

April 6, 2016

VIA ELECTRONIC MAIL

Mr. Christopher J. Kirkpatrick
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

RE: CFTC Regulation 39.5(b) Notification of Acceptance of USD Interest Rate Swaptions for Clearing. CME Submission No. 16-132

Dear Mr. Kirkpatrick:

Pursuant to Commodity Futures Trading Commission (“CFTC” or “Commission”) Regulation 39.5(b), Chicago Mercantile Exchange Inc. (“CME”) hereby notifies the CFTC that CME will begin accepting options on interest rate swaps (“Swaptions”) for clearing on April 11, 2016. Initially, CME will accept European style Swaptions for physical exercise into the corresponding underlying interest rate swap (“IRS”) exposures, for which the maximum term to option expiration is two years and 10 calendar days, and for which the corresponding underlying IRS are denominated in US Dollars, referencing USD LIBOR as the floating rate, with maximum term to maturity of thirty years and 10 calendar days.

39.5(b)(3)(i): Eligibility to Clear Swaptions and Compliance with the DCO Core Principles

On March 3, 2015, the CFTC determined that CME is eligible to clear Swaptions.¹ While central clearing of Swaptions provides several important risk management benefits, including transparency in prices, at least daily mark-to-market and systemic risk reduction, CME does not believe that Swaptions should become subject to the clearing mandate. If, however, the Commission were to determine that Swaptions are required to be cleared, CME would be able to maintain compliance with the DCO Core Principles set forth in section 5b(c)(2) of the Commodity Exchange Act.

39.5(b)(3)(ii)(A): Outstanding Notional Exposures, Trading Liquidity and Pricing Data

CME is providing the CFTC with details regarding the existence of significant outstanding notional exposures and trading liquidity in Appendix A hereto. With respect to the end of day settlement price process, please refer to CME Submission #14-327, which includes a description of the settlement model for Swaptions.²

¹ See letter from Christopher J. Kirkpatrick, Secretary of the Commission to Christopher K. Bowen, Managing Director and Chief Regulatory Counsel of CME, dated March 3, 2015 (the “March 2015 Letter”).
<http://www.cftc.gov/idc/groups/public/@otherif/documents/ifdocs/cmewaptionsletter3-3-15.pdf>.

² CME Submission #14-327 was provided by CME as an advance notice to the Commission of a rule change in pursuant to Commission Regulation 40.10. In a letter dated, December 15, 2014, from Phyllis Dietz, Acting Director, Division of Clearing and Risk (“DCR”) of the Commission to Jason Silverstein, Executive Director &

39.5(b)(3)(ii)(B): Rule Framework, Capacity, Operational Expertise and Resources, and Credit Support Infrastructure

The terms and conditions for Swaptions can be found in new CME Chapter 902 (Swaptions). Chapter 900 (Interest Rate Products) is being amended to include other Swaption specific terms. New Chapter 902 and revised Chapter 900 were submitted to the Commission in CME Submission #16-131.³ Enclosed with this submission and marked with a request confidential treatment is the document titled “*OTC IR Swaptions Specification*” which contains Swaptions specifications and enhancements to CME’s IRS clearing processes for Swaptions. Details regarding CME’s capacity, operational expertise and resources, and credit support infrastructure are provided in the document titled “*CME Clearing Risk Management and Financial Safeguards*”⁴.

39.5(b)(3)(ii)(C): Effect on Mitigation of Systemic Risk

A key goal of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) is the reduction of systemic risk through the use of central clearing for over-the-counter (“OTC”) derivatives. The Commission has noted that the central clearing of IRS would likely reduce systemic risk in the swap market and the financial system as a whole.⁵ As a central counterparty, CME interposes itself between counterparties to the IRS (and other derivatives products) that it clears, becoming the buyer to every seller and the seller to every buyer. For each swap that it clears, CME provides all clearing house services, including a mark-to-market function, on a daily basis.

The size of the Swaptions market is significant.⁶ According to the most recent data published by the Bank for International Settlements (“BIS”), as of mid-year 2015 the outstanding notional amount of US dollar-denominated OTC Swaptions was approximately \$15.562 trillion. Central clearing of Swaptions provides several important risk management benefits, including transparency in prices, at least daily mark-to-market and systemic risk reduction. Additional benefits of clearing include:

- *Risk reduction.* Swaptions represent the price risk of positions in the underlying swap, contingent upon Swaption exercise, which means that a portfolio that includes options and swaps may have less market risk, depending on its specific composition. Bringing these risks into the cleared pool may reduce market risk for the CME as well as the original bilateral counterparties. This risk reduction may come from directly offsetting price risks (i.e. duration dollar and dollar delta) and also indirectly through standardized pricing, regulatory, margin, and collateral systems.
- *Centralized clearing.* Clearing OTC Swaptions through CME enhances risk management through the daily mark-to-market process, which ensures mutually consistent valuation of swaptions and the swap exposures into which such swaptions are exercisable, and which includes objective pricing, margining, and collateral management.

