CME Group

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BY ELECTRONIC FILING

CONFIDENTIAL TREATMENT REQUESTED

Mr. David Stawick
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

RE: Request for Approval to Commingle Customer Positions and Related Collateral in Interest Rate Futures and Interest Rate Swaps, CME Submission #12-151

Dear Mr. Stawick:

Pursuant to Commission Regulations 39.15(b)(2) and 40.5, Chicago Mercantile Exchange Inc. ("CME") respectfully requests that the Commodity Futures Trading Commission approve its rules to allow the commingling of customer positions in Eurodollar and Treasury futures contracts (collectively, "Interest Rate Futures") and cleared-only interest rate swaps ("IRS"),[1] and any money, securities or property used to margin, guarantee or secure such positions, in accounts subject to section 4d(f) of the Commodity Exchange Act (the "Act"). As further explained below, approving the rules will benefit customers and the overall derivatives markets by: (1) enabling customers who clear trades through CME to obtain the benefit of margin offsets between Interest Rate Futures and IRS, thus reducing their trading costs and allowing for more efficient capital usage; (2) improving the efficiency and effectiveness of risk management; and (3) encouraging greater utilization of clearing, thereby facilitating systemic risk reduction.

I. Background

CME is registered with the Commission as a derivatives clearing organization ("DCO") and as a designated contract market ("DCM"). CME's clearing house division ("CME Clearing") is the DCO for contracts listed for trading on CME and its affiliates, the Chicago Board of Trade ("CBOT"), the New York Mercantile Exchange, and the Commodity Exchange, each of which is also a registered DCM. The Eurodollar futures that are a subject of this submission are listed for trading on CME, and the Treasury futures that are a subject of this submission are listed for trading on CBOT.

CME Clearing launched its IRS clearing services in October 2010, initially offering USD swap products out to a 31-year maturity. CME Clearing has since expanded its IRS offering to include USD products out to a 50-year maturity, Euro (EUR) and Sterling (GBP) products out to a 50-year maturity, and Canadian Dollar (CAD) products out to a 30-year maturity. On April 16, 2012, CME Clearing began offering Japanese Yen (JPY), Swiss Franc (CHF), and Australian Dollar (AUD) products, all available out to a 30-year maturity. As of April 13, 2012, IRS total open interest at CME was over $225 billion.

Interest Rate Futures and IRS share similar risk characteristics and are significantly and reliably correlated. CME's rules allowing commingling of Interest Rate Futures and IRS in 4d(f) or "customer

[1] The proposed rules and portfolio margining program do not encompass any options on Interest Rate Futures.

cleared swaps" accounts will enable customers to expend less capital on margin by utilizing margin offsets between their related positions in these futures and swaps under CME's risk management framework for portfolio margining.[2] Such portfolio margining promotes sound risk management by allowing a DCO, its clearing members and their customers to view a portfolio of positions based on the portfolio's overall economic and risk impact, rather than dividing a portfolio based on regulatory "account class" distinctions that may not fully reflect commercial and economic realities. By approving CME's rules, the Commission will (i) provide customers with additional economic incentives and capital efficiencies necessary to promote clearing of swaps, and (ii) facilitate the Dodd-Frank Act's goal of reducing systemic risk.

Given the close relationship between Interest Rate Futures and IRS, on May 7, 2012, CME Clearing launched its portfolio margining program for these products in proprietary or "house" accounts of clearing member firms. We expect that the risk reductions achieved by this program will result in capital efficiencies of up to 85 percent for certain portfolios. Through the present submission, CME seeks to extend the portfolio margining program to all market participants, including those that are not clearing members. In a comment letter in support of another DCO's submission to commingle certain foreign futures with swaps in 4d(f) accounts, the Managed Funds Association raised concerns about greater capital requirements for customer positions than clearing member proprietary positions, noting that "[t]his inequality will not only create a significant barrier to buy-side clearing in the derivatives markets, but will substantially restrain the healthy evolution of increased liquidity that should develop with increased clearing."[3]

The enclosed rule amendments consist of revisions to CME Rule 8G831 (Commingling of Eligible Futures and Swaps Positions), and to Chapter 10 (Portfolio Margining) of the IRS Clearing House Manual of Operations (the "Manual"). A copy of the proposed amendments to Rule 8G831 is enclosed as Exhibit A, with additions underlined and deletions overstruck. A copy of the proposed amendments to Chapter 10 of the Manual is enclosed as Exhibit B (marked for Confidential Treatment), with additions underlined and deletions overstruck. The portfolio margining benefits achieved through holding Interest Rate Futures and IRS in 4d(f) accounts will not be available to customers unless the Commission approves CME's rules.

