

**SUBMISSION COVER SHEET**

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

Registered Entity Identifier Code (optional): 19-336

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

Filing as a:  DCM  SEF  DCO  SDR

Please note - only ONE choice allowed.

Filing Date (mm/dd/yy): 09/06/19 Filing Description: Amendments to CME Chapter 8G ("Interest Rate Derivative Clearing") and Chapter iii. ("CME Definitions") Regarding End of Waterfall Rules for Interest Rate Swaps

**SPECIFY FILING TYPE**

Please note only ONE choice allowed per Submission.

**Organization Rules and Rule Amendments**

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|-------------------------------------|-------------------------------------|------------|
| <input type="checkbox"/>            | Certification                       | § 40.6(a)  |
| <input type="checkbox"/>            | Approval                            | § 40.5(a)  |
| <input type="checkbox"/>            | Notification                        | § 40.6(d)  |
| <input checked="" type="checkbox"/> | Advance Notice of SIDCO Rule Change | § 40.10(a) |
| <input type="checkbox"/>            | SIDCO Emergency Rule Change         | § 40.10(h) |

Rule Numbers: See filing.

**New Product**

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|--------------------------|---------------------------------------|------------|
| <input type="checkbox"/> | Certification                         | § 40.2(a)  |
| <input type="checkbox"/> | Certification Security Futures        | § 41.23(a) |
| <input type="checkbox"/> | Certification Swap Class              | § 40.2(d)  |
| <input type="checkbox"/> | Approval                              | § 40.3(a)  |
| <input type="checkbox"/> | Approval Security Futures             | § 41.23(b) |
| <input type="checkbox"/> | Novel Derivative Product Notification | § 40.12(a) |
| <input type="checkbox"/> | Swap Submission                       | § 39.5     |

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

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

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

Rule Numbers:

September 6, 2019

**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 – Amendments to CME Chapter 8G (“Interest Rate Derivative Clearing”) and Chapter iii. (“CME Definitions”) Regarding End of Waterfall Rules for Interest Rate Swaps.  
CME Submission No.19-336**

Dear Mr. Kirkpatrick:

Chicago Mercantile Exchange Inc. (“CME”), a registered derivatives clearing organization (“DCO”) under the Commodity Exchange Act, as amended (“CEA” or “Act”) hereby provides advance notice to the Commodity Futures Trading Commission (“CFTC”) of proposed changes to Chapter 8G (“Interest Rate Derivative Clearing and Chapter iii. (“CME Definitions”) of the rules of the CME (the “Rulebook”) applicable to IRS Contracts (as defined in the Rulebook, which includes any positions in Base Guaranty Fund Products that are commingled with IRS Contracts pursuant to Rule 8G831 (“Commingling of Eligible Futures and Swap Positions”)) (“IRS products”)<sup>1</sup> on the earlier of November 6, 2019, or the receipt of regulatory approval or non-objection<sup>2</sup> (collectively, the “Rule Amendments”). 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 CME, The Board of Trade of the City of Chicago, Inc., New York Mercantile Exchange, Inc., and Commodity Exchange, Inc. 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 the maintenance of financial stability.<sup>4</sup> The Rulebook provides for a robust financial safeguards package for IRS products that would be used to address losses that arise from the default of one or more IRS Clearing Members on obligations to the Clearing House. The financial safeguards package includes performance bond collateral

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<sup>1</sup> “IRS Contract” is defined in Rule 90002.R as “An IR Swap Contract or an IR Swaption Contract” except that, in accordance with proposed rule 8G831, the term “IRS Contract” shall include Commingled Futures Positions when used in Chapter 8G except as otherwise provided therein. As used herein, “IRS product” means an IR (Interest Rate) Swap Contract, IR Swaption Contract and any positions commingled with IRS Contracts (“Commingled Futures Positions”) (which together constitute “IRS Contracts” for the purposes of Chapter 8G). Commingled Futures Positions are positions in Base Guaranty Fund Products that are commingled with positions in IRS Contracts in accordance with Rule 8G831 in order to provide for risk offsets for proprietary and customer positions on the basis that the price risks with respect to such products are significantly and reliably correlated. The Commingled Futures Positions are subject to the financial safeguards package for IRS Contracts and risk methodology associated with IRS Contracts to the extent provided under the Rulebook.

<sup>2</sup> CME, 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.

<sup>4</sup> See CPMI-IOSCO, Board of the International Organization of Securities Commissions Report, Recovery of Financial Market Infrastructures (October 2014), revised July 2017 (“CPMI-IOSCO Report”) at p.8, <https://www.bis.org/cpmi/publ/d162.pdf> (defining “critical” services).

that is posted by each IRS Clearing Member (as defined in the Rulebook); CME would sell, and use the proceeds from, the performance bond collateral of an IRS Clearing Member if the member defaults to the Clearing House.<sup>5</sup> The financial safeguards package also includes a funded commitment by CME to cover \$150 Million of losses associated with a default of one or more IRS Clearing Members (such commitment, the “CME IRS Contribution”)<sup>6</sup> and funded and unfunded commitments by clearing members to cover such losses (up to a maximum obligation) in the form of IRS Guaranty Fund contributions<sup>7</sup> and assessments<sup>8</sup>, respectively.<sup>9</sup>

The Rule Amendments will add new recovery tools to the Rulebook to facilitate the continuity of CME’s clearing services and operations for IRS products in the unlikely event that the losses arising from the default of one or more IRS Clearing Members exceed the financial safeguards package for IRS products. The Rule Amendments also seek to conform a number of Rulebook provisions relating to IRS products with certain changes adopted in the Base silo in December 2016 designed 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 exceed the financial safeguards packages for Base<sup>10</sup>. The Rule Amendments add the following recovery tools relating to IRS products: (i) portfolio gains haircuts for certain settlement cycles;<sup>11</sup> (ii) mandatory tear-ups in connection with such settlement cycles;<sup>12</sup> (iii) voluntary contributions by IRS Clearing Members (and their customers);<sup>13</sup> and (iv) voluntary tear-ups by IRS Clearing Members (and their customers)<sup>14</sup> (collectively, the “New Recovery Tools”). Each of these tools is described in detail below.<sup>15</sup>

CME also proposes amendments to Rule 8G802.E (“Rights of Clearing House for Recovery of Loss”) to clarify that if CME uses non-defaulted IRS Clearing Members’ guaranty fund contributions, assessments, voluntary contributions and/or gains haircuts and subsequently recovers any portion of those amounts from the defaulted clearing member’s estate, CME will reimburse such non-defaulted IRS 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>16</sup>

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

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<sup>5</sup> See Rule 8G802.A.

<sup>6</sup> See Rule 8G802.B (committing the Clearing House to use a corporate contribution of CME in the amount of \$150 Million to mitigate losses associated with a default of one or more IRS Clearing Members as provided therein).

<sup>7</sup> See Rule 8G07 (requiring each IRS Clearing Member to make an IRS Guaranty Fund deposit with CME); See *also* Rule 8G802.A (providing that a IRS Clearing Member’s IRS Guaranty Fund contribution may be applied by the Clearing House to mitigate losses associated with a default of one or more IRS Clearing Members).