Associate General Counsel of CME, DCR notified CME that following DCR’s review of CME Submission #14-327, DCR did not object to the acceptance of Swaptions for clearing.

<http://www.cftc.gov/idc/groups/public/@otherif/documents/ifdocs/cme401012-15-14.pdf>.

³ <http://www.cmegroup.com/market-regulation/files/16-131.pdf>.

⁴ <http://www.cmegroup.com/clearing/files/financialsafeguards.pdf>.

⁵ See Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed Reg 74284, 74312 (Dec. 13, 2012).

⁶ See Semiannual OTC Derivatives Statistics, Interest Rate Derivatives, Table D7, BIS, 6 March 2016, which is available at <http://www.bis.org/statistics/derstats.htm>.

- *Operational efficiencies.* Centralized clearing of Swaptions reduces operational burdens in several ways. Standardization and centralized clearing enables consolidation of collateral management and cash flows and eliminates the need for novations or tear-ups.
- *Ease of position adjustment.* In non-cleared markets, the only means to completely eliminate the risk of a swap is to (i) enter into a tear-up agreement with the swap counterparty, or (ii) enter into a novation (i.e., find another entity willing to assume its side of the swap). In either case, the tear-up or the novation must be approved by the bilateral swap counterparty.
- *Portfolio risk management.* By accepting Swaptions for clearing, CME would provide market participants the opportunity to manage risk associated with IRS and Swaptions on a portfolio basis, by combining cleared IRS and Swaptions portfolios, which would mitigate risks and inefficiencies present in the OTC Swaptions market due to mandatory clearing of IRS. Swaptions and IRS demonstrate strongly correlated responses to changes in interest rate levels. For this reason, prior to the Dodd-Frank Act, IRS and Swaptions were risk managed on a portfolio basis, with IRS hedging the risk of changing interest rates (“delta”). One negative consequence of IRS transitioning from OTC to clearing is that as IRS have become centrally cleared, these IRS delta hedges have been separated from Swaptions. This separation complicates portfolio-based risk management, leads to mismatched risk profiles, and potentially increases risk during default situations. Without portfolio risk management, market participants post margins for their cleared IRS and uncleared Swaptions without any offsetting benefits. Clearing Swaptions will provide portfolio based risk management and its associated benefits.

As described in CME’s advance notice to the Commission of its intention to accept swaptions for clearing and associated enhancements to the IRS margin model, CME has the necessary resources available to clear the Swaptions that are the subject of this submission.⁷ In accordance with CFTC Regulations 39.11 and 39.33, CME maintains financial resources for IRS products (including Swaptions) sufficient to enable it to meet its financial obligations to its IRS Clearing Members notwithstanding a default by the two IRS Clearing Members (and their affiliates that are IRS Clearing Members) creating the largest combined loss to CME in extreme but plausible market conditions.⁸ CME maintains such financial resources for IRS products (including Swaptions) through its IRS financial safeguards, which include IRS performance bonds, the CME IRS Contribution, the IRS Guaranty Fund, and IRS Assessments (each as defined in Chapter 8G of the CME Rules). CME is keeping the structure of the IRS Guaranty Fund unchanged, as the existing framework for constructing an appropriate safeguards package is flexible and can accommodate additional IRS products, including Swaptions.

39.5(b)(3)(ii)(D): Effect on Competition – Fees and Charges

CME does not believe that the acceptance of Swaptions will have any material effect on competition. It is possible that as a result of the benefits of clearing Swaptions, including the mitigation of systemic risks as noted in the preceding section (39.5(b)(3)(ii)(C): Effect on Mitigation of Systemic Risk), market

⁷ See CME Submission #14-327. <http://www.cmegroup.com/market-regulation/files/14-327.pdf>.