II. Information Required Under Regulation 39.15(b)(2)

Subparts (A) through (L) of Regulation 39.15(b)(2) describe information a DCO must include in a submission seeking to commingle futures with cleared swaps in 4d(f) accounts. In adopting this Regulation, the Commission remarked that to the extent it adopted the "legally segregated, operationally commingled" ("LSOC") customer protection model for 4d(f) accounts, "a DCO could more easily justify the approval of rules ... allowing the commingling of futures, options and swaps, since the impact of any different risk from the product being brought into the portfolio would be limited to the customer who chooses to trade that product."[4] The Commission further noted that, under LSOC, "its specific concerns" in connection with commingling requests "may be minimized", and it may "revisit its ongoing need for all of the information listed in" 39.15(b)(2)(A)-(L).[5]

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[2] Allowing risk offsets between Interest Rate Futures and IRS commingled in 4d(f) accounts is consistent with Commission Regulation 39.13(g)(4) (Spread and portfolio margins), which states, in relevant part, that a DCO "may allow reductions in initial margin requirements for related positions if the price risks with respect to such positions are significantly and reliably correlated." *See also* CPSS-IOSCO *Principles for Financial Market Infrastructures* (April 2012) ("In calculating margin requirements, a CCP may allow offsets or reductions in require margin amounts between products that for which it is the counterparty if the risk of one product is significantly and reliably correlated with the risk of another product"), Explanatory note 3.6.12, available at http://www.bis.org/publ/cpss101a.pdf.
[3] Letter from Managed Futures Association (Stuart J. Kaswell, Executive Vice President and Managing Director, General Counsel) to the CFTC (Apr. 19, 2012), at 5.
[4] 76 Fed. Reg. 69391, n. 189 (Nov. 8, 2011).
[5] *Id.*

Since that time, the Commission has issued its Part 22 regulations, which implement the LSOC model for customer cleared swaps. The fact that the Commission has now adopted LSOC lends further support to CME's request for approval of its proposed commingling rules and portfolio margining program. We address each category of information identified in subparts (A) through (L) of Regulation 39.15(b)(2) below.

A. Products Eligible for Commingling

CME's IRS offering currently includes seven currencies – USD, EUR, GBP, CAD, AUD, JPY, and CHF – each with varying contract attributes. The specifications for these contracts are located in Chapters 900 (Interest Rate Swaps) and 901 (Interest Rate Swaps Contract Terms) of the CME rule book, copies of which are enclosed as part of Exhibit C.

CME Clearing has identified the following Interest Rate Futures that will be eligible for commingling with IRS in customer cleared swaps accounts:

- *Eurodollar Futures*: The specifications for these contracts are located in Chapter 452 (Three-Month Eurodollar Futures) of the CME rule book, a copy of which is attached as part of Exhibit C.
- *Treasury Futures*:
  - *U.S. Treasury Bonds*: The specifications for these contracts are located in Chapter 18 (U.S. Treasury Bond Futures) of the CBOT rule book, a copy of which is attached as part of Exhibit C.
  - *2, 5 and 10-Year Treasury Notes*: The specifications for these contracts are located in Chapters 21 (Short-Term U.S. Treasury Note Futures), 20 (Medium-Term U.S. Treasury Note Futures) and 19 (Long-Term U.S. Treasury-Note Futures), respectively, of the CBOT rule book, copies of which are enclosed as part of Exhibit C.

As further discussed below, these Interest Rate Futures were identified as eligible for commingling based on their exposure to similar or correlated risk factors as IRS, thus allowing for margin offsets. In accordance with the proposed amendments to Rule 8G831 (Exhibit A), Interest Rate Futures may only be commingled with IRS in 4d(f) accounts if they are risk reducing.