<sup>8</sup> See Rule 8G807 (subjecting each non-defaulted IRS Clearing Member to an assessment, determined by the Clearing House using stress test methodology equal to the theoretical third and fourth largest IRS Clearing Member losses produced by such stress test (and assuming for purposes of the model that already-defaulted IRS Clearing Members will fail to contribute) or such other methodology determined by the IRS Risk Committee).

<sup>9</sup> The CME IRS Contribution and commitments by non-defaulted IRS Clearing Members will only be used if the obligations of the defaulted clearing member to the Clearing House with respect to IRS Contracts exceed the defaulted clearing member’s performance bond collateral and IRS Guaranty Fund contribution and any other assets of the defaulted clearing member that are available to the Clearing House for the defaulted IRS Clearing Member’s IRS Contracts. See Rules 8G802.A and 8G802.B. In such instance, the Clearing House would first exhaust the CME IRS Contribution and then the IRS Guaranty Fund contributions of non-defaulted IRS Clearing Members before utilizing assessment funds of non-defaulted IRS Clearing Members. See *id.*

<sup>10</sup> See CME Group Advisory No. 16-539 “Addition of Portfolio Gains Haircuts, Tear-Ups, and Limited Recourse to the Financial Safeguards Package for Base; Amendments to CME Rule 802 and 818”, see <https://www.cmegroup.com/notices/clearing/2016/12/Chadv16-539.pdf>

<sup>11</sup> See proposed rule 8G802.B.2.

<sup>12</sup> See proposed rules 8G802.B.3(b) and (c).

<sup>13</sup> See proposed rule 8G802.B.2.

<sup>14</sup> See proposed rule 8G802.B.3(a).

<sup>15</sup> As discussed below, pursuant to the proposed amendments to Rule 8G802, (i) portfolio gains haircuts; (ii) mandatory tear-ups; and (iii) voluntary contributions and voluntary tear-ups by IRS Clearing Members (and their customers) may be used only if (x) an IRS Clearing Member defaults and (y) at any time following the default of the IRS Clearing Member, the assets available to cover the default under the preceding sections of Rule 8G802 are insufficient to satisfy the IRS Loss and the obligations of the Clearing House to IRS Clearing Members as a result of such default.

<sup>16</sup> The proposed conforming rule changes to Rule 8G802.E are discussed below.

## **CFTC Regulatory Requirements**

The Rule Amendments add portfolio gains haircuts for certain settlement cycles and add voluntary contributions to the Rulebook as rulebook tools 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 IRS products specifically address how CME would allocate losses that exceed the financial resources available to CME, as required by CFTC Regulation 39.35(a)(1), while promoting the continuity of clearing services and operations for IRS products.

The Rule Amendments add the New Recovery Tools to the Rulebook for IRS products 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>17</sup> and restore a matched book.<sup>18</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 Rule Amendments which add new portfolio gains haircuts for certain settlement cycles 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 while providing for continuity of clearing services and operations for IRS products. Thus, the Rule Amendments are designed to enable CME’s recovery, as required by CFTC Regulation 39.39(a)(3).

## **Background**

On December 30, 2016, following engagement with government regulators, clearing members, customers of clearing members and other stakeholders, CME introduced certain changes to the financial safeguards package for Base, including limited recourse, portfolio gains haircuts for certain settlement cycles, mandatory tear-ups in connection with such haircuts, voluntary contributions by Base Clearing Members (and their customers), and voluntary tear-ups by Base Clearing Members (and their customers).<sup>19</sup> CME now seeks to make certain changes to conform and harmonize the rules governing the clearing of IRS products with the updated Base rules.

In formulating the Rule Amendments, CME 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,” as revised in July 2017.<sup>20</sup> Furthermore, during 2019 in the period prior to the date of this filing, CME discussed the Rule Amendments with the members of the CME IRS Risk Committee, including IRS clearing members and other market participants. CME also undertook a consultation of all founding and active IRS clearing members to solicit feedback on the Rule Amendments.

The Rule Amendments are a product of such guidance and discussions with, and feedback from, the IRS Risk Committee, clearing members and market participants. Given the extent of the consultation described above and the fact that the revised rules serve to align and harmonize the rules governing the clearing of IRS products with the relevant provisions of the Base rules that were previously consulted on by CME with,

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<sup>17</sup> Uncovered credit losses are losses arising from the default of one or more IRS Clearing Members on obligations to CME that exceed the IRS financial safeguards package.

<sup>18</sup> CME’s book is matched when there is a solvent clearing member standing behind every transaction.

See CME Group Advisory No. 16-539 “Addition of Portfolio Gains Haircuts, Tear-Ups, and Limited Recourse to the Financial Safeguards Package for Base; Amendments to CME Rule 802 and 818”, see <https://www.cmegroup.com/notices/clearing/2016/12/Chadv16-539.pdf>

<sup>20</sup> See CPMI-IOSCO Report.

among others, the Futures Industry Association (“FIA”), CME did not directly consult with the FIA or other industry bodies.

### **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 New Recovery Tools, CME would conduct its default management processes<sup>21</sup> to liquidate open positions of each defaulted IRS Clearing Member through open market transactions and/or auctions.<sup>22</sup> Depending upon the nature of the portfolio of the defaulted IRS Clearing Member, CME may enter into hedging transactions to reduce risk associated with certain open positions.

To discharge the obligations of the defaulted IRS Clearing Member to the Clearing House (which include the funds needed to hedge, auction and liquidate the defaulted IRS Clearing Member’s positions), CME would first use all of the assets of the defaulted IRS Clearing Member that are available to the Clearing House.<sup>23</sup> If the obligations of the defaulted IRS Clearing Member to the Clearing House with respect to IRS Contracts exceed the assets of the defaulted IRS Clearing Member that are available to the Clearing House for such contracts,<sup>24</sup> to address the resulting loss, the Clearing House would exhaust the CME IRS Contribution and then the IRS Guaranty Fund contributions of non-defaulted clearing members before utilizing assessment funds of non-defaulted clearing members.<sup>25</sup>

The Rule Amendments would not alter this order of usage. The Clearing House would exhaust these resources before turning to the New Recovery Tools proposed herein.<sup>26</sup>

As CME’s default management process is continuous, CME would continue working to reduce the amount of uncovered credit losses and restore a matched book while using the New 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>27</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 IRS Clearing Members—through the CME’s corporate contribution, the IRS Guaranty Fund (as defined in Rule 8G802.A) and IRS Assessments (as defined in Rule 8G07)—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.

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<sup>21</sup> See Rules 8G802.A and 8G802.B.1 and proposed rule 8G802.B.2 (describing the default management process). Pursuant to proposed rule 8G802.B.10 (which restates current Rule 8G802.B.6), the detailed implementation of liquidating, auctioning and selling the positions and assets of the defaulted clearing member shall be conducted by the Clearing House in consultation with the IRS Default Management Committee.

<sup>22</sup> Auction design and auction scope will be tailored to the portfolio of the defaulted IRS Clearing Member.

<sup>23</sup> See Rule 8G802.A.2 (describing the assets of the defaulted IRS Clearing Member that may be available to the Clearing House) and the definition of IRS Collateral (which the proposed rules would move to Chapter iii).

<sup>24</sup> See Rule 8G802.A.2. and the definition of IRS Collateral which the proposed rules would move to Chapter iii (defining IRS Collateral as excluding customer assets).

