

**SUBMISSION COVER SHEET**

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

Registered Entity Identifier Code (optional): 14-462

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

Filing as a:  DCM  SEF  DCO  SDR

Please note - only ONE choice allowed.

Filing Date (mm/dd/yy): October 30, 2014 Filing Description: Addition of Limited Recourse and Portfolio Gain Haircut Settlement Cycles to the Financial Safeguards Package for Base Products

**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: Rule 802.B.

**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 30, 2014

**VIA ELECTRONIC PORTAL**

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

**RE: Regulation 40.10 Submission Regarding Addition of Limited Recourse and Portfolio Gain Haircut Settlement Cycles to the Financial Safeguards Package for Base Products.  
CME Submission No. 14-462**

Dear Mr. Kirkpatrick:

Chicago Mercantile Exchange Inc. (“CME”), The Board of Trade of the City of Chicago, Inc. (“CBOT”), New York Mercantile Exchange, Inc. (“NYMEX”), and Commodity Exchange, Inc. (“COMEX”) (collectively, the “Exchanges”) hereby provide advance notice to the Commodity Futures Trading Commission (“CFTC”) of proposed changes to the rules of the Exchanges (each, a “Rulebook”) to add limited recourse and a portfolio gain haircut settlement cycle (“Base Haircuts”) to the financial safeguards package for Base<sup>1</sup> on the earlier of December 31, 2014 or the receipt of regulatory approval.

**CFTC Regulatory Requirements**

CME is making the aforementioned changes in connection with CFTC Regulation 39.35 (Default rules and procedures for uncovered credit losses or liquidity shortfalls (recovery) for systemically important derivatives clearing organizations and subpart C derivatives clearing organizations).<sup>2</sup> CFTC Regulation 39.35(a) requires a systemically important derivatives clearing organization (“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].” The additions of limited recourse and Base Haircuts to the financial safeguards package for Base specifically address how CME would allocate losses exceeding the financial resources available to it as required by CFTC Regulation 39.35(a)(1). The proposed changes are also structured to harmonize the financial safeguards structure for Base with our financial safeguards structures for IRS and CDS offerings which contain similar limited recourse and Base Haircuts features should their respective losses exceed their respective available financial safeguards packages.

---

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

<sup>2</sup> CME received an extension to comply with CFTC Regulation 39.35 until December 31, 2014.

## **Overview of Proposed Changes**

### *Limited Recourse*

Currently, the Rulebook provides for limited recourse for IRS products and CDS products, but not Base products, after losses exceed their respective financial safeguards packages.<sup>3</sup> The proposed rules would add limited recourse as a formal component of the financial safeguards package for Base. The addition of Base limited recourse will provide certainty for market participants with Base Contracts<sup>4</sup> in the event losses should exceed the financial safeguards package for Base. If such event occurs without the limited recourse/Base Haircuts features as part of the financial safeguards package for Base, CME would likely experience an insolvency event under the commodity broker liquidation provisions of the US Bankruptcy Code and would result in the close out and netting of all contracts cleared by CME (including IRS and CDS) pursuant to Rule 818. Limited recourse in the financial safeguards package for Base would reduce the risk to which CDS Clearing Members and IRS Clearing Members are exposed by preventing clearing member defaults with respect to Base Guaranty Fund Products (as defined in Rule 802.A) from causing a Bankruptcy Event or Default Event (each, as described in Rule 818) and, in turn, from triggering the close-out and netting procedures set forth in the Rulebook. If the loss resulting from the default of a Base Clearing Member (as defined in the proposed rules) is not satisfied in full from the application of the financial safeguards package for Base, the limited recourse provision would prohibit further recourse to other funds of CME Inc., IRS Clearing Members or CDS Clearing Members.

### *Base Portfolio Gain Haircuts and Base Contract Extinguishment*

Currently, the Rulebook provides for mandatory haircuts for IRS products after losses exceed the performance bonds of the defaulted IRS Clearing Member, the CME IRS Contribution (as such term is defined in the Rulebook), the IRS Guaranty Fund and IRS Assessments (each, as defined in Rule 8G07). Similarly, the Rulebook provides for mandatory haircuts for CDS products after losses exceed the performance bonds of the defaulted CDS Clearing Member, the CME CDS Contribution (as such term is defined in the Rulebook), the CDS Guaranty Fund and CDS Assessments (each, as defined in Rule 8H07).<sup>5</sup> The proposed rules would add similar haircuts for Base as a formal component of the financial safeguards package for Base.

Pursuant to the proposed rules, in the event a Base Termination Event (as defined in proposed rule 802.B.6) occurs, CME will conduct a Base Haircut Settlement Cycle (as defined in proposed rule 802.B.7) to determine a final settlement price for all Base Contracts and thereby determine a U.S. dollar amount to be paid to or received from CME in respect of all Base Contracts. Accounts with net portfolio losses would be required to make all payments to CME for such settlement cycle. Then, CME would haircut those accounts with net portfolio gains pro rata on the basis of the amounts received from accounts with net portfolio losses. The haircut would be applied pro rata to each proprietary account of each Base Clearing Member, the non-swap customer account of each Base Clearing Member and at the beneficial owner level for each cleared swaps customer of each Base Clearing Member. Upon the completion of payments, all Base Contracts will be extinguished.

As discussed above, Base Haircuts benefit market participants by providing certainty to market participants with Base Contracts in the event that losses associated with the default of a Base Clearing Member exceed the financial safeguards package for Base. The addition of Base Haircuts enables the

---

<sup>3</sup> See Rules 8G802 and 8H802, respectively.

<sup>4</sup> As defined in the proposed rules.

<sup>5</sup> See Rules 8G802 and 8H802, respectively.

clearing function to continue for IRS and CDS in the event of a Base Termination Event. Furthermore, accounts with net portfolio gains are likely to recover more of the amounts owed to them (and on a more expedient basis) through Base Haircuts than through a bankruptcy claims process.

### **Analysis of the Proposed Rules under Derivatives Clearing Organization (“DCO”) Core Principles**

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

- **Financial Resources:** In accordance with CFTC Regulations 39.11 and 39.33, CME maintains financial resources for Base Guaranty Fund Products sufficient to enable it to meet its financial obligations to its Base Clearing Members notwithstanding a default by the two Base Clearing Members (and their affiliates (as defined in the proposed rules) that are Base Clearing Members) creating the largest combined loss to CME in extreme but plausible market conditions. CME maintains such financial resources for Base Guaranty Fund Products through its financial safeguards package for Base , which includes performance bonds, the CME Contribution, and the Base Guaranty Fund (each as defined in Chapter 8 of the Rulebook) and Base Assessments (as defined in the proposed rules). CME's addition of limited recourse to the financial safeguards package for Base is designed to protect the non-defaulted CDS Clearing Members and non-defaulted IRS Clearing Members with respect to their CDS and IRS positions, respectively. CME is keeping the structure of the Base Guaranty Fund unchanged. If, after using the financial safeguards package for Base, the funds available to CME are insufficient to cover a loss associated with a Base Clearing Member Default, CME will use conduct a settlement cycle, haircut positions, and then close out the contracts in the Base Guaranty Fund. This Base Haircuts settlement cycle is designed to stem the losses occurring in the Base Guaranty Fund so that CME can continue to operate for other products and avoid an insolvency process and/or winding down.
- **Settlement Procedures:** If losses remain after exhausting the performance bonds of the defaulted Base Clearing Member, the CME Contribution (as defined in the Rulebook), the Base Guaranty Fund, and Base Assessments, CME will conduct one final settlement cycle for Base Guaranty Fund Products. CME will collect mark-to-market funds from the Base Clearing Members with net portfolio losses, and CME will make mark-to-market payments to non-defaulting Base Clearing Members with net portfolio gains. CME's payments to non-defaulting Base Clearing Members would be haircut to reflect the monies collected by the Clearing House during the settlement cycle plus any remaining portion of the financial safeguards package for Base. Following the finality of this settlement cycle, CME will close out all Base Contracts.
- **Default Rules and Procedures:** Consistent with CFTC Regulation 39.35 (Default rules and procedures for uncovered credit losses or liquidity shortfalls (recovery) for systemically important derivatives clearing organizations and subpart C derivatives clearing organizations), limited recourse and Base Haircuts are designed to allocate losses exceeding the financial safeguards package for Base.
- **Public Information:** The proposed rules will be added to the Exchanges’ publicly available rulebooks, permitting clearing members to account for the proposed rules’ potential impact in the event that losses associated with the default of a Base Clearing Member exceed the financial safeguards package for Base.

