.com).

Sincerely,

/s/ Christopher Bowen  
Managing Director & Chief Regulatory Counsel

---

<sup>58</sup> Determinations of the CHOC and recommendations of the Emergency Financial Committee that relate to the scope of tear-ups must also aim to extinguish the Remaining Open Base Positions (or a portion thereof) and any additional positions in Base Contracts deemed necessary to mitigate further disruptions to the markets affected by the Remaining Open Base Positions (or the portion of the Remaining Open Base Positions).

cc: Board of Governors of the Federal Reserve System

Attachments: Exhibit 1 – CME RULES

## CME RULES

## 802.A. Default by Clearing Member or Other Participating Exchanges

\* \* \*

## 2. Defaulting Clearing Member's Collateral

Upon the default of a clearing member, all assets of such defaulting clearing member that are available to the Clearing House, including without limitation its Base Guaranty Fund contribution (pursuant to Rule 816) including any excess amounts, its performance bonds on deposit with the Clearing House relating to the Base Guaranty Fund Product Classes, any partial payment amounts or settlement variation gains in respect of Base Guaranty Fund Product Classes, the proceeds of the sale of any membership assigned to it for clearing qualification, excess performance bond or guaranty fund deposits of the clearing member for non-Base Guaranty Fund Product Classes and any of its other assets held by, pledged to or otherwise available to the Clearing House but excluding amounts carried in any customer account class (collectively, the "Base Collateral"), shall be applied by the Clearing House to discharge ~~the clearing member's obligation~~any loss to the Clearing House- associated with such default (a "Loss"). A Loss shall include, but shall not be limited to, costs associated with the liquidation, transfer and managing of Base Contracts of the defaulted clearing member, hedging costs and other costs incurred by the Clearing House related to managing the risk surrounding the default of the clearing member.

The defaulting clearing member shall take no action, including but not limited to, attempting to obtain a court order that would interfere with the ability of the Clearing House to so apply such assets and proceeds.

If the Base Guaranty Fund contribution, performance bond relating to Base Fund Products and other assets of a clearing member available to the Clearing House are insufficient to satisfy all of its obligations to the Clearing House, including all claims against the Clearing House by reason of its substitution for that clearing member pursuant to Rule 804 or Rule 8F05, the Clearing House shall nonetheless pay all such claims, which payments by the Clearing House shall be deemed a Loss to it (~~hereinafter "Loss"~~) and which shall be a liability of the defaulting clearing member to the Clearing House, which the Clearing House may collect from any other assets of such clearing member or by process of law.

A Loss arising in the defaulted Base Clearing Member's proprietary account class shall be satisfied from the Base Collateral. A Loss resulting from any cleared swaps customer's cleared swap position in a Base Product shall be satisfied by application of performance bond, excess performance bond, other collateral and settlement variation gains held for the respective cleared swaps customer consistent with Part 22 of the CFTC's regulations (collectively, "Base Swap Customer Collateral"). A Loss resulting from any customer's futures position or swap position in a Base Product that is commingled with futures positions shall be

satisfied by application of performance bond, excess performance bond, other collateral and settlement variation gains held in the Base Clearing Member's customer account in a manner consistent with section 4d(a) of the Commodity Exchange Act (collectively, "Base Futures Customer Collateral").

For purposes of this Rule, the positions in the cross-margin account of a Participating Clearing Member or its Cross-Margining Affiliate at a Cross-Margining Clearing Organization, and the performance bond thereon, shall be considered assets of the Participating Clearing Member available to the Clearing House to the extent provided in the Cross-Margining Agreement between the Clearing House and such Cross-Margining Clearing Organization. A clearing member in default shall immediately make up any deficiencies in its Base Guaranty Fund contribution resulting from such default and in any event no later than the close of business on the banking day following demand by the Clearing House.

\* \* \*

#### **802.B. Satisfaction of Clearing House Obligations**

\* \* \*

#### 7. Modification of Clearing House's Obligations for Base Contracts

(a) If at any time following a default of a Base Clearing Member: (i) the assets available to cover the default under the preceding sections of Rule 802 are insufficient to satisfy the obligations of the Clearing House as a result of such default, (ii) a default of the Exchange occurs as described in Rule 818.B or (iii) a Bankruptcy Event of the Exchange occurs, then the Clearing House shall, in a manner that is consistent with the requirements of the Commodity Exchange Act and the regulations adopted thereunder (including, without limitation Part 190 of the Regulations, if applicable), conduct its next settlement cycle as described in Rule 802.B.7.(b).

