

# SUBMISSION COVER SHEET

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

**Registered Entity Identifier Code (optional):** 14-448

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

**Filing as a:**  DCM  SEF  DCO  SDR Please note - only ONE choice allowed.

**Filing Date (mm/dd/yy):** 10/23/14 **Filing Description:** Enhancements to CDS Risk Model  
**SPECIFY FILING TYPE** Please note only ONE choice allowed per Submission.

## Organization Rules and Rule Amendments

- |                                     |                                     |            |
|-------------------------------------|-------------------------------------|------------|
| <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:** 8H802.B; 8H06; 80104.A

## New Product

Please note only ONE product per Submission.

- |                          |                                       |            |
|--------------------------|---------------------------------------|------------|
| <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     |

**Official Product Name:** \_\_\_\_\_

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

- |                          |   |                      |
|--------------------------|---|----------------------|
| <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:** \_\_\_\_\_

October 23, 2014

**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: CFTC Regulation 40.10(a) Advance Notice – Enhancements to CDS Risk Model.  
CME Submission No. 14-448**

Dear Mr. Kirkpatrick:

On September 18, 2014, Chicago Mercantile Exchange Inc. (“**CME**”) received notice from the Division of Clearing and Risk (the “**Division**”) of the Commodity Futures Trading Commission (the “**CFTC**”) under delegated authority stating that the Division did not object to the changes to the credit default swaps (“**CDS**”) risk model described in CME Submission No.14-291R (the “**CDS Risk Model Filing**”) and authorized implementation of such changes. CME is proposing herein to further enhance its risk model for CDS (the “**CDS Risk Model**” and such enhanced model, the “**Proposed CDS Risk Model**”) to enable CME to offer clearing of additional CDS instruments. Pursuant to CFTC Regulation 40.10(a), CME is hereby providing advance notice of a proposal to make further enhancements to its CDS Risk Model to address self-referencing risk arising from contracts that include component transactions for which the reference entity is a clearing member or one of its affiliates. All capitalized terms not defined herein shall have the meaning given to them in the CME clearing rules (the “**CME Rules**”) or the CDS Risk Model Filing.

The proposed further changes that are the subject of this filing will become effective on the earliest possible date after the CFTC authorizes implementation of these changes and CME receives all required regulatory approvals or such later date as CME may determine. The proposed enhancements to the CDS Risk Model are summarized as follows:

**1. Additional CDS Guaranty Fund Charge for Self-Referencing Risk**

CME is proposing to add a new CDS Guaranty Fund charge to CDS Clearing Members that clear CDS Products that reference themselves or their affiliates and delete the current threshold based approach.

**2. Proposed Changes to CDS Stress Test Methodology for Sizing and Allocation of CDS Financial Resources**

CME proposes to add a new risk component to its CDS Stress Test Methodology to capture self-referencing risk arising from contracts that include component transactions for which the reference entity is a clearing member or one of its affiliates. In addition, CME proposes to add a new stress exposure calculation to size the self-referencing risk.

Although CME does not permit a CDS Clearing Member or a customer to enter into or maintain a single-name CDS position referencing the clearing member or an affiliate, a self-referencing CDS position may arise where the CDS Clearing Member or its affiliate is the Reference Entity in respect of a component

transaction within the index referenced in a CDS position. For example, such a situation may arise in the context of index CDS contracts which reference CDS Clearing Members or their affiliates. In such cases, the CDS Clearing Member (a “**CDS SR Clearing Member**”), either through its own account or that of a customer, has exposure to a CDS Product that references itself or its affiliate (each an “**SR Transaction**”). CME proposes to address this potential exposure to self-referencing risk by allocating an additional JTD risk for each CDS SR Clearing Member under its Stress Test Methodology. CME considers a CDS Clearing Member default to be an extreme tail risk event which is subject to the CDS financial safeguards, including mutualization across all other CDS Clearing Members via the CDS Guaranty Fund.

Currently, CDS SR Clearing Members, clearing self-referencing indices for itself or its customers, are required to collateralize the self-referencing exposure in an amount specified in the CME Rules. CME is now proposing to adopt a risk based approach without reference to any preset threshold, to capture this self-referencing risk. The additional risk associated with CDS SR Clearing Members will be added to the stress scenarios used to size the CDS Guaranty Fund and CME will require each CDS SR Clearing Member to make an additional CDS Guaranty Fund Deposit to address this risk (such additional deposit, the “**CDS SR Deposit**”). The aggregate amount of CDS SR Deposits will be sized to cover the net self-referencing exposure of the two CDS SR Clearing Members whose combined default would create the largest possible loss to CME in extreme but plausible market conditions<sup>1</sup> using the stress testing methodology and will be allocated proportionately to each CDS SR Clearing Member. The required CDS SR Deposit will then be allocated to each CDS SR Clearing Member in proportion to each such CDS SR Clearing Member’s net self-referencing exposure.