B. Risk Characteristics of Interest Rate Futures and IRS

CME Clearing has considerable experience clearing and managing the risks of Interest Rate Futures, and has been clearing IRS since October 2010. Under amended Rule 8G.831, Interest Rate Futures are determined to be eligible for commingling based on the fact that the price risks of such products are significantly and reliably correlated with IRS. For example, Eurodollar futures are a LIBOR-based contract, and the LIBOR curve serves as an input to CME Clearing's USD-based IRS, thus providing a natural correlation, and potential margin offsets, between the two. The US Treasury curve is highly correlated with the LIBOR curve (swap spreads are a widely known and traded strategy), hence Treasury futures are also eligible for commingling.

While many of the risk characteristics of Interest Rate Futures and IRS are similar and correlated, it is expected that liquidity risk will vary across these products. Given the extensive volume, market depth, CLOB-based trading, and contract-standardization of Interest Rate Futures,[6] these products can be classified as highly liquid and are generally subject to one day close-out assumptions. Cleared IRS markets offer high liquidity but also highly flexible contract terms and, thus, are subject to at least five-day close-out assumptions (potentially more depending on portfolio size). CME Clearing's margin model for IRS considers liquidity add-ons on a per-currency basis. CME will extend its IRS margin framework and coverage standards (including any liquidity add-on feature) to commingled portfolios to account for disparity in liquidity risk. The margin calculation and liquidity add-on are described more fully in Section I,

[6] Globex volume for Interest Rate Futures is available at http://www.cmegroup.com/trading/interest-rates/.

and in the white paper on CME's IRS margin model, "Historical VaR Margin Methodology for Multi-Currency Interest Rate Swaps", a copy of which is enclosed as Exhibit D (marked for Confidential Treatment).

C. Execution Venues

Interest Rate Futures are executed on a DCM (CME and CBOT), in accordance with the DCM's rules. The primary method of execution for Interest Rate Futures is electronic through the CME Globex platform. Interest Rate Futures are also traded on the floor of the relevant Exchange, and can be privately negotiated and submitted for clearing in accordance with applicable CME and CBOT rules. At present, IRS are executed bilaterally and sent to CME Clearing through an affirmation platform. In the future, IRS may also be executed on one or more SEFs and submitted for clearing. The manner of execution for Interest Rate Futures and IRS will not be affected by CME's proposed commingling rules.

D. Liquidity

As noted in Section B, Interest Rate Futures are highly liquid. A presentation with detailed information regarding recent historical Eurodollar futures liquidity and Treasury futures liquidity (both for the quarterly roll and outright) is available at http://www.cmegroup.com/trading/interest-rates/files/interest-rate-futures-liquidity-report.pdf and relevant pages from the presentation are enclosed as Exhibit E.

As a general matter, CME Clearing closely examines the liquidity of any cleared-only product before offering it for clearing. This includes researching open interest and obtaining industry input on the viability of potential products to determine if sufficient liquidity exists for clearing. Interest rate swaps are used and traded extensively. They are used by nonfinancial firms in the management of the interest rate risk of their corporate debt. Likewise, financial firms use the swap market intensively to hedge the difference in the interest rate exposure of their assets and liabilities. The Bank for International Settlements ("BIS") measured the total notional outstanding of interest rate swaps as of June 2011 at approximately $441 trillion.[7] CME's IRS offering includes the most liquid interest rate swaps.

E. Availability of Reliable Prices for Interest Rate Futures and IRS

Prices for Interest Rate Futures are set based upon trading activity on the relevant Exchange (CME or CBOT), in accordance with the settlement procedures employed by each Exchange:

- *Eurodollar Futures:* Settlement prices in the front 12 quarterly Eurodollar contract months are based on Globex bid/ask activity between 13:59:00-14:00:00 Central Time. Settlement prices may be adjusted within the bid/ask range to accommodate calendar spreads and butterflies. Back-month contract months are settled by Exchange officials based on market participant input, taking into account a CME-conducted survey for the last five-year bundle and additional Eurodollar futures settlement guidelines.[8] The Serial contract months settle to the volume-

[7] The BIS survey is available at http://www.bis.org/statistics/otcder/dt07.pdf.
[8] For CME Eurodollar futures beyond the first 12 quarterly contract months, all other quarterly months settle based on the following back-month settlement guidelines.