<sup>25</sup> See Rule 8G802.B.

<sup>26</sup> One exception is that, pursuant to proposed rule 8G802.B.3(a), voluntary tear ups could occur at any time following the default of an IRS Clearing Member. In addition, CME retains the ability to call an IRS Termination Event prior to utilization of the New Recovery Tools, in accordance with proposed rule 8G802.B.5.

<sup>27</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.

Portfolio gains haircuts is a recovery tool that provides for the allocation of losses following complete utilization of the IRS financial safeguards resources. This tool is designed to extinguish (or “haircut”) a portion of amounts due to IRS Clearing Members and their customers with a net portfolio gain<sup>28</sup> for a settlement cycle while collecting the full amount due from IRS 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 IRS Clearing Members and their customers with net portfolio losses applied on a pro rata basis across the IRS Clearing Members and their customers with net portfolio gains for the relevant account class for the settlement cycle.<sup>29</sup>

Currently, Rules 8G802.B.2 and 3 provide that in the unlikely event that CME experiences a Bankruptcy Event (as defined in Rule 818.A) following the default of an IRS Clearing Member or any of the other three IRS Termination Events<sup>30</sup> occur, a single round of portfolio gains haircuts would be conducted, and all open IRS Contracts would be extinguished. While these provisions have been retained (in proposed rule 8G802.B.5., with the close-out provisions set out in proposed rule 8G802.B.6, as discussed further below), CME proposes to add a new proposed rule 8G802.B.2 to provide for portfolio gains haircuts cycles for IRS products (“IRS Gains Haircuts”) as a Recovery Tool to promote the continuity of clearing services and operations for IRS products. Such IRS Gains Haircut cycles would be utilized in connection with a settlement cycle for which (i) CME has not received all payments for IRS products due to the default of one or more IRS Clearing Members and (ii) the assets available to cover such default under Rules 8G802.A and 8G802.B.1-2 would be insufficient to satisfy the IRS Loss and obligations of the Clearing House to IRS Clearing Members as a result of such default, absent an IRS Termination Event. 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>31</sup> to be appropriate to mitigate further disruptions to the markets, after considering the then existing facts and circumstances and any recommendation made by the IRS Emergency Financial Committee (as defined in Rule 8G975).<sup>32</sup> The IRS Gains Haircuts set forth in proposed Rule 8G802.B.2 are substantially similar in nature and process to the Base gains haircuts provided for in Rule 802.B.7(b)(v).

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

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

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<sup>28</sup> For the avoidance of doubt, neither Rule 8G802.B.2-3 nor proposed rules 8G802.B.5-6 nor the proposed rule 8G802.B.2 that would add IRS Gains Haircuts (discussed and defined below) would haircut performance bonds. CME strongly opposes haircuts of performance bonds for the reasons discussed below on page 7.

<sup>29</sup> Any haircuts conducted under existing Rules 8G802.B.2-3, proposed rules 8G802.B.5-6 or proposed rule 8G802.B.2 would be determined at the proprietary account level of each IRS Clearing Member and at the beneficial owner level for each cleared swaps customer of each IRS Clearing Member in accordance with Part 22 of the CFTC’s regulations, as applicable.

<sup>30</sup> Current Rule 8G28(a) states that the Exchange may wind up clearing operations for IRS products in circumstances in which the IRS financial safeguards package is exceeded producing an “IRS Termination Event.” Under current Rule 8G802.B.2 an “IRS Termination Event” is defined as circumstances where, “if at any time following a default: (a) the Clearing House is unable to cover a settlement variation payment obligation when due and has no expectation of accessing funds to permit it to cover such payment obligation (for example through access to credit lines or assessment funds), (b) the Clearing House determines (after consultation with the IRS Risk Committee) that the available IRS Collateral and the IRS Priority of Payments will be insufficient to satisfy auction bid results for the defaulted IRS Clearing Member’s portfolio, (c) the Clearing House otherwise determines (after consultation with the IRS Risk Committee) the IRS Loss will exceed the available IRS Collateral and IRS Priority of Payments, or (d) a Bankruptcy Event of the Exchange” occurs. Note also that CME has additional powers to wind-down its IRS clearing service under Rule 8G28(b) and (c).

<sup>31</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.”

<sup>32</sup> Proposed Rule 8G802.B.2(b)(i)

IRS Gains Haircuts would distribute remaining losses associated with the default of an IRS Clearing Member pro-rata across all market participants with net portfolio gains in IRS Contracts. During each IRS 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 IRS Clearing Member and at the beneficial owner level for each cleared swaps customer of each IRS Clearing Member in accordance with the CFTC's Part 22 regulations.<sup>33</sup>

The amount of a net portfolio gain of an IRS Clearing Member or each of its customers represents the net amount the IRS Clearing Member or each of its customers are owed in connection with the relevant settlement cycle.

In discussions relating to the introduction of this tool for products falling within the Base Guaranty Fund, certain market participants 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. As with the approach adopted for Base gains haircuts, CME proposes haircuts across all market participants in respect of IRS Contracts, 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 IRS Gains Haircuts, other participants would need to absorb such losses in order for IRS Gains Haircuts to fully allocate the loss to the benefit of those exempted.<sup>34</sup> As any application of IRS 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.

IRS 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 IRS Contracts would be exposed to losses, such losses enable such holders to collect the remainder of their gains while maintaining their positions.

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

Proposed rule 8G802.B.2(v) provides for three Business Days of IRS Gains Haircuts and a mechanism to shorten or extend the duration of IRS Gains Haircuts depending upon the then existing facts and circumstances (as discussed below).<sup>35</sup> In contemplating the number of IRS Gains Haircuts settlement cycles, CME aimed to allow for a sufficient amount of time for CME to reestablish the matched book and for IRS Clearing Members and customers of IRS Clearing Members to measure and manage their exposures. By providing certainty on the maximum number of IRS 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 IRS Gains Haircuts settlement cycles, thereby allowing IRS Clearing Members and customers of IRS Clearing Members to measure and manage this risk.

Pursuant to proposed rule 8G802.B.2(v)(C), the CHOC<sup>36</sup> may extend or reduce the number of days during which IRS Gains Haircuts are applied by one or two Business Days, such that the maximum number of days with IRS Gains Haircuts is five Business Days.

Proposed rule 8G802.B.2(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

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<sup>33</sup> Proposed Rule 8G802.B.2(ii)(b).

<sup>34</sup> See CPMI-IOSCO Report at p.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...").

<sup>35</sup> This mechanism is to the same as the mechanism for Base provided under Rule 802.B.7(b)(v).

<sup>36</sup> See *supra* note 31 (discussing the purpose and priorities of the CHOC).

system; and (iii) by taking into consideration the legitimate interests of clearing members and customers of clearing members.<sup>37</sup>

Before making any adjustments to the duration of IRS Gains Haircuts, the CHOC would consider the recommendation(s)—if any—made by the IRS Emergency Financial Committee. Pursuant to proposed CME rule 8G802.B.2(v)(C), any recommendation by the IRS Emergency Financial Committee regarding whether to extend or reduce the duration of IRS Gains Haircuts must 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; and (iii) take into consideration the legitimate interests of clearing members and customers of clearing members.<sup>38</sup>

Proposed rule 8G802.B.2(v)(C) thus enables CME to extend the IRS 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 IRS Gains Haircuts is five Business Days. Similarly, proposed rule 8G802.B.2(v)(C) enables CME to reduce the duration of IRS 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 IRS 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 IRS Contracts and (ii) it would be imprudent to conduct additional haircut cycles.