A CDS Clearing Member default may result in contagion among financial institutions, widening spreads and exposing portfolios consisting of index CDS that reference financial entities to potential wrong-way risk. For example, the default of a CDS Clearing Member based in the United States, which is not referenced in an index referencing European names, could lead to overall widening of the credit spreads among financial institutions worldwide, leading to widening of spreads in non-US indices. This may lead to variations in correlations between such non-US indices and other North American indices, potentially adversely impacting certain portfolios which are sensitive to such correlations. This increase in potential exposure caused by contagion is addressed in the CME Proposed CDS Risk Model and Stress Test Methodology via incorporation of stressed correlation scenarios.

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

- **Core Principle B - Financial Resources:** The proposed changes are consistent with maintaining financial resources sufficient to cover its financial obligations and cover its costs as required by the CFTC Regulations 39.11(a) and 39.33(a) as well as performing stress testing that allows CME to make a reasonable calculation of such financial resources as specified in the CFTC Regulations 39.11(c) and 39.33(a). In particular, CME continues to aim to size and maintain the amount of financial resources sufficient to meet its financial obligations to its CDS Clearing Members notwithstanding a default by the two clearing members creating the largest combined loss to CME in extreme but plausible market conditions as specified in CFTC Regulation 39.33(a). CME is adding an additional CDS Guaranty Fund deposit using this approach to address self-referencing risk, which has historically not been a material risk in relation to the CDS products cleared by CME to date. In anticipation of clearing additional products CME proposes to replace the existing threshold-based margin requirement with a risk based additional CDS Guaranty Fund charge.

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<sup>1</sup> For purposes of determining the largest potential residual losses, the self-referencing exposure of a CDS SR Clearing Member will be aggregated with that of any affiliated CDS SR Clearing Member.

- Core Principle D – Risk Management: Consistent with the requirements under CFTC Regulation 39.13(g), the CDS Risk Model establishes margin requirements that are commensurate with the risks of each CDS product and CDS portfolio, including unusual characteristics or risks associated with particular portfolios (such as JTD risk and JTH risk and F/X risk). The CDS Risk Model utilizes a minimum 5-day liquidation time pursuant to CFTC Regulation 39.13(g)(2)(ii) and meets an established confidence level of at least 99% based on data from appropriate historic time periods as specified under CFTC Regulation 39.13(g)(2)(iii). By proposing changes to the CDS Stress Test Methodology which are in line with the Proposed CDS Risk Model, CME will continue to be in compliance with the stress test requirements in CFTC Regulations 39.13(h)(3) and 39.36(a).
- Core Principle L - Public Information: As required by CFTC Regulation 39.21(c)(3), CME will disclose publicly the information concerning the proposed further changes to the CDS Risk Model by posting this submission on the CME Group website.

CME's CDS Risk Model is considered proprietary and confidential to CME. A further description of the CDS Risk Model together with the enhancements described herein is being provided concurrently with the filing for which a request for confidential treatment is being simultaneously submitted to the Commission.

Exhibit 1 sets forth the applicable rule amendments with additions underscoring and deletions ~~overstruck~~.

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

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

If you require any additional information regarding this submission, please contact Sasha Rozenberg at 212-299-2106 or via e-mail at [Sasha.Rozenberg@cmegroup.com](mailto:Sasha.Rozenberg@cmegroup.com), or contact me at 212-299-2228 or [Jason.Silverstein@cmegroup.com](mailto:Jason.Silverstein@cmegroup.com). Please reference our CME Submission No. 14-448 in any related correspondence.

Sincerely,

/s/ Jason Silverstein  
Executive Director & Associate General Counsel

cc: Board of Governors of the Federal Reserve System

## EXHIBIT 1

(In the text of the rule below, additions are shown underscored and deletions ~~overstruck~~.)

### **CME RULE 8H802.B. Satisfaction of Clearing House Obligations**

#### *1. Application of Clearing House and non-defaulting CDS Clearing Member contributions*

If the CDS Collateral, the CDS Customer Collateral, and any excess assets from other product classes made available to cover CDS Losses, as described in Rule 8H802.A, are insufficient to cover the CDS Loss produced by the default, the Clearing House shall cover, or reduce the size of, such CDS Loss by applying the following funds to such losses in the order of priority as follows (the “CDS Priority of Payments”):

*First*, the corporate contribution of CME for CDS Products (the “CME CDS Contribution”), which shall be equal to the greater of (x) \$50 million and (y) 5% of the CDS Guaranty Fund, up to a maximum of \$100 million;

*Second*, the CDS Guaranty Fund (including any CDS SR Deposits but excluding the contribution of the defaulted CDS Clearing Member), which shall be applied pro rata to each non-defaulted CDS Clearing Member’s deposit to the CDS Guaranty Fund in accordance with Rule 8H07; and

*Third*, CDS Assessments against all CDS Clearing Members (excluding any previously defaulted CDS Clearing Members),

### **8H06. ~~[RESERVED]~~ CDS SR Deposit**

A. The Clearing House shall require an additional CDS Guaranty Fund Deposit from CDS SR Clearing Members to address potential risks of CDS SR Clearing Members clearing contracts where it or its affiliate is a Reference Entity (the “CDS SR Deposit”).

The aggregate amount of CDS SR Deposits will be calculated by the Clearing House using stress test methodology, calculated on a net exposure basis within each of the proprietary account and the customer account, equal to the largest theoretical aggregate losses caused by the default of any two CDS SR Clearing Members produced by such stress test or such other methodology, also on such a net exposure basis, determined by the CDS Risk Committee (such amount, the “CDS SR Aggregate Amount”).

“CDS SR Clearing Member” means a CDS Clearing Member that is clearing index CDS Contracts that contain Reference Entities that reference the CDS Clearing Member or one of its affiliates.

B. Each CDS SR Clearing Member’s required CDS SR Deposit shall be such CDS SR Clearing Member’s proportionate share of the largest two losses described in 8H06.A above at the end of the prior calendar month.

Following any recalculation of the CDS SR Aggregate Amount, the Clearing House shall, within one Business Day, provide a report to each CDS Clearing Member showing the detail of its required CDS SR Deposit and the amount of any required additional or any excess CDS SR Deposit. A CDS Clearing Member shall make any required additional CDS SR Deposit within two Business Days after delivery of such report and any reported excess may be withdrawn immediately.

## **80104. CLEARING SELF-REFERENCING CDS CONTRACTS**

### **80104.A. Clearing Through Clearing Member's House (or Proprietary) Account**

#### **~~CDS Contracts Referencing Indices~~**

~~If, as a consequence of CDX Index Untranching CDS Contracts, a CDS Clearing Member holds a net exposure in its house (or proprietary) account to itself or any of its Affiliates, with such exposure calculated on a cross index and cross maturity basis and across the net positions held by such CDS Clearing Member and its Affiliates, in excess of the lesser of either:~~

~~(i) \$50 million notional; or~~

~~(ii) 1% of its adjusted net capital (as defined in accordance with regulation applicable to such entity or, in the absence of any such regulation, as calculated under CFTC Rule 1.17 as though such entity were a Futures Commission Merchant, including the requirement to prepare and provide to the Clearing House a Form 1-FR-FCM or FOCUS Report as of the times required for Futures Commission Merchants);~~

~~then, in addition to any existing collateral requirements (other than in relation to the CDX Component Transaction referencing the relevant Reference Entity), the CDS Clearing Member must, following notice by the Clearing House of the amount, fully collateralize its exposure in excess of this amount in accordance with the Rules. For this purpose exposure shall be deemed to be either (a) if the CDS Clearing Member is a Seller under such CDX Index Untranching CDS Contracts, the portion of the Floating Rate Payer Calculation Amount of such CDX Index Untranching CDS Contracts attributable to the relevant Reference Entity and (b) if the CDS Clearing Member is a Buyer under such CDX Index Untranching CDS Contracts, the aggregate of the portion of all future Fixed Amounts which may become due under such CDX Index Untranching CDS Contracts and which are attributable to the relevant Reference Entity~~

### **80104.B. Clearing Through Clearing Member's Customer Account**

#### **~~CDS Contracts Referencing Indices~~**

~~If a CDS Clearing Member clears positions in CDX Index Untranching CDS Contracts for a customer through such CDS Clearing Member's customer account and such positions result in a net exposure on the part of its customer to such customer or any of such customer's Affiliates, with such exposure calculated on a cross index and cross maturity basis and across the net positions held by such customer and its Affiliates, in excess of the lesser of either:~~

~~(i) \$25 million notional; or~~

~~(ii) 0.5% of such CDS Clearing Member's adjusted net capital (as defined in accordance with regulation applicable to such entity or, in the absence of any such regulation, as calculated under CFTC Rule 1.17 as though such entity were a Futures Commission Merchant, including the requirement to prepare and provide to the Clearing House a Form 1-FR-FCM or FOCUS Report as of the times required for Futures Commission Merchants);~~

~~then, in addition to any existing collateral requirements (other than in relation to the CDX Component Transaction referencing the relevant Reference Entity), the CDS Clearing Member must fully collateralize such customer's exposure in excess of this amount in accordance with these Rules and such requirement to provide full collateralization shall constitute a performance bond requirement applicable to the~~

~~customer or its affiliates, as applicable. For this purpose exposure shall be deemed to be either (a) if the CDS Clearing Member is agent for a Seller under such CDX Index Untranchcd CDS Contracts, the portion of the Floating Rate Payer Calculation Amount of such CDX Index Untranchcd CDS Contracts attributable to the relevant Reference Entity and (b) if the CDS Clearing Member is agent for a Buyer under such CDX Index Untranchcd CDS Contracts, the aggregate of the portion of all future Fixed Amounts which may become due under such CDX Index Untranchcd CDS Contracts and which are attributable to the relevant Reference Entity.~~