(b) The Clearing House shall issue a Clearing Advisory Notice and conduct a settlement cycle to determine settlement prices for all Base Contracts and the portfolio gain or loss for each Base Clearing Member and its customers, in accordance with the following:

(i) The net portfolio gain of a Base Clearing Member (a "collect"), or the net portfolio loss of a Base Clearing Member to the Clearing House (a "pay") shall be determined separately for:

(A) the Base Clearing Member's proprietary positions in Base Contracts ("Proprietary Base Collects" or "Proprietary Base Pays"),



(B) (i) the non-swap positions of the Base Clearing Member’s customers in Base Contracts and (ii) any swap positions of such customers that are commingled with such non-swap positions in an account consistent with section 4d(a) of the Commodity Exchange Act (such non-swap positions and swap positions described in (i) and (ii) collectively, “Customer Futures Collects” or “Customer Futures Pays”), and

(C) the swap positions in Base Contracts of each customer of the Base Clearing Member held in an account consistent with Part 22 of the CFTC’s regulations (“Individual Customer Swap Collects” or “Individual Customer Swap Pays”).

(ii) The Clearing House Oversight Committee (after considering any recommendation of the Emergency Financial Committee) may determine a maximum amount of position liquidation payments that may be included in the Aggregate Base Collects, based upon then existing facts and circumstances, that it deems appropriate to mitigate further disruptions to the markets.

(iii) The Clearing House shall then notify each Base Clearing Member of the amount of its remaining Base Assessments, Proprietary Base Pays, Customer Futures Pays and Individual Customer Swap Pays and each Base Clearing Member shall pay all such amounts no later than the time required for the relevant settlement cycle. If a Base Clearing Member does not pay all such amounts to the Clearing House, the Clearing House shall determine such Base Clearing Member to be in default and may take any of the actions specified in Rule 802.A with respect to such Base Clearing Member and its customers.

(iv) If the amount of Aggregate Base Available Funds received by the Clearing House exceeds the Aggregate Base Collects, the Clearing House shall calculate reimbursements of, and distribute, the excess funds, in reverse order of the utilization of Base Priority of Payments.

(v) If the amount of the Aggregate Base Collects exceeds the amount of Aggregate Base Available Funds received:

(A) the Clearing House shall notify Base Clearing Members and provide an opportunity for Base Clearing Members and their customers to make voluntary contributions to the Clearing House;

(B) If the amount of the Aggregate Base Collects continues to exceed the amount of Aggregate Base Available Funds after the Clearing House adds any voluntary contributions from Rule 802.B.7(b)(v)(A) to the Aggregate Base

Available Funds, then the Clearing House shall apply Base Gains Haircuts (as defined below) to the Proprietary Base Collects, Customer Futures Collects and Individual Customer Swap Collects for the current settlement cycle and each successor settlement cycle on the current Business Day and, unless a Bankruptcy Event has occurred, each of the next two Business Days, in accordance with the following:

Proprietary Base Collects, Customer Futures Collects and Individual Customer Swap Collects each shall be reduced on a pro rata basis according to the amount of such collects, to equal the amount of Aggregate Base Available Funds received relative to Proprietary Base Collects, Customer Futures Collects, and Individual Customer Swap Collects (such process, a “**Base Gains Haircut**”).

Customer Futures Collects shall be haircut by the Clearing House at the customer account class level of each Base Clearing Member. Each Base Clearing Member shall allocate the haircut of its Customer Futures Collects pro rata among its customers with net portfolio gains for the relevant settlement cycle;

(C) The Clearing House Oversight Committee may instruct the Clearing House to extend or reduce the number of days during which Base Gains Haircuts are applied by one or two Business Days, provided that in no circumstance may the Clearing House conduct settlement cycles in which Base Gains Haircuts are applied for longer than five Business Days. Before providing such instruction, the Clearing House Oversight Committee must consider any recommendation of the Emergency Financial Committee. Any recommendation of the Emergency Financial Committee and the decision of the Clearing House Oversight Committee, each regarding adjusting the duration of settlement cycles with Base Gains Haircuts, must be based upon then existing facts and circumstances, be in furtherance of the integrity of the Clearing House and the stability of the financial system, and take into consideration the legitimate interests of clearing members and market participants; and