1. Outright Orders (including both single months and strips)
2. Packs (Years 4-10 Blues through Coppers)
3. 3-month Calendar Spreads
4. 6-month Calendar Spreads
5. Pack vs. Pack Spreads
6. 12-month Calendar Spreads
7. Calendar Spreads Beyond 12 months
8. Butterfly Spreads (monthlies)
9. Bundles
10. Butterfly Strip Spreads

weighted average price of the prices on Globex between 13:59:00-14:00:00 Central Time or the midpoint of the bid/ask, with adjustments made to incorporate relevant spread activity.[9]

- *Treasury Futures*: Globex trades in the lead month between 13:59:30-14:00:00 Central Time are used to derive the volume-weighted average price. Back months are settled based on traded/quoted spread relationships.[10]

With respect to IRS, CME obtains pricing data from a number of third-party sources and derives prices based upon CME's internal settlement process. This process uses a blending algorithm to combine price data from multiple third-party sources and calculates the exponentially weighted price of the market activity in the last five minutes before the close. Further information regarding CME's IRS settlement procedures is enclosed as Exhibit F (marked for Confidential Treatment).

F. Financial, Operational and Managerial Standards for Clearing Members

To be permitted to commingle Interest Rate Futures and IRS in 4d(f) accounts, a firm must be a futures commission merchant ("FCM") and an IRS clearing member of CME, and it must be a clearing member of CME and/or CBOT in order to clear Interest Rate Futures. Each category of membership requires successful completion of the membership application process. CME Clearing conducts regular reviews of, and requires regular reporting from, existing clearing members to ensure applicable membership standards continue to be satisfied.

1. *Financial Standards*

FCM clearing members must satisfy minimum regulatory capital requirements under applicable law (including Commission regulations), in addition to the requirements imposed under CME and/or CBOT rules. Relevant rules include 901 (General Requirements and Obligations), 902 (Clearing Membership Assignment Requirements), 930 (Performance Bond Requirements: Account Holder Level), 970 (Financial Requirements), 971 (Segregation, Secured and Sequestered Requirements), 972 (Reductions in Capital), and 8G04 (IRS Clearing Member Obligations and Qualifications). These rules are available at http://www.cmegroup.com/rulebook/CME/index.html, and copies are enclosed as part of Exhibit G. Currently, under CME Rule 8G04, an IRS clearing member that is an FCM "must maintain minimum capital (as defined in CFTC Regulation 39.12(a)(2)) of $50 million." In addition, an IRS Clearing Member must maintain capital "at least equal to 20% of the aggregate performance bond requirement for its proprietary and customer IRS Contracts." Revised Rule 8G831 (Exhibit A) expands the term "IRS Contracts" to include Interest Rate Futures commingled with IRS in 4d(f) accounts.

2. *Operational and Managerial Standards*

In addition to complying with applicable Commission regulations and rules of the National Futures Association, FCM clearing members permitted to commingle Interest Rate Futures with IRS in 4d(f) accounts will be required to comply with CME Clearing's operational and risk-management rules and requirements for IRS and CME/CBOT clearing members. These include rules referenced above under Financial Standards, in addition to Rules 809 (Trade Data Processing System), 949 (Credit Controls), 950 (Supervision), 954 (Customer Complaints), 957 (Confirmations to Customers), 981 (Anti-Money Laundering and Economic Sanctions Compliance), 982 (Risk Management), 983 (Disaster Recover and Business Continuity), 8F009 (Customer Registration), 8F010 (Risk Management), and 8F015 (Trade Submission on CME ClearPort). These rules are available at http://www.cmegroup.com/rulebook/CME/index.html, and copies are enclosed as part of Exhibit G. Detailed clearing member operational and managerial requirements specific to the proposed Interest Rate Futures/IRS commingling program are set forth in Chapter 10 of the Manual (Exhibit B).

[9] *See also* CME Rule 813 (Settlement Price), available at http://www.cmegroup.com/rulebook/CME/index.html.
[10] *See also* CBOT Rule 813 (Settlement Price), available at http://www.cmegroup.com/rulebook/CBOT/index.html.

G. Systems and Procedures to Oversee Clearing Members' Risk Management of Commingled Customer Positions

To become a CME and/or IRS clearing member, a firm must demonstrate (among other things) sufficient risk-management capabilities. Clearing members permitted to commingle Interest Rate Futures and IRS in 4d(f) accounts will be subject to CME Rules 982 and 8F010, both of which address the subject of risk management:

CME Rule 982. RISK MANAGEMENT

All clearing members must have written risk management policies and procedures in place to ensure they are able to perform certain basic risk and operational functions at all times. At a minimum, the following areas must be considered in the firm's policies and procedures, depending on the firm's size and its business and product mix:

A. Trade Submission and Account Monitoring. Clearing members must have procedures in place to demonstrate compliance in the following areas for trades executed through both electronic platforms and open outcry:

1. Monitoring the credit risks of accepting trades, including give-up trades, of specific customers.
2. Monitoring the risks associated with proprietary trading.
3. Limiting the impact of significant market moves through the use of tools such as stress testing or position limits.
4. Maintaining the ability to monitor account activity on an intraday basis, including overnight.
5. Ensuring order entry systems include the ability to set automated credit controls or position limits or requiring a firm employee to enter orders.
6. Defining sources of liquidity for increased settlement obligations.

B. Additional and/or Alternative Requirements. Exchange or Clearing House staff may prescribe additional and/or alternative requirements in order for clearing members to comply with this Rule.
C. Each clearing member shall promptly provide to Clearing House staff, upon request, information and documents regarding its risk management policies, procedures and practices, including, without limitation, information and documents relating to the liquidity of its financial resources, settlement procedures and operational issues.

D. Each clearing member shall make information and documents regarding its risk management policies, procedures and practices available to the CFTC upon the CFTC's request.

CME Rule 8F010. RISK MANAGEMENT

OTC Clearing Members will be subject to risk management and monitoring practices by CME relating to transactions submitted to the Clearing House. OTC Clearing Members shall promptly provide all information requested by Clearing House staff, including, without limitation, information respecting risk, settlement, liquidity, and operational issues. OTC Clearing Members shall make information and documents regarding their risk management policies, procedures and practices available to the CFTC upon the CFTC's request.

In limited circumstances, the Clearing House may decline to accept certain OTC Derivatives trades or migration positions if the Clearing House determines in good faith that, based on the exercise of prudent risk management standards, the Clearing House should not accept the OTC Derivatives trades or migration positions. In the event that the Clearing House declines to accept certain OTC Derivative trades or migration positions, it shall incur no liability with respect to the trades and positions that are not accepted. It shall be the sole responsibility of the OTC Clearing Members who are parties to such trades or positions to take action as they deem necessary or proper for their own protection.

In addition, if the Clearing House determines in good faith that, based on the exercise of prudent risk management standards, that an OTC Clearing Member poses undue risk to the Clearing House based on its OTC Derivatives portfolio, the Clearing House may take any or all of the following actions with respect to such OTC Clearing Member: 1) impose an additional performance bond requirement; 2) prohibit the addition of any new OTC Derivative positions, or 3) require the reduction or unwinding of OTC Derivatives positions.

OTC Clearing Members shall permit on-site risk reviews in accordance with CME Rules and subject to reasonable standards of confidentiality. OTC Clearing Members will also be subject to on-going oversight by the Clearing House Risk Committee regarding their activities related to the CME Clearing House. All such inquiries shall be conducted in a manner consistent with oversight of CME Clearing Members and in accordance with reasonable standards of confidentiality

In connection with implementing these risk management rules, and in compliance with Commission Regulation 39.13(b),[11] CME Clearing has developed a risk-management framework, which includes procedures to monitor clearing member risk management. We believe this risk management framework will be equally effective with regard to oversight of risk management by clearing members permitted to commingle Interest Rate Futures and IRS in 4d(f) accounts. Furthermore, as explained in Section L, customer commingled Interest Rate Futures and IRS will be kept in CME's clearing system at the level of individually registered customer accounts. CME Clearing will stress test the commingled customer portfolios as required under Commission Regulation 39.13(h)(3).

As part of CME's risk management framework, CME Clearing risk management staff monitors clearing members throughout the day by measuring risk through the firm's exposures and profit/loss, using real-time market observations. Such daily monitoring includes the following components:

- Monitoring price moves of products in relation to current margin levels.
- Examining real-time profit/loss for each firm to detect large losses or large short options positions.
- Examining trading activity on the books of all clearing members, looking for large increases in positions, transfers and/or give-up activity that could trigger a significant margin call.
- Monitoring for extreme abnormalities in a firm's trading behavior and individual trade characteristics to identify potential erroneous trade entries (*e.g.*, "fat finger" trades).

CME Clearing assigns to each clearing member tolerance levels for intra-day and aggregate trading activity, based on the firm's capital, credit risk, trading history, and risk management capabilities and policies. Exceptions to a firm's tolerance levels are escalated to CME Clearing senior management to determine appropriate measures to be taken.

In addition to daily risk management procedures, CME Clearing conducts on-site reviews of clearing member firms approximately every one to two years, as appropriate under the circumstances particular to each firm. The reviews are conducted by CME Clearing risk management staff, including at least one member of senior management. CME Clearing evaluates standard measures of firm financial performance, such as liquidity, capital adequacy, asset quality, earnings/profitability, risk management, and any recent changes to the firm's business profile. CME Clearing also reviews the firm's risk models, reporting structures, and internal escalation procedures to ensure risk management processes are sufficiently thorough and properly maintained. This includes a review of the firm's risk management procedures for customer and proprietary exposures, its operational capabilities, and default management preparedness. Results of on-site reviews are presented to CME Clearing's senior management team, and may be the basis for corrective actions to the extent that potential weaknesses or other areas of concerns are identified.

H. CME Clearing's Financial Resources for Commingled Customer Positions

CME Clearing maintains three separate financial safeguards packages: one for IRS (the "IRS Waterfall"), one for cleared-only credit default swaps, and one for all other products cleared by CME Clearing, including but not limited to futures and options on futures. Each financial safeguards package is governed by and complies with Commission Regulation 39.11, which implements DCO core principle B (Financial Resources).

Interest Rate Futures and IRS in 4d(f) accounts will be covered by the IRS Waterfall. In accordance with CME Rules 8G07 (IRS Financial Safeguards and Guaranty Fund Deposit) and 8G802 (Protection of Clearing House) (available at http://www.cmegroup.com/rulebook/CME/index.html and enclosed as part

[11] Regulation 39.13(b) requires each DCO to "establish and maintain an appropriate risk management framework that, at a minimum, clearly identifies and documents the range of risks to which the [DCO] is exposed, addresses the monitoring and management of the entirety of those risks, and provides a mechanism for internal audit. The risk management framework shall be regularly reviewed and updated as necessary."

of Exhibit G), the IRS Waterfall is comprised of: (1) performance bonds (or margin) of the defaulting clearing member (and, under the Commission's LSOC regulations, of any customer that caused the clearing member's default);[12] (2) the guaranty fund contribution of the defaulting clearing member; (2) CME's capital contribution to the IRS Waterfall (currently set at $100 million); (3) the guaranty fund contributions of non-defaulting clearing members; and (4) CME's rights to assess non-defaulting clearing members to make additional contributions to the guaranty fund. As of March 30, 2012, the guaranty fund contributions for the IRS Waterfall on deposit with CME equaled $800 million, and the assessments portion of the IRS Waterfall amounted to $208 million.[13]

The IRS Waterfall is sized to cover simultaneous defaults by the four IRS clearing members creating the largest financial exposures to CME in extreme but plausible market conditions. The stress-testing methodology employed by CME Clearing for sizing the IRS Waterfall leverages a combination of extreme but plausible historical and synthetic scenarios, which are calibrated to cover 99.9% of seven-day profit/loss moves. Defaults by the two clearing members creating the first and second largