FICC-CME CUSTOMER POSITION CROSS-MARGINING STRUCTURE RECOMMENDATION

This document sets out a high-level overview of our preferred structure for expanding the current FICC-CME cross-margining arrangement[1] to cover customer positions. This structure may need to be adjusted to account for the terms of any SEC final rule requiring the clearing of Treasury transactions; any FICC rules implementing such requirement; any SEC final rule requiring, or conditioning a debit in the customer reserve formula on, the segregation of customer margin; any FICC rules and arrangements implementing such segregation; and any other limitations on the ability of FICC to custody customer margin.

I. Relevant Precedent

- CME and FICC first received the CFTC's and the SEC's approval to offer cross-margining for Treasury securities transactions and Treasury futures in 2004.
    - Limited to non-customer (proprietary) cross-margining of positions.
    - Certain enhancements to be implemented early next year.
- The CFTC and the SEC approved customer cross-margining for Treasury securities transactions/Treasury futures offered by FICC and NYPC in 2012.
    - Customer positions and funds held under the CEA/CFTC futures account structure, but segregated from those of other futures customers (the XM account).
    - Regulatory approvals' scope limited to customers that are "market professionals."[2]
    - CFTC 4d order imposed certain conditions, including that participants agree to bear losses in the event there is a shortfall either in the XM account or in the futures account (effectively subordinating themselves to other futures customers) and opt-out of SIPA.
    - FICC-NYPC ceased offering the program, and no other customer cross-margining program for Treasury securities transactions/Treasury futures currently exists.
- The CFTC and the SEC have approved various customer cross-margining programs over the years (going back decades) for securities options products cleared by OCC and related futures cleared by DCOs, including CME.
    - Under the CEA/CFTC futures account structure; also subject to conditions including under the CFTC 4d orders.
    - Scope also limited to customers that are market professionals.
- The CFTC and the SEC have also approved customer portfolio margining across cleared swaps and security-based swaps that are credit default swaps (CDS)
    - Relief granted to dually registered clearing agencies/DCOs and dually registered broker-dealers/FCMs.
    - Conditions for clearing members include that customer margin for cleared CDS be held in a 4d(f) account (i.e., same as customer's other swaps) and opt-out by customer of SIPA.[3]

---

[1] Any reference to the current clearing member cross-margining arrangement refers to such arrangement as modified by the recent proposal.

[2] A "market professional" could be a market-maker, specialist or person acting in a similar capacity on a securities exchange, or a member of a futures exchange trading for its own account.

[3] The SEC's CDS portfolio margining order requires that the clearing member adopt and calculate margin requirements pursuant to an internal risk management program that has been approved in advance by the SEC; this should not be required for the proposal because the preferred structure would use the greater number produced by FICC's and CME's respective methodologies.

- Scope of the relief covers all customers that wish to avail themselves of the portfolio margining program, not just market professionals.
- Neither limiting customer cross-margining to market professionals nor mandating segregation of cross-margining customer positions and property from those of other futures customers of the clearing member is required under any statutory provision or agency rule.

II. Objectives

Our preferred structure is intended to achieve the following objectives:

- Make the benefits of cross-margining available to a broader range of sophisticated customers than "market professionals," namely, to all customers that will be subject to any SEC-imposed Treasury clearing requirement as well as to all customers that voluntarily elect to clear Treasury transactions and to post margin in respect of such transactions;
- Allow those customers to benefit from an established and trusted customer protection regime, CEA 4d segregation;[4]
- Address and (where possible) eliminate exposure to credit risk for CME, FICC, and their respective members and customers generally; and
- Comply, to the extent possible, with existing SEC and CFTC regulatory requirements, especially relating to customer property requirements, and thereby limit the scope of required regulatory relief.

III. Proposal

1. Basic Structure

- Cross-margining would be applied by the clearinghouses at the clearinghouse level and by the clearing members at the customer level:
    - At the clearinghouse level, CME and FICC would calculate margin requirements for a participating customer's clearing member based on the positions the clearing member clears for the customer at each of FICC and CME.
    - This is designed to allow the clearing member to recognize risk offsets when determining the margin requirements for the customer (though the bilateral agreement between the clearing member and the customer will determine such margin requirements).
- Participation would be voluntary for both members and customers.
- Participation would be available for all customers in scope of any Treasury clearing mandate adopted by the SEC.
- FICC would revise its rules to create a mechanism whereby FICC would hold and record positions and clearing fund (i.e., margin) posted by customers that participate in cross-margining separately from both the proprietary margin and positions of the clearing member and the margin and positions of the clearing member's other customers. Such margin would not be subject to loss mutualization under FICC's rules.
- Eligible customers could access FICC through the Sponsored Service. Eligible customers could also access FICC through the prime brokerage or correspondent clearing services, as long as the positions are maintained in an FICC account that provides for gross margining.[5]

---

[4] In theory, customer cross-margining could be offered under a securities account structure, where SIPA would apply in the event of a BD/FCM clearing member insolvency. For various reasons we believe that using the futures account structure subject to CEA and CFTC segregation protections is preferable, and as noted the established precedent uses the CEA/CFTC structure.

[5] If the SEC adopts the Treasury clearing requirement as proposed, broker-dealer clearing members at FICC would be able to, subject to certain conditions, include initial margin held with FICC as a debit in the 15c3-3 customer

- CCIT Members would not be eligible because they do not post margin (rather they provide an equivalent security interest to FICC in the collateral pledged to them in the cleared tri-party repo)
- The customer's clearing member would need to be a dually registered broker-dealer/FCM and a clearing member of both FICC and CME.[6]
- Eligible products, cross-guarantee, and default management would be the same as under the current clearing member cross-margining arrangement, as would the method for determining the amount of the margin reduction.

2. Customer Protection Model

- Customers' margin and positions would be held in a futures account at their clearing member.[7]
  - As a result, the clearing member would be required to segregate the margin and positions in accordance with the same rules that apply to futures customers generally (i.e., in a 4d account).
- However, the FICC-cleared positions would be cleared by FICC, rather than a DCO.
- In the event of a clearing member insolvency, customers would enjoy the same protections under Part 190 that apply to futures and associated margin.
  - These benefits include the provisions of Part 190 supporting porting.
  - FICC would consider with its supervisors whether to amend its rules to allow porting of cross-margined customer positions.
  - Customers would **not** be required to subordinate their claims to those of other futures customers.[8]
- Consistent with existing precedent, customers would have to contractually opt out of SIPA protection.[9]

---

reserve formula. To accommodate this, FICC would permit broker-dealer clearing members to identify certain positions and margin as held for 15c3-3 customers. For such positions and margin, FICC would calculate margin requirements on a gross (i.e., customer-by-customer) basis, segregate margin and positions and exclude such margin and positions from loss mutualization under FICC's rules. By virtue of this arrangement, FICC would be able to identify the margin and positions for each participating customer and would send CME such information. CME would likewise establish mechanisms to identify the positions and margin allocable to each participating customer at CME and provide this information to FICC.

[6] Many customers currently access clearing at FICC through clearing members that are banks. These customers would benefit from a model that makes cross-margining available to customers with a bank clearing member at FICC and an FCM clearing member at CME. However, such a model presents additional regulatory and other challenges, including (i) the requirement that only FCMs hold margin posted by futures customers in connection with futures positions; (ii) potential challenges for each of the bank and the FCM to access margin and positions held by the other clearing member; (iii) more complex customer protection analyses (since margin held at a bank would not automatically be subject to the CFTC's Part 190 rules); and (iv) regulatory limitations on banks' ability to enter into arrangements with non-bank chain affiliates.

[7] The CFTC's prior 4d orders have imposed the requirement that positions and funds of cross-margin futures customers must be held separately from the positions and fund of other futures customers. The plan would be to seek a broader order without that restriction.

[8] If, contrary to the preferred approach, the 4d order imposes the requirement that positions and funds of cross-margin futures customers must be held separately from the positions and fund of other futures customers, the special distribution framework in Appendix B Framework 1 to the CFTC Part 190 Rule would apply, and under certain scenarios where there is a "shortfall" of segregated funds, cross-margin futures customers could receive proportionally less than other futures customers.

[9] This would technically require a "subordination" agreement because that is the mechanism used to opt out of SIPA. However, the market understands that such is simply a mechanism to opt into the CFTC regime and out of the SIPA regime. Indeed, this would be similar to the conditions under the current cleared CDS portfolio margining

    - The form agreement to effect such opt-out would be included in the FICC's rule filing to be approved by the SEC.

3. CFTC and SEC Approvals

- The SEC will have to grant an order approving the customer cross-margining program and treatment of the securities transactions and collateral as non-customer funds for purposes of SEC Rule 15c3-3 and SIPA.
- The CFTC will have to grant a 4d order permitting treatment of the securities transactions and collateral as part of the 4d segregation. This would require an order that goes beyond existing precedent.[10]
- The CFTC may have the following principal concerns in this regard:
    - That the overall margin CME and FICC collect in respect of customer positions would be less than in the absence of implementation of the model.
    - Whether customers would receive back margin posted to FICC
        - This is because all futures customers share pro rata in the available pool of customer property held for futures customers. As a result, reduced margin at CME on account of cross-margining may mean less customer property for all customers, unless such difference is made up by payments from FICC.
- It should be relatively easy to address the CFTC's concern about the overall margin collection amount:
    - The CFTC has direct oversight over CME's margin methodology, and the proposed cross-margining structure would calculate margin using the greater requirement as produced by both clearinghouses' methodologies (which is the same as under the existing clearing member cross-margining arrangement).
- It should likewise be relatively easy to address the CFTC's concern about ensuring that customers obtain a return of margin posted to FICC:
    - FICC would maintain such margin in a segregated account that generally would be consistent with the requirements applicable to futures margin held at a DCO.
        - Such margin would not be available for loss mutualization under FICC's rules.
    - Clearing members would pledge to CME the margin held in the account such that CME does not need to rely exclusively upon the cross-guarantee.
        - FICC would hold the margin as agent and bailee for CME, thus ensuring that CME's security interest is perfected.
        - The account would not be part of FICC's estate in the unlikely event of FICC's bankruptcy. Accordingly, the amounts would be returned to the clearing member (or available for to CME) in a FICC failure.

---

framework. If the special distribution framework under Part 190 Appendix B Framework 1 were to apply, customers would also have to sign an agreement acknowledging that, although this would not be the preferred approach.

[10] See note 7.