(D) For each settlement cycle conducted in accordance with this subparagraph (v), absent a Bankruptcy Event, the Clearing House shall pay the haircut Proprietary Base Collects, Customer Futures Collects, and Individual Customer Swap Collects to Base Clearing Members as soon as practicable after receipt of the Aggregate Base Available Funds. Subject to

applicable law, the Clearing House will make arrangements to pay the customers of a defaulted Base Clearing Member; and

(E) If a Bankruptcy Event occurs following a default of a Base Clearing Member on a day during which Base Gains Haircuts are applied to settlement cycles, on the day of the Bankruptcy Event, the Clearing House shall conduct a final settlement cycle which shall be subject to a Base Gains Haircut. The price determined in accordance with such settlement cycle shall be used as the price for a Base Contract when netting and closing out pursuant to Rule 818.

#### 8. Base Partial Tear-Ups and Base Full Tear-Ups

(a) The Clearing House may, at any time, notify Base Clearing Members and provide an opportunity for Base Clearing Members to voluntarily agree to have their proprietary positions or, with a customer's consent, to agree to have each such customer's positions, extinguished by the Clearing House.

(b) If proprietary or customer positions in Base Contracts of a defaulted Base Clearing Member remain open (the "Remaining Open Base Positions") following the last settlement cycle conducted pursuant to Rule 802.B.7(b)(v), the Clearing House shall extinguish the Remaining Open Base Positions through a partial tear-up process ("Base Partial Tear-Up") or a full tear-up process ("Base Full Tear-Up") of proprietary and customer positions of non-defaulted Base Clearing Members and non-defaulted customers of the defaulted Base Clearing Member in accordance with the following:

(i) The Clearing House Oversight Committee shall determine the appropriate scope of each Base Partial Tear-Up or shall determine that a Base Full Tear-Up is appropriate.

Before making such determination, the Clearing House Oversight Committee must consider any recommendation of the Emergency Financial Committee. Any recommendation of the Emergency Financial Committee and each determination of the Clearing House Oversight Committee made for purposes of this Rule 802.B.8 must:

(A) be based upon then existing facts and circumstances;

(B) be in furtherance of the integrity of the Clearing House and the stability of the financial system;

(C) take into consideration the legitimate interests of clearing members and market participants; and

(D) aim to extinguish Remaining Open Base Positions and any additional positions in Base Contracts deemed necessary to mitigate further disruptions to the markets affected by the Remaining Open Base Positions.

(ii) A Base Partial Tear-Up may include, but need not be limited to, the following methods:

(A) Line-by-Line Tear-Up Against The Remaining Open Base Positions. Proportionately extinguish Base Contracts held by non-defaulted Base Clearing Members, their non-defaulted customers and the non-defaulted customers of the defaulted Base Clearing Member that are opposite to the Remaining Open Base Positions and relative to the size of the Remaining Open Base Positions; and

(B) Tear-Up of All Positions in Base Contracts within a Product or Combination of Products. Extinguish all open positions in Base Contracts for a product or combination of products.

(iii) A Base Full Tear-Up would involve the extinguishment of all open positions in Base Contracts.

(c) In connection with any settlement cycle with Base Gains Haircuts, the Clearing House Oversight Committee may instruct the Clearing House to extinguish a portion of the Remaining Open Base Positions through a Base Partial Tear-Up of proprietary and customer positions of non-defaulted Base Clearing Members and non-defaulted customers of the defaulted Base Clearing Member. The Clearing House Oversight Committee would determine the appropriate scope of each such Base Partial Tear-Up in accordance with the procedures set forth in Rule 802.B.8(b)(i) and (ii), except that each reference to "Remaining Open Base Positions" shall mean the relevant portion of Remaining Open Base Positions.

#### 9. Limited Recourse for Base Guaranty Fund Products

If a default occurs, Base Collateral, Base Customer Collateral and the Base Priority of Payments shall be the sole source of payments to cover the Loss until the default is fully and finally resolved, as applicable. In the event the Base Collateral, Base Customer Collateral and the Base Priority of Payments are insufficient to cover the Loss, regardless of whether the CME is able to require a Base Clearing Member to cure a deficiency in the Base Guaranty Fund because of the occurrence of a Bankruptcy Event (as such term is defined in Rule 818.A.), Base Clearing Members and the holders of Base Contracts shall

have no recourse to any other funds or any other entity, including without limitation the guaranty funds that support clearing of other products, CME, CME Group Inc. or any of its affiliates, other than any amounts recovered as described in Rule 802.E.