At the conclusion of the IRS 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 IRS positions through a tear-up process pursuant to proposed rule 8G802.B.3(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, both in the context of consultations regarding the Base Rules and these New Recovery Tools for IRS products, 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 IRS 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 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 clearing member and (ii) creating a procyclical liquidity requirement for all 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 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

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<sup>37</sup> By explicitly requiring that any such determination be in furtherance of the integrity of the Clearing House and stability of the financial system and take into consideration the legitimate interests of clearing members and customers of clearing members, the proposed rule explicitly supports the stability of the broader financial system and other relevant public interest considerations of relevant stakeholders (clearing members and their customers of clearing members) in accordance with CFTC Regulation 39.32(a)(1)(iv). By explicitly requiring that such determination take into consideration the legitimate interests of the relevant stakeholders (clearing members and their customers), the proposed rule ensures that such determination would appropriately reflect the legitimate interests of the relevant stakeholders in accordance with CFTC Regulation 39.32(a)(2).

<sup>38</sup> See *id.*



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.

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

Currently, Rule 8G802.B.3 provides for a mandatory tear-up process of all open IRS Contracts upon the occurrence of an IRS Termination Event (as defined in Rule 8G802.B.5)<sup>39</sup>. Through proposed rules 8G802.B.5 and 8G802.B.6, CME would retain such process to tear up all open IRS Contracts in the event of an IRS Termination Event<sup>40</sup>.

However, absent an IRS Termination Event, CME also proposes to introduce a new mandatory IRS Partial Tear-Up and IRS Full Tear-Up process in proposed Rule 8G802.B.3 to promote continuity of clearing services and operations in addition to reestablishing a matched book. Such new process is substantially similar in nature to the mandatory Base partial tear-up and Base full tear-up process set forth in Rule 802.B.8.

CME designed the new mandatory tear-up process in proposed rule 8G802.B.3 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 Rule Amendments refer to the proprietary and customer positions in IRS Contracts of the defaulted IRS Clearing Member(s) that remain open as the "Remaining Open IRS Positions."<sup>41</sup> Following the last settlement cycle conducted in connection with IRS Gains Haircuts, the Clearing House would extinguish all Remaining Open IRS Positions through a partial tear-up process ("IRS Partial Tear-Up") or through a full tear-up process of all IRS Contracts ("IRS Full Tear-Up") of proprietary and customer positions of non-defaulted IRS Clearing Members and non-defaulted customers of the defaulted IRS Clearing Member.<sup>42</sup> On days when IRS Gains Haircuts are occurring, the Clearing House could extinguish a portion of the Remaining Open IRS Positions through a IRS Partial Tear-Up of proprietary and customer positions of non-defaulted IRS Clearing Members and non-defaulted customers of the defaulted IRS Clearing Member.<sup>43</sup> In either case, the CHOC would determine the appropriate scope of tear-ups as described below.

### Tear-Ups Which Occur Following the Last Settlement Cycle with IRS Gains Haircuts.

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<sup>39</sup> See *supra* note 30

<sup>40</sup> The proposed rules in 8G802.B.5 and 8G802.B.6 (which retain the IRS Termination Event provisions currently under Rule 8G802.B.3) ensure that CME retains flexibility to determine to wind-up clearing operations for IRS products as a result of a default in which the IRS financial safeguards package is exceeded. Such a determination would be made by CME in its absolute discretion, subject to the obligation on the Clearing House to consult the IRS Risk Committee as set out in proposed rule 8G802.B.5. In the relevant circumstances of an IRS Termination Event arising as a result of a default in which the IRS financial safeguards package is exceeded, CME may determine to terminate all IRS Contracts promptly and without mandatory application of the New Recovery Tools. This power has been retained to ensure that the Clearing House has the discretion to move promptly to tear-up where the financial safeguards package for IRS has been exceeded and it considers this step to be necessary rather than to be required to conduct multiple IRS Gains Haircut cycles or carry out IRS Partial Tear-Ups, which may not be in the best interests of default management in the circumstances. Following the termination of all IRS products on an IRS Termination Event the Clearing House would distribute any IRS Collateral and the IRS Priority of Payments in accordance with proposed rule 8G802.B.6.

<sup>41</sup> See proposed rule 8G802.B.3(b).

<sup>42</sup> See proposed rule 8G802.B.3(b). For the avoidance of doubt, we note that Commingled Futures Positions would be included as IRS Contracts in connection with an IRS Partial Tear-Up or an IRS Full Tear-Up under proposed rule 8G802.B.3. By contrast, in accordance with Rule 8G831, upon the occurrence of a Bankruptcy Event of CME (which would be required to trigger tear-ups under proposed Rules 8G802.B.5-6), any Commingled Futures Positions of non-defaulted IRS Clearing Members would become Base Contracts and would be torn up in accordance with Rules 802.B and 818.

<sup>43</sup> See proposed rule 8G802.B.3(c).

Following the final IRS Gains Haircuts settlement cycle, the CHOC<sup>44</sup> would determine either the appropriate scope of each IRS Partial Tear-Up or that an IRS Full Tear-Up is appropriate.<sup>45</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>46</sup> and (iv) with the aim of extinguishing all of the Remaining Open IRS Positions and any additional positions in IRS Contracts deemed necessary to mitigate further disruptions to the markets affected by the Remaining Open IRS Positions.<sup>47</sup>

Before making such determination, the CHOC would consider the recommendation(s)—if any—made by the IRS Emergency Financial Committee.<sup>48</sup> Any such IRS 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>49</sup> and (iv) aim to extinguish all of the Remaining Open IRS Positions and any additional positions in IRS Contracts deemed necessary to mitigate further disruptions to the markets affected by the Remaining Open IRS Positions.<sup>50</sup>

Potential forms of IRS Partial Tear-Ups in connection with the final IRS Gains Haircuts settlement cycle include, but are not limited to: (a) proportionately extinguishing IRS Contracts held by non-defaulted IRS Clearing Members, their non-defaulted customers and the non-defaulted customers of the defaulted IRS Clearing Member whose positions offset the Remaining Open IRS Positions; and (b) extinguishing all open positions in IRS Contracts for a particular product or combination of products.<sup>51</sup> The type of IRS Partial Tear-Up utilized at any time would depend on the then existing facts and circumstances.

An IRS Full Tear-Up would involve extinguishing all open positions in IRS Contracts.<sup>52</sup>

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

While IRS Gains Haircuts settlement cycles are ongoing, the CHOC could determine to extinguish a portion of the Remaining Open IRS Positions through an IRS Partial Tear-Up of proprietary and customer positions of non-defaulted IRS Clearing Members and non-defaulted customers of the defaulted IRS Clearing Member in IRS Contracts.<sup>53</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 IRS Gains Haircuts settlement cycle, except with a narrower aim of extinguishing a portion of the Remaining Open IRS Positions and any additional positions in IRS Contracts deemed necessary to mitigate further disruptions to the markets affected by the portion of the Remaining Open IRS Positions.<sup>54</sup> The CHOC would only determine to tear-up a portion of the Remaining Open IRS Positions if the CHOC believed that the Clearing House would not be able to dispose of the positions through default management, but that the Clearing House may be able to successfully default manage the Remaining Open IRS Positions not being torn up.