CME certifies that the proposed rules comply with the CEA and the regulations thereunder. There were no substantive opposing views.

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

If you require any additional information regarding this submission, please contact me at 212-299-2228 or [Jason.Silverstein@cmegroup.com](mailto:Jason.Silverstein@cmegroup.com). Please reference our CME Submission No. 14-462 in any related correspondence.

Sincerely,

/s/ Jason Silverstein  
Executive Director & Associate General Counsel

cc: Board of Governors of the Federal Reserve System

Attachment: Exhibit 1

## **EXHIBIT 1**

### **PROPOSED RULES**

#### **CME/CBOT/NYMEX/COMEX Rule 802.B. Satisfaction of Clearing House Obligations**

.....

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

If one or more Base Clearing Members default on an obligation owed to the Clearing House in respect of a Base Contract, and the assets available to cover the default, including Base Priority of Payments, are insufficient to satisfy the obligations of the Clearing House as a result of such default, the Clearing House shall discount its obligations as provided in Rule 802.B.7. Persons who have not been paid in full in respect of Base Contracts shall have no recourse to any other funds or any other entity, including without limitation guaranty funds that support clearing of other products, CME Inc., CME Group Inc. or any of its affiliates, other than any amounts recovered as described in Rule 802.E.

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 Clearing House Risk Committee) that the available Base Collateral, Non-Base Proprietary Collateral, Base Customer Collateral and the Base Priority of Payments will be insufficient to satisfy all Losses from the defaulted Base Clearing Member(s), (c) the Clearing House otherwise determines (after consultation with the Clearing House Risk Committee) that the Loss will exceed the available Base Collateral and Base Priority of Payments, (d) a default of the Exchange occurs as described in Rule 818 or (e) a Bankruptcy Event of the Exchange occurs (each a “Base Termination Event”), then as promptly as reasonably practicable following the Base Termination Event, the Clearing House shall, in a manner that is consistent with the requirements of the Commodity Exchange Act and the regulations adopted thereunder (including, without limitation Part 190 of the Regulations, if applicable) fix a U.S. dollar amount to be paid to or received from the Clearing House in respect of all Base Contracts to be terminated by conducting a Base Haircut Settlement Cycle to determine a final settlement price for all open Base Contracts as described below.

##### 7. Base Haircut Settlement Cycles and Termination of Base Contracts

(a) If a Base Termination Event occurs, the Clearing House shall notify the non-defaulted Base Clearing Members and conduct a settlement cycle for all Base Contracts to determine settlement prices for all Base Contracts and the portfolio gain or loss for each non-defaulted Base Clearing Member and its customers as follows (such settlement cycle, “Base Haircut Settlement Cycle”):

(i) The net portfolio gain of a non-defaulted Base Clearing Member (a “collect”), or the net portfolio loss of a non-defaulted Base Clearing Member to the Clearing House (a “pay”), shall be determined separately for (a) its proprietary positions in Base Contracts (a “Proprietary Base Collect” or a “Proprietary Base Pay”), (b) the non-swap positions of its customers in Base Contracts (collectively, a “Customer Futures Collect” or a “Customer Futures Pay”), and (c) the

swap positions of each of its customers in Base Contracts (each, an “Individual Customer Swap Collect” or an “Individual Customer Swap Pay”). For the non-defaulted cleared swaps customers of a defaulted Base Clearing Member, the Clearing House shall also determine Individual Customer Swap Collects and Individual Customer Swap Pays. The sum of all Proprietary Base Collects, Customer Futures Collects and Individual Customer Swap Collects shall be the “Aggregate Base Collects”. The sum of all Proprietary Base Pays, Customer Futures Pays and Individual Customer Swaps Pays shall be the “Aggregate Base Pays.”

(ii) The Clearing House shall determine the amount of each non-defaulted Base Clearing Member’s remaining payment obligations, if any, in respect of Base Assessments (which, together with any remaining CME Contribution, any remaining Base Guaranty Fund amounts and any remaining Base Assessments previously funded, constitute the “Remaining Base Priority of Payments”).

(iii) The Clearing House shall calculate the sum of any remaining Base Collateral, any remaining Base Customer Collateral (if applicable as described in Rule 802.A.2) and Remaining Base Priority of Payments to the Aggregate Base Pays, and deduct the amount of any uncovered Loss (the resulting amount, the “Aggregate Base Available Funds”).

(iv) The Clearing House shall then notify each Base Clearing Member of the amount of its remaining Base Assessments, Proprietary Base Pay, Customer Futures Pay and Individual Customer Swaps Pays and each Base Clearing Member shall pay all such amounts no later than the time specified by the Clearing House in such notice. If a Base Clearing Member does not make such payment to the Clearing House, the Clearing House shall determine such Base Clearing Member to be in default and may take any of the actions specified in Rule 802.A with respect to such Base Clearing Member and its customers.

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

(vi) If the Aggregate Base Collects exceed the amount of Aggregate Base Available Funds received, the Clearing House shall haircut the amount of each Proprietary Base Collect (such haircut amount, the “Allocated Proprietary Base Collect”), Customer Futures Collect (such haircut amount, the “Allocated Customer Futures Collect”) and Individual Customer Swap Collect (such haircut amount, the “Allocated Individual Customer Swap Collect”) on a pro rata basis based on the amount of Aggregate Base Available Funds received relative to the Proprietary Base Collect, Customer Futures Collect, and Individual Customer Swap Collect.

(vii) For non-defaulted Base Clearing Members, the Clearing House shall pay the Proprietary Base Collect or Allocated Proprietary Base Collect, as applicable, the Customer Futures Collect or Allocated Customer Futures Collect, as applicable, and the Individual Customer Swap Collect and Allocated Individual Customer Swap Collect, as applicable, as soon as practicable after receipt of the Aggregate Base Available Funds. For non-defaulted customers of a defaulted Base Clearing Member, the Clearing House will make arrangements to pay directly to such non-defaulted customers.

(viii) The Base Clearing Member shall allocate any Allocated Customer Futures Collect pro rata among the Base Clearing Member's customers.

(b) Upon the completion of payments, all Base Contracts shall be extinguished, and the Clearing House shall have no further access to funds or collateral in respect of Base Contracts or Base clearing activity of a non-defaulting Base Clearing Member in Base Contracts. Base Clearing Members, their affiliates and their customers shall have no claim against the Exchange, CME Group Inc. or any of its affiliates, including but not limited to any other guaranty fund established by the Exchange, CME Group Inc. or any of its affiliates with respect to losses suffered as a result of the application of this Rule 802.B, nor shall any beneficial holder of a Base Contract have any claim against its non-defaulting Base Clearing Member as a result of the application of this Rule 802.B other than any amounts recovered as described in Rule 802.E.

## 8. Non-Petition

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

69. Details of Implementation.....

## **New Definitions**

### **BASE ASSESSMENTS**

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

### **BASE CLEARING MEMBER**

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

### **BASE CONTRACT**

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

### **BASE CUSTOMER COLLATERAL**

Performance bond, excess performance bond, other collateral and settlement variation gains that are held for the respective cleared swaps customer consistent with Part 22 of the CFTC's regulations or held for the respective futures customers consistent with section 4d of the Commodity Exchange Act.

### **BASE PRIORITY OF PAYMENTS**

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

### **NON-BASE PROPRIETARY COLLATERAL**

Excess defaulted Base Clearing Member assets from other product classes made available to cover Losses.