#### 10. No Claims Against the Exchange or Clearing House

(a) Base Clearing Members, their affiliates and their customers shall have no claim against the Exchange, CME Group Inc. or any affiliates of the Exchange or CME Group Inc., or any directors, officers or employees of any of the foregoing, including but not limited to claims against any other guaranty fund established by the Exchange, CME Group Inc. or any of its affiliates with respect to losses suffered as a result of the application of any provision in this Rule 802.B. No beneficial holder of a Base Contract shall have any claim against its non-defaulted Base Clearing Member as a result of the application of this Rule 802.B other than any amounts recovered as described in Rule 802.E.

(b) Notwithstanding anything in subparagraph (a), Base Clearing Members, for both their proprietary positions in Base Contracts and their customers' positions in Base Contracts, and non-defaulted customers of defaulted Base Clearing Members will have a claim on any recovery from the defaulted Base Clearing Member or the estate of the defaulted Base Clearing Member in the amount of the Base Gains Haircuts, in the aggregate, applied to such positions (such amount with respect to all non-defaulted Base Clearing Members and their customers and the non-defaulted customers of the defaulted Base Clearing Member, "Aggregate Base Gains Haircuts"), as set forth more fully in Rule 802.E. If the recovery from the defaulted Base Clearing Member is less than the Aggregate Base Gains Haircuts, non-defaulted Base Clearing Members and their customers and the non-defaulted customers of defaulted Base Clearing Members will share pro rata in the recovery.

#### 11. Non-Petition

No Clearing Member and no customer of a Clearing Member shall institute against, or join any other person in instituting against, the Exchange any bankruptcy, reorganization, arrangement, insolvency, moratorium, liquidation or examinership proceedings, or other similar proceedings under U.S. federal or state bankruptcy laws or other applicable law arising out of any claimed default by the Clearing House on a Base Contract as a result of the extinguishment of such Base Contract and related payments in accordance with these Rules.

\* \* \*

**802.E. Rights of Exchange for Recovery of Loss**

Losses caused by the default of a Base eClearing mMember, Participating Exchange or Partner Clearinghouse are amounts due to the Clearing House from such Base eClearing mMember, Participating eExchange or clearing-housePartner Clearinghouse and shall remain legal obligations thereof notwithstanding the Clearing House's recourse to the loss-mutualization provisions of this Rule 802, ~~which amounts~~ and the Clearing House shall take commercially reasonable steps to recover (including claims submitted in ~~bankruptcy court~~). ~~If a Loss for which clearing members or their Base Guaranty Fund contributions have been assessed~~ an insolvency or resolution proceeding) such amounts. If any portion of these amounts is subsequently recovered by the Exchange ~~in whole or in part~~, the net amount of such recovery shall be credited to ~~such~~ non-defaulted Base eClearing mMembers (whether or not they are still clearing members at the time of recovery) in ~~proportion to the amount of the assessment~~ the following order on a pro rata basis based on (1) the amount of their (and their customers', if applicable) voluntary contributions with respect to such default, (2) the amount of their (and their customers', if applicable) Aggregate Base Gains Haircuts with respect to such default, (3) the amount of their Base Assessments utilized by the Clearing House with respect to such default, and (4) the amount of their guaranty fund contribution utilized by the Clearing House with respect to such default, each in the order listed, and then to the Exchange for the amount of the CME Contribution utilized by the Clearing House with respect to such default.

\* \* \*

**818.B Default of the Exchange**

If at any time the Exchange fails to comply with an undisputed obligation to pay money or deliver property to a Clearing Member that is due and owing in connection with a transaction on the Exchange or cleared by the Exchange, for a period of five Business Days from the date that the Exchange receives notice from the Clearing Member of the past due obligation, the Clearing Member's open proprietary and customer (including, for this rule, CFTC Regulation Section 30.7 ~~secured~~ customers and ~~cleared~~ swaps ~~customers~~) positions at the Clearing House shall, at the election of that Clearing Member, be closed promptly. For the avoidance of doubt, any modification to any Base Contract under Rule 802.B.7., any IRS Contract under 8G802.B.3. or any CDS Contract under 8H802.B.3. shall not be considered a failure by the Exchange to comply with an obligation to pay money or deliver property.

\* \* \*

**818.C. Netting and Offset**

1.