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<sup>44</sup> As noted above, the CHOC is a Committee of the Board of Directors. See *supra* note 31 (discussing the purpose and priorities of the CHOC).

<sup>45</sup> See proposed rule 8G802.B.3(b)i.

<sup>46</sup> See *supra* note 37.

<sup>47</sup> See proposed rule 8G802.B.3(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>48</sup> See *id.*

<sup>49</sup> See *supra* note 37.

<sup>50</sup> See proposed rule 8G802.B.3(b)i.

<sup>51</sup> See proposed rule 8G802.B.3(b)ii.

<sup>52</sup> See proposed rule 8G802.B.3(b)iii. IRS Full Tear-Ups could only be conducted in connection with the final IRS Gains Haircuts settlement cycle and could not be conducted while IRS Gains Haircuts settlement cycles are ongoing.

<sup>53</sup> See proposed rule 8G802.B.3(c).

<sup>54</sup> See proposed rules 8G802.B.3(b)(i)-(ii) 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.

Before determining the appropriate scope of each IRS Partial Tear-Up to conduct while IRS Gains Haircuts settlement cycles are ongoing, the CHOC would consider the recommendation(s)—if any—made by the IRS Emergency Financial Committee.<sup>55</sup> Any such IRS Emergency Financial Committee recommendations would be based upon the same four factors as an IRS Emergency Financial Committee recommendation regarding tear ups conducted in connection with the final IRS Gains Haircuts settlement cycle, except with a narrower aim of extinguishing a portion of the Remaining Open IRS Positions and any additional positions in IRS Contracts necessary to mitigate further disruptions to the markets affected by the portion of Remaining Open IRS Positions.<sup>56</sup>

Potential forms of IRS Partial Tear-Ups that may be conducted while IRS Gains Haircuts settlement cycles are ongoing include, but are not limited to: (a) proportionately extinguishing IRS Contracts held by non-defaulted IRS Clearing Members, their non-defaulted customers and the non-defaulted customers of the defaulted IRS Clearing Member whose positions offset a portion of the Remaining Open IRS Positions; and (b) extinguishing all open positions in IRS Contracts for a particular product or combination of products.<sup>57</sup> The type of IRS Partial Tear-Up utilized at any time would depend on the then existing facts and circumstances.

### The Effects of IRS Partial Tear-Ups

IRS Partial Tear-Ups are designed to enable CME to re-establish a matched book and provide for continuity of clearing services and operations to clearing members and their customers. CME does not propose to use IRS 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>58</sup> Any torn-up position would still be subject to any applicable IRS 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 IRS Partial Tear-Ups, IRS Clearing Members and customers of IRS Clearing Members would lose the positions that were torn up. IRS Clearing Members and customers of IRS Clearing Members that elect to reestablish such market positions could incur replacement costs in doing so. Because IRS Partial Tear-Ups enable CME to tear up only those contracts necessary to reestablish a matched book, the utilization of IRS 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. IRS 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 IRS Cooling Off Period (as defined in Rule 8G802.H), CME and non-withdrawing IRS Clearing Members would replenish their contributions to the IRS Guaranty Fund, allowing for the continued functioning of the markets.<sup>59</sup>

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<sup>55</sup> See *id.*

<sup>56</sup> See proposed rules 8G802.B.3(c).

<sup>57</sup> See proposed rules 8G802.B.3(c).

<sup>58</sup> The price for the contracts that are torn up would be determined in connection with the current IRS Gains Haircuts settlement cycle. All contracts being torn up would be marked to market during the current IRS 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 IRS Gains Haircuts settlement cycle and thus potentially allocating the loss to the beneficial owner of the contract being extinguished.

<sup>59</sup> The IRS Cooling Off Period is the time period starting with the date of the original default until the later of (i) the 25<sup>th</sup> Business Day thereafter or (ii) if another clearing member defaults during the 25 Business Days following an initial or any subsequent default, the 25<sup>th</sup> Business Day following the last such default. See Rule 8G802.H. Rule 8G802.H provides that during the relevant IRS Cooling Off Period, non-defaulted clearing members shall be subject to a maximum obligation to contribute to the IRS Guaranty Fund and to fund assessments as set forth in Rule 8G802.B. This maximum obligation is based upon each IRS Clearing Member's IRS Guaranty Fund contribution and assessment exposure in effect at the commencement of the IRS Cooling Off Period. See Rule 8G802.H. If CME utilizes any IRS Guaranty Fund contributions of non-defaulted IRS Clearing Members during the IRS Cooling Off Period, clearing members would need to replenish their contributions to the previously required level prior to the close of business on the next banking day to the extent that such replenishment would not cause the clearing members to exceed their maximum obligation. See Rules 8G802.F and 8G802.H.

## The Effects of IRS Full Tear-Up

IRS Full Tear-Up is designed to enable CME to re-establish a matched book and provide for continuity of clearing services and operations. As discussed above in relation to IRS Partial Tear-Ups, CME does not propose to use IRS 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>60</sup> Any torn-up position would still be subject to any applicable IRS Gains Haircut for that settlement cycle.

As a result of an IRS Full Tear-Up, IRS Clearing Members and customers of IRS Clearing Members would lose all open positions in IRS Contracts through the extinguishment of such contracts. IRS Clearing Members and customers of IRS 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 an IRS Full Tear-Up is appropriate must be in furtherance of the integrity of the Clearing House and the stability of the financial system.<sup>61</sup> Given the systemic importance of CME and the systemic impact that the IRS Full Tear-Up may have on the stability of the financial system, the CHOC would not determine to conduct a IRS Full Tear-Up if it determined that IRS Partial Tear-Ups would be equally or more effective to mitigate the then existing facts and circumstances.

IRS Full Tear-Up is 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. It is possible that some clearing members may withdraw their memberships after an IRS Full Tear-Up. After CME reestablishes a matched book and following the IRS Cooling Off Period, CME and any IRS Clearing Members that elect to remain would replenish their contributions to the IRS Guaranty Fund.<sup>62</sup> Replenishment of the IRS financial safeguards would allow IRS Clearing Members and their customers to reestablish positions and thus provide for the continued functioning of the markets.

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

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

Pursuant to proposed rule 8G802.B.2(b)(v)(A), if, following a default of an IRS Clearing Member, the Clearing House has exhausted the financial safeguards package for IRS products but not yet recovered, the Clearing House will provide IRS Clearing Members and their customers an opportunity to make voluntary contributions to assist in curing remaining losses. The incentive for IRS Clearing Members and their customers to provide voluntary contributions to the Clearing House is to avoid IRS Gains Haircuts, IRS Partial Tear-Ups and/or a IRS Full Tear-Up.

Pursuant to proposed rule 8G802.B.3(a), at any time following the default of an IRS Clearing Member, the Clearing House could notify IRS Clearing Members and provide an opportunity for IRS Clearing Members to voluntarily agree to have their proprietary IRS positions or, with a customer's consent, to agree to have each such customer's IRS positions, extinguished by the Clearing House. CME would quickly identify and approach IRS Clearing Members whose positions, or whose customer's positions, offset the defaulter

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deposit obligation and its assessment exposure pursuant to Rule 8G802.H. The rules proposed herein would not alter the IRS Cooling Off Period or obligations to replenish the IRS Guaranty Fund following such period; feedback received from firms regarding the length of the IRS Cooling Off Period suggested that firms consider the amount of time to be appropriate in the circumstances.

<sup>60</sup> See *supra* note 58. One respondent requested that implementation of tear-up should ensure that the price of tear-up of any transaction should be as close as possible to the "market price" or replacement value of that transaction. The proposed revised rules are clear that an IRS Partial Tear-Up and an IRS Full Tear-Up would occur contemporaneously with the settlement cycle and at the settlement price.

<sup>61</sup> See proposed rules 8G802.B.3(b) i. See *also* CFTC Regulations 39.32(a)(1)(iv) and 39.32(a)(2).

<sup>62</sup> See *supra* note 59.

positions that remain open. Such IRS 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 IRS 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 IRS Gains Haircuts, IRS Partial Tear-Ups and/or an IRS Full Tear-Up. By participating in voluntary contributions and/or voluntary partial tear-ups, IRS 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*

Currently, Rule 8G802.B.2 provides for limited recourse in the event of a default by an IRS Clearing Member. As revised, the limited recourse language of this provision will become Rule 8G802.B.4 and will remain substantially similar to the existing limited recourse language in Rule 8G802.B.2. CME proposes a small number of changes to clarify how this rule will interact with certain CME Rules. First, the Rule Amendments add language to clarify that limited recourse would not be affected by any inability of CME to require an IRS Clearing Member to cure a deficiency in the IRS Guaranty Fund in the unlikely event that CME becomes the subject of a Bankruptcy Event in accordance with Rule 818.C.2.<sup>63</sup> Second, the Rule Amendments add a reference to recourse that Rule 8G802.E provides to IRS Clearing Members and the holders of IRS Contracts with respect to any amounts recovered by the Clearing House from the defaulted IRS Clearing Member.<sup>64</sup>

As discussed above, CME will move the last sentence of Rule 8G802.B.3(viii) to a new proposed rule 8G802.B.7.<sup>65</sup> CME proposes to amend and supplement this proposed rule 8G802.B.7 such that it is substantially identical in nature to the corresponding rule for Base (Rule 802.B.10).

Limited recourse for IRS products, together with the other recovery tools, promotes the continuity of clearing for Base and IRS products by providing that CME's usage of New 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 IRS Clearing Members to replenish their IRS Guaranty Fund contributions following the IRS Cooling Off Period<sup>66</sup> 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 challenges in connection with such haircut gains or torn up positions. CME would similarly replenish its CME IRS Contribution (as defined in Rule 8G802.B).

Furthermore, by maintaining a limited recourse structure for IRS Contracts, limited recourse should continue to protect clearing members' and clearing members' customers' Base positions and facilitate CME's continuity of clearing for Base.

Limited recourse is designed to limit the impact of an IRS Clearing Member default on clearing members and customers of clearing members to those clearing members and customers of clearing members that clear and trade IRS products.

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<sup>63</sup> This clarifying language is present in the Base limited recourse provision (Rule 802.B.9).

<sup>64</sup> *Id.*

<sup>65</sup> Rule 8G802.B.3(viii) provides that upon the completion of payments and the extinguishment of all IRS Contracts, IRS Clearing Members, their Affiliates and their customers shall have no claim against any other guaranty fund. Additionally, as discussed above on page 5 and in note 40, the language regarding "IRS Termination Events" has been retained but moved from the limited recourse rule for clarity.

<sup>66</sup> See *supra* note 59.

Currently, Rule 8G802.B.4 provides that 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 IRS Contract as a result of the extinguishment of such IRS Contract and related payments in accordance with CME rules. As revised, this rule would become Rule 8G802.B.8, would be identical to Rule 8G802.B.4 and should provide certainty and finality with respect to IRS Partial Tear-Ups and IRS Full Tear-Up and should enable CME to avoid a Bankruptcy Event. Thus, proposed rule 8G802.B.8 should promote continuity of clearing.

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

If an IRS Clearing Member defaults on its obligations to the Clearing House, the Clearing House may use IRS Guaranty Fund contributions of non-defaulted IRS Clearing Members, IRS Assessments of non-defaulted IRS Clearing Members and Aggregate IRS Gains Haircuts (as defined in proposed rule 8G802.B.2)) to address losses caused by such default. Rule 8G802.E currently provides that CME shall take commercially reasonable steps to recover amounts so used. CME proposes amendments to Rule 8G802.E to set forth the order in which distributions would be made if CME subsequently recovers any funds from the defaulter (or its estate), reflecting the addition of the New Recovery Tools.

Pursuant to proposed rule 8G802.E, the net amount of any portion of recovered funds would be credited to non-defaulted IRS 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 IRS Gains Haircuts with respect to such default; (iii) their IRS Assessments utilized by the Clearing House with respect to such default; and (iv) their IRS 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 IRS Contribution utilized by the Clearing House with respect to such default.

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

In developing the New Recovery Tools, during 2019 in the period prior to the date of this filing, CME consulted the members of the CME IRS Risk Committee, including IRS Clearing Members and other market participants. CME also consulted all founding and active IRS Clearing Members to solicit feedback regarding the proposed revised rules. Given the extent of the consultation described above and the fact that the revised rules serve to align and harmonize the rules governing the clearing of IRS products with the relevant provisions of the Base rules that were previously consulted on by CME with, among others, the FIA, CME did not directly consult with the FIA or other industry bodies.

The majority of feedback from the consultation was positive; a significant majority of the respondents confirmed in each case that they understood the rationale for the proposed revised rules and the adoption of the New Recovery Tools, with those respondents providing feedback to the effect that the revised rules were appropriate and necessary to extend the IRS waterfall and to better align the IRS rules within the Rulebook with the current equivalent Base provisions.

The following is a description of the substantive opposing views received during the consultation process, in addition to those discussed above, that were not incorporated in the Rule Amendments:

#### *Governance*

A small number of respondents suggested that CME should poll its IRS Clearing Members and/or require approval of a majority of IRS Clearing Members prior to implementing mandatory tear-up processes or IRS Gains Haircuts. Where a majority of firms participating in a poll did not approve or support use of the relevant

recovery tool, it was proposed by one firm that the tool should not be utilized and CME should instead proceed to wind down the IRS clearing service.

CME does not believe that an IRS Clearing Member vote or approval mechanism would be timely or prudent in the circumstances of a default. IRS Clearing Members may not be properly representative of all impacted market participants. Additionally, IRS Clearing Members would likely be incentivized to vote or withhold consent in a manner or based on an outcome that best affects their market positions. Furthermore, it is not possible or practicable for all market participants to vote or to be consulted in a timely manner.

While the proposed rules do not require CME to poll or require the approval of IRS Clearing Members prior to implementing recovery tools, the proposed rules do include a requirement for the CHOC to consider, among other things, the legitimate interests of clearing members and customers of clearing members and any recommendation of the IRS Emergency Financial Committee, when deciding whether to curtail or extend the duration of IRS Gains Haircuts and/or when determining the appropriate scope of IRS Partial Tear-Up. The Rule Amendments also require the IRS 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 IRS Gains Haircuts and/or the appropriate scope of Partial Tear-Up.

A small number of respondents suggested that implementation of certain recovery tools such as tear-up and IRS Gains Haircuts should be subject to the oversight of the primary supervisor of the Clearing House and the systemic regulator and/or the resolution authority, noting in relation to gains haircutting that the practice could be procyclical and destabilizing where losses are passed on to other participants during stressed conditions, which could in turn lead to market instability and to disorderly attempts for market participants to leave the central counterparty (“CCP”).

CME is required by applicable CFTC regulations to have in place recovery tools to allocate losses and to restore a matched book and it follows that such tools should be available for use by the CCP in accordance with its rulebook and should not be reserved for use by, or their use subject to prior approval by, a supervisory or resolution authority. In any default scenario and when utilizing the New Recovery Tools, CME would keep the CFTC, as supervisory authority, apprised with respect to CME’s recovery efforts and use of its recovery tools, on which basis the CFTC would be positioned to provide CME with feedback in relation to use of those recovery tools. While the Rule Amendments provide that use of the New Recovery Tools is subject to a clear governance process that takes into account the legitimate interests of clearing members and their customers, in furtherance of the integrity of the Clearing House and stability of the financial system, use of the New Recovery Tools is not subject to prior supervisory approval or non-objection.

### *IRS Gains Haircuts*

The majority of respondents agreed that IRS Gains Haircuts are an appropriate tool for allocation of losses, subject to the concern noted above raised by one respondent around the potentially procyclical nature of gains haircutting. A small number of respondents requested that CME should consider the use of a “cumulative” approach to gains haircutting under which haircuts are applied based on cumulative gains and losses experienced by position holders over the duration of the gains haircutting cycles, rather than assessed on gains on a standalone basis on each settlement cycle over the relevant period.

CME considers that a “cumulative” approach to gains haircutting would not be effective and, furthermore, is not compatible with the applicable CFTC regulatory requirements that a Clearing House shall ensure that each Clearing House settlement cycle is final.

### *Tear-Ups*

The majority of respondents agreed that IRS Partial Tear-Up provides flexibility for CME to manage a default. A number of IRS Clearing Members recommended that the Clearing House should have the

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additional flexibility to conclude IRS Partial Tear-Up prior to exhaustion of the prior recovery tools in order for the Clearing House to respond as early as possible to risks or losses arising in relation to a particular asset or product class. While firms are able to participate in voluntary IRS Partial Tear-Up at any time<sup>67</sup>, it is important to note that the proposed revised rules do not impose a fixed period in terms of the duration of IRS Gains Haircut settlement cycles. Instead, the recommendations of the IRS Emergency Financial Committee and any decision of the CHOC regarding the duration of IRS Gains Haircut settlement cycles (and therefore the length of the period prior to proceeding from gains haircutting to tear-up) must take into account, among other things, the legitimate interests of clearing members and their customers. The proposed revised rules therefore provide a degree of flexibility to the duration of the period of IRS Gains Haircuts, such that partial or full tear-up may be commenced after a shortened period of gains haircutting where this is in the legitimate interests of clearing members and their customers. Similarly, as noted above, the CHOC could determine to extinguish a portion of the Remaining Open IRS Positions through an IRS Partial Tear-Up of proprietary and customer positions of non-defaulting IRS Clearing Members and non-defaulted customers of the defaulted IRS Clearing Member while IRS Gains Haircut settlement cycles are ongoing<sup>68</sup>.

#### *Compensation:*

CME received feedback from a small number of clearing firms that participants affected by IRS Gains Haircuts losses allocated by CME should be eligible to receive compensation from CME. The firms in question understood the operation of proposed Rule 8G802.E which provides that, if CME subsequently recovers from the estate(s) of the defaulted IRS Clearing Member(s) any portion of amounts comprising non-defaulted IRS Clearing Members' guaranty fund contributions, assessments, voluntary contributions and/or IRS Gains Haircut amounts, CME will use such amounts to reimburse such non-defaulted IRS 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. However, the firms asserted that, if such amounts recovered from the estate(s) of the defaulted IRS Clearing Member(s) were not sufficient to compensate the non-defaulted IRS Clearing Members in the case of IRS Gains Haircuts, affected IRS Clearing Members should retain claims against CME for deferred payment of the amount of their haircut gains. Firms suggested that where such residual claims are not satisfied by recoveries from the estate(s) of the defaulter(s), the affected IRS Clearing Member should hold a claim that should remain senior to the claims of CCP equity holders and which should be paid to the affected claimholder out of future earnings of the CCP.

One firm suggested further that claims for recoveries or compensation for IRS Gains Haircuts should rank above voluntary contributions in relation to any distribution by CME. A small number of respondent firms further requested that CME should consider compensating non-defaulted IRS Clearing Members for the costs of reinstating any positions of a non-defaulting firm that are subject to mandatory tear-up.

The Rule Amendments do not include a share in future CME revenues or profits or additional sources of compensation by CME, either for firms affected by IRS Gains Haircuts or mandatory tear-up. The incentives of the Clearing House, clearing members and customers of clearing members are better aligned if early participation in auctions and the default management of the defaulter's positions is encouraged. The absence of an expectation of receiving compensation for haircuts or torn-up positions would incentivize clearing members and their customers to participate early in the auctions when CME first commences its default management process. Similarly, in order to incentivize active participation and voluntary action by non-defaulted clearing members, CME considers that voluntary contributions by a non-defaulted market participant should benefit from a priority in terms of recoveries from the estate(s) of defaulted clearing member(s) over gains haircuts or other allocations of losses.

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<sup>67</sup> Pursuant to proposed rule 8G802.B.3(a), at any time following the default of an IRS Clearing Member, the Clearing House could notify IRS Clearing Members and provide an opportunity for IRS Clearing Members to voluntarily agree to have their proprietary IRS positions or, with a customer's consent, to agree to have each such customer's IRS positions, extinguished by the Clearing House.

<sup>68</sup> See proposed rule 8G802.B.3(c).



### **Additional feedback:**

During the consultation process, CME received certain additional comments not directly relevant to the Rule Amendments, summarized below:

#### *CME Equity or “Skin in the Game”:*

One commenter requested that CME should consider the addition of a further tranche of CME’s own financial resources (also known as additional CCP “skin in the game”) to be made available and to act as an additional CME contribution to set against any remaining losses arising from an IRS Clearing Member default following the use of IRS Assessments. It was asserted that this additional CME contribution should be exhausted prior to allocating further losses to IRS Clearing Members in the form of requests for voluntary contributions from IRS Clearing Members or by IRS Gains Haircuts.

CME did not include the additional senior CME skin in the game tranche or increase the CME contribution in the proposed rules as CME already maintains a significant amount of skin in the game, which will be used before any non-defaulting IRS Clearing Member’s funds, including guaranty fund contributions. CME believes that the proposed structure in the revised rules promotes the appropriate incentives for firms to participate in default management and to promote the recovery of the CCP and CME does not believe that inclusion of an additional tranche would affect CME’s risk management decisions. The commenters’ suggestions are therefore more appropriate for the broader “skin in the game” conversation than the narrow context of the proposed New Recovery Tools.