⁸ See March 2015 Letter where the Commission found that: (i) CME’s financial resources are sufficient under Commission Regulations 39.11 and 39.33; (ii) CME has demonstrated that it would be able to manage the risks associated with clearing swaptions under Commission Regulations 39.13 and 39.36; and (iii) CME has demonstrated that, if CME accepts swaptions for clearing, CME can otherwise maintain compliance with the core principles applicable to DCOs as described in Section 5b(c)(2) of the CEA and Part 39 of the Commission’s regulations.

participants could increase the amount of their existing interest swap business at CME. The fees for Swaptions were included in CME Submission #16-131.

39.5(b)(3)(ii)(E): Reasonable Legal Certainty in DCO or Clearing Member Insolvency

The bankruptcy of a DCO is governed by subchapter IV of Chapter 7 of the U.S. Bankruptcy Code (11 U.S.C. §§ 761-767) and by Part 190 of the CFTC's regulations (Bankruptcy Rules). Also relevant in the event that CME were to enter into bankruptcy proceedings is CME Rule 818 (Close-Out Netting) included in Chapter 8 (Clearing House and Performance Bonds) of the CME Rulebook. Chapter 8 of the CME Rulebook is available at <http://www.cmegroup.com/rulebook/CME/I/8/8.pdf>.

The bankruptcy of a clearing member that is a U.S. futures commission merchant ("FCM") would be governed by subchapter IV of Chapter 7 of the U.S. Bankruptcy Code (11 U.S.C. §§ 761-767) and the Part 190 of the CFTC's regulations (Bankruptcy Rules). If an FCM is registered as a broker-dealer, certain aspects of its insolvency proceeding may also be governed by the Securities Investor Protection Act. Further details regarding the legal certainty provided under the relevant U.S. insolvency laws are provided in the document titled "*CME Clearing Risk Management and Financial Safeguards*."

39.5(b)(3)(iii): Product Specifications

The specifications for the Swaptions CME will accept for clearing are included in the document titled "OTC IR Swaptions Specification" which is being marked with a request confidential treatment.

39.5(b)(3)(iv): Participant Eligibility Standards

To be eligible to clear Swaptions, a clearing member must satisfy CME's standard criteria applicable to clearing members that clear any IRS products pursuant to CME Rule 8G04 (a member satisfying such criteria, an "IRS Clearing Member"). An IRS Clearing Member must satisfy additional criteria pursuant to proposed CME Rule 8G18.A, to be approved by CME as eligible to clear Swaptions (a member satisfying such criteria, an "IRS Swaptions Clearing Member")⁹.

CME has established objective, publicly disclosed, and risk-based admission and continuing participation requirements for IRS Swaptions Clearing Members. To become an IRS Swaptions Clearing Member, a clearing member must be an IRS Clearing Member and satisfy the additional criteria in CME Rule 8G18.A. These additional criteria include: a demonstration of operational capabilities to clear Swaptions; the ability, commitment, and expertise to manage risk associated with clearing Swaptions; a requirement to provide traders to the IRS Default Management Committee; and other questionnaires and diligence. Pursuant to CME Rule 8G18.B¹⁰, IRS Swaptions Clearing Members will also be required to submit Swaptions pricing data on a daily basis to CME and will be subject to certain penalties for failure to provide the required submission as further described in proposed CME Rule 8G18.B.

39.5(b)(3)(v): Pricing Sources, Models and Procedures

Pursuant to CME Rule 8G18.B, IRS Swaptions Clearing Members will be required to submit Swaptions pricing data on a daily basis to CME and will be subject to certain penalties for failure to provide the required submission. Additional information regarding pricing sources, models and procedures was included in CME Submission #14-327.

⁹ See CME Submission #14-327.

¹⁰ Id.

39.5(b)(3)(vi): Risk Management Procedures

CFTC Regulation 39.13(g)(2)(i) requires a DCO to establish initial margin requirements that are commensurate with the risks of each product and portfolio. As described in CME Submission 14-327, CME is enhancing IRS margin model Historical Value at Risk (HVaR) based performance bond and liquidity/concentration add-on models for IRS to cover the additional risk factors presented by the clearing of Swaptions and will margin existing IRS and Swaptions on a portfolio basis. CME will continue to use a minimum liquidation time that is five days for IRS portfolios that include Swaptions. CME's Swaptions margin model is designed to meet an established confidence level of at least ninety-nine percent as required by CFTC Regulation 39.13(g)(2)(iii). The existing IRS financial safeguards will be utilized to cover exposures from IRS Swaptions Clearing Members and will include stressed volatility scenarios to size the IRS Guaranty Fund. CME will include Swaptions related stress scenarios in the IRS Guaranty Fund sizing methodology. CME's Swaptions margin model is back-tested using various types of IRS and Swaption risk profiles to assess the adequacy of the model and to meet a confidence level of at least ninety-nine percent.