\* \* \*

Notwithstanding the foregoing, the amount of any proprietary or customer claim extinguished as a result of the application of the terminating and netting procedures set forth in either Rule [802.B \(with respect to Base Products\)](#), Rule 8G802.B (with respect to IRS Products) or Rule 8H802.B (with respect to CDS Products), shall not be available for netting in Proprietary Netting, Futures Customer Netting or Swap Customer Netting, as applicable. Proprietary Netting, Futures Customer Netting and Swap Customer Netting shall be performed in accordance with the Bankruptcy Code, the Commodity Exchange Act and the regulations promulgated thereunder. Rule 818 shall be deemed to be (i) a master netting agreement for Proprietary Netting; (ii) a master netting agreement for Futures Customer Netting and (iii) a master netting agreement for Swap Customer Netting.

\* \* \*

**818.D. Valuation**

As promptly as reasonably practicable, but in any event within thirty days of the: (i) Bankruptcy Event, or (ii) if a Clearing Member elects to have its open positions closed in a default as described in Paragraph B of this Rule, the date of the election, the Exchange shall, in a manner that is consistent with the requirements of the Commodity Exchange Act and the regulations adopted thereunder (including, without limitation) Part 190 of the Regulations, fix a U.S. dollar amount (the “Close-out Value”) to be paid to or received from the Exchange by each Clearing Member, after taking into account all applicable netting and offsetting pursuant to paragraph C of this Rule.

The Exchange shall value open positions subject to close-out by using the market prices for the relevant market (including without limitation, any over the counter markets) at the moment that the positions were closed-out, assuming the relevant markets were operating normally at such moment. If the relevant markets were not operating normally at such moment, the Exchange shall exercise its discretion, acting in good faith and in a commercially reasonable manner, in adopting methods of valuation to produce reasonably accurate substitutes for the values that would have been obtained from the relevant market if it had been operating normally at the moment that the positions were closed-out.

If a default of a Base Clearing Member, IRS Clearing Member or CDS Clearing Member has also occurred and the Clearing House has not fully liquidated (or ported) all of the clearing member's proprietary and customer positions, the Exchange shall value open positions subject to close-out by using the prices that were determined pursuant to the final settlement cycle that was conducted pursuant to Rules 802.B, 8G802.B and 8H802.B, as appropriate.

In determining a Close-out Value, the Exchange may consider any information that it deems relevant. Amounts stated in a currency other than U.S. Dollars shall be converted to U.S. Dollars at the current rate of exchange, as determined by the Exchange. If a Clearing Member has a negative Close-out Value it shall promptly pay that amount to the Exchange.



## New Definitions (to be added to Chapter iii.)

### AGGREGATE BASE AVAILABLE FUNDS

The sum of any remaining Base Collateral, any remaining Base Customer Collateral (if applicable as described in Rule 802.A.2), any Remaining Base Priority of Payments and the Aggregate Base Pays.

### AGGREGATE BASE COLLECTS

The sum of all Proprietary Base Collects, all Customer Futures Collects, all Individual Customer Swap Collects and the amount of payments utilized for position liquidation pursuant to Rule 802.B.7(b)(ii).

### AGGREGATE BASE PAYS

The sum of all Proprietary Base Pays, Customer Futures Pays and Individual Customer Swap Pays.

### AUCTION PAYMENTS

The amounts that would be owed to winner(s) of an auction of a defaulted Clearing Member's portfolio (or some portion thereof).

### BASE ASSESSMENTS

The amounts by which the Clearing House assesses Base Clearing Members collectively pursuant to Rule 802.

### BASE CLEARING MEMBER

A firm meeting the requirements of, and approved for, clearing membership with respect to Base Contracts at the Exchange.

### BASE CONTRACT

A Base Guaranty Fund Product that has been accepted for clearing by the Clearing House.

### BASE CUSTOMER COLLATERAL

The sum of Base Swap Customer Collateral and Base Futures Customer Collateral, each as applicable pursuant to Rule 802.A.2.

### BASE PRIORITY OF PAYMENTS

The CME Contribution, the Base Tranche, the Comingled Tranche, the Alternate Tranche and the Base Assessments, which shall be used in the order set forth in Rule 802.B.

#### **REMAINING BASE PRIORITY OF PAYMENTS**

The amount of each non-defaulted Base Clearing Member's remaining payment obligations, if any, in respect of Base Assessments, any remaining CME Contribution, any remaining Base Guaranty Fund amounts and any remaining Base Assessments previously funded.