### **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 B – Financial Resources:** The addition to the Rulebook of IRS Gains Haircuts and voluntary contributions are designed to address how CME would allocate losses that exceed the financial resources currently available to the Clearing House under the Rulebook and they also seek to facilitate the continuity of CME’s clearing services and operations for IRS products<sup>69</sup>.

The New Recovery Tools are designed to provide for additional resources that are available in the unlikely event of an IRS Clearing Member default that results in losses beyond the IRS financial safeguards package. However, the proposed rules do not introduce any changes to CME’s IRS Guaranty Fund contribution, introduce any requirements for a non-defaulting IRS Clearing Member to make additional contributions to the mutualized resources held within the IRS Guaranty Fund or otherwise extend the Clearing House’s powers of assessment during the IRS Cooling Off Period<sup>70</sup>. As a result, during the IRS Cooling Off Period, in order to ensure that the Clearing House remains in compliance with the requirements under CFTC Regulation 39.33(a) to “maintain financial resources to enable it to meet its financial obligations to its clearing members notwithstanding a default by the two largest clearing members creating the largest combined loss to the DCO in extreme but plausible market conditions”, there may be circumstances where the Clearing House may be required to call for additional margin from IRS Clearing Members until the end of the IRS Cooling Off Period.

Whether prior to or subsequent to a default, each non-defaulting IRS Clearing Member remains subject to its obligations in respect of cleared positions under the Rulebook throughout the period

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<sup>69</sup> However, the proposed rules also retain flexibility on the part of the Clearing House to determine to wind-up clearing operations for IRS products without use of the New Recovery Tools as a result of a default in which the IRS financial safeguards package is exceeded— see supra note 30.

<sup>70</sup> The length of the IRS Cooling Off Period was negotiated with founding IRS Clearing Members prior to the establishment of the IRS clearing service. During the consultation, respondents supported the retention and the duration of the existing IRS Cooling Off Period and, as a result, CME does not propose to make any changes in this regard.

in which it is an IRS Clearing Member. These obligations include a requirement to comply with any Clearing House call for performance bond (Rule 820 ("Performance Bonds")) and additional performance bond (Rule 824 ("Additional Performance Bond")). For example, the Clearing House may require additional performance bond to be provided by IRS Clearing Members in the circumstances set out in Rule 824, which include (amongst other scenarios) unstable conditions relating to one or more products, to maintain an orderly market or to preserve fiscal integrity. In practice, the Clearing House may determine in its absolute discretion to exercise its powers to increase performance bond in certain circumstances that precede a default event and/or which exist subsequent to a default event, as dictated by risk management requirements. However, in the event where the financial safeguards package for IRS is exhausted and the operation of the IRS Cooling Off Period under the Rulebook is such that that no further contributions to the financial resources of the Clearing House will be provided by IRS Clearing Members until the expiry of the IRS Cooling Off Period, CME may be required to increase performance bond requirements to a level necessary to meet CME's minimum regulatory financial resources requirements as a DCO until the expiry of the IRS Cooling Off Period.

While performance bond called from IRS Clearing Members in these circumstances would be counted towards satisfaction of CME's minimum regulatory financial resources, such performance bond would be held by the Clearing House in the same manner in which CME holds performance bond in "business as usual" circumstances. As a result, such performance bond resources do not form part of the mutualized resources available to the Clearing House on a default and therefore cannot be used by the Clearing House to cover losses except any such losses that occur in the accounts of the IRS Clearing Member that provides the performance bond in accordance with the provisions of the Rulebook.

- Core Principle E – Settlement Procedures: If losses remain after exhausting the performance bonds of the defaulted IRS Clearing Member, the CME IRS Contribution, the IRS Guaranty Fund, and IRS Assessments, CME will conduct up to three days of IRS Gains Haircuts settlement cycles for IRS products. CME will collect from the IRS Clearing Members with net portfolio losses, and CME will make payments to non-defaulting IRS Clearing Members with net portfolio gains. CME's payments to non-defaulting IRS 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 IRS Gains Haircuts settlement cycles by one or two Business Days at a time after considering the recommendation(s)—if any—of the IRS Emergency Financial Committee, such that the maximum number of days with IRS Gains Haircuts is five Business Days in aggregate.
- Core Principle G – Default Rules And Procedures: Consistent with CFTC Regulation 39.35, adding IRS Gains Haircuts and voluntary contributions to the Rulebook specifically addresses how CME would allocate losses that exceed the financial resources available to CME under the Rulebook.
- Core Principle L – Public Information: The Rule Amendments will be reflected on 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 an IRS Clearing Member exceed the financial safeguards package for IRS products.
- Core Principle O – Governance Fitness Standards: The Rule Amendments 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 IRS Gains Haircuts; (ii) whether to conduct IRS Partial Tear-Ups while settlement cycles with IRS Gains Haircuts are ongoing (and if so, the appropriate scope of such tear-ups); and (iii) the appropriate scope of IRS Partial Tear-Ups or that a IRS Full Tear-Up is appropriate in connection with the last settlement cycle conducted in connection with IRS 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>71</sup> The Rule Amendments provide that the CHOC must also consider any recommendation of the IRS Emergency Financial Committee. When making such recommendations to the CHOC, the Rule Amendments provide that the IRS Emergency Financial Committee must also take into consideration the legitimate interests of clearing members and customers of clearing members. The Rule Amendments also provide that the CHOC would determine, after considering any recommendation of the IRS Emergency Financial Committee, the maximum amount of liquidation and auction payment amounts that may be factored in when conducting IRS Gains Haircuts.

- **Core Principle P – Conflicts of Interest:** Pursuant to the Rule Amendments, the CHOC must take into consideration the legitimate interests of clearing members and customers of clearing members when determining (i) whether to extend or reduce the duration of IRS Gains Haircuts; (ii) whether to conduct IRS Partial Tear-Ups while settlement cycles with IRS Gains Haircuts are ongoing (and if so, the appropriate scope of such tear-ups); and (iii) the appropriate scope of IRS Partial Tear-Ups or that a IRS Full Tear-Up is appropriate in connection with the last settlement cycle conducted in connection with IRS Gains Haircuts. The proposed rules provide that before the CHOC makes such determinations, the CHOC must consider any recommendations of the IRS Emergency Financial Committee. When making such recommendations to the CHOC regarding these determinations, the Rule Amendments provide that the IRS Emergency Financial Committee must also take into consideration the legitimate interests of clearing members and customers of clearing members.

The Rule Amendments are provided in Exhibit A which is provided under separate cover, with additions underscored and deletions ~~struck through~~.

CME certifies that the Rule Amendments 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 [CMEGSubmissionInquiry@cmegroup.com](mailto:CMEGSubmissionInquiry@cmegroup.com).

Sincerely,

/s/ Christopher Bowen  
Managing Director & Chief Regulatory Counsel

cc: Board of Governors of the Federal Reserve System

Attachment: Exhibit A – CME Rulebook Amendments (blackline format) (provided under separate cover)

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<sup>71</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 IRS Positions (or a portion thereof) and any additional positions in IRS Contracts deemed necessary to mitigate further disruptions to the markets affected by the Remaining Open IRS Positions (or the portion of the Remaining Open IRS Positions).

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