Pursuant to CFTC Regulation 39.14(b), CME effects a settlement with each IRS Clearing Member, and will effect a settlement with each IRS Swaptions Clearing Member, at least once each business day and has the authority and operational capacity to effect a settlement with each IRS Clearing Member on an intraday basis either routinely, when specified thresholds are breached, or in times of extreme market volatility. CME will settle Swaptions using a proprietary model based on the Swaptions market information provided by IRS Swaptions Clearing Members pursuant to proposed CME Rule 8G18.B. This proprietary model will calibrate a settlement price for Swaptions of different expiries, tenors, and moneyness. Additional detail regarding the settlement model and the processes that will be used to price Swaptions was provided in the confidential materials included in CME Submission #14-327.

To ensure proper management of defaulted Swaptions portfolios, CME will follow an approach to the default management process currently in place for IRS under the IRS Default Management Guidelines, with appropriate modifications such that portfolios of IRS and Swaptions across different risk profiles can be successfully closed out within the margin period of risk. As required by CFTC Regulation 39.16(c), CME's default management procedures—including the default management procedures applicable to Swaptions—permit it to take timely action to contain losses and liquidity pressures and to continue to meet its obligations in the event of a clearing member default. CME has adopted rules that set forth its default procedures and makes these rules publicly available. CME will require an IRS Swaptions Clearing Member to provide prompt notice to CME if it becomes the subject of a bankruptcy petition, receivership proceeding, or the equivalent as detailed in CFTC Regulation 39.16(d).

39.5(b)(3)(vii): Applicable Rules, Manuals, Policies and Procedures

Links to applicable rulebook sections are included in this submission. Revisions to CME Chapter 900 and new CME Chapter 902 were submitted in CME Submission #16-131.

39.5(b)(3)(viii): Notice of Submission

Notice of this submission (without enclosures, many of which have been designated for Confidential Treatment) has been concurrently posted on CME's web site at <http://www.cmegroup.com/market-regulation/rule-filings.html>.

If you require any additional information regarding this submission, please contact me at 212-299-2200 or via e-mail at CMEGSubmissionInquiry@cmegroup.com.

Sincerely,

Christopher Bowen
Managing Director and Chief Regulatory Counsel

Enclosure marked for confidential treatment

Appendix A

Swaption Outstanding Notional Exposures and Trading Liquidity

Estimated Open Interest: As of 6/30/2015, the BIS reported the size of the global US dollar-denominated swaptions market as \$15.562 trillion in terms of notional amount outstanding. Of this, 49.5% was held by reporting dealers, 43.0% was held by other financial institutions, and the remaining 7.5% was held by non-financial customers.¹¹

Estimated Notional Volume: The most recent compilation of triennial OTC derivatives statistics published by the BIS indicates that during April 2013 trading volume in the market for OTC US dollar-denominated swaptions ran \$89B per day (in terms of notional principal amounts exchanged), signifying 13.5% of the total notional value of US dollar-denominated OTC derivatives traded during the same month. During 2015, the global volume of trade in cleared US dollar-denominated OTC derivatives was approximately \$598 billion per day in terms of notional value, accounting for 91.0% of the entire market as reported by the BIS.¹²

Breakdown by Maturity and Expiration: We estimate that more than 80% of these have an option expiry of less than 2 years and therefore may be eligible for clearing under CME's proposed offering.

Total Transaction Count in 2015

		Maturity of Underlying Swap					Total
		0 to 1Y	1Y to 2Y	2Y+ to 5Y	5Y+ to 10Y	10Y+	
Option Expiry	0 to 3M	99	67	304	1,738	394	2,602
	3M+ to 6M	198	136	204	765	261	1,564
	6M+ to 1Y	118	104	120	195	170	707
	1Y to 2Y	224	165	178	327	209	1,103
	2Y+ to 5Y	281	183	276	168	339	1,247
	5Y+	2	10	334	248	261	855
		922	665	1,416	3,441	1,634	8,078

Source: DTCC Swap Data Repository, as accessed through ClarusFT's SDR View

¹¹ <http://www.bis.org/statistics/derstats.htm>

¹² <http://www.bis.org/statistics/derstats3y.htm>

APPENDIX B

OTC IR Swaption Specification

(attached under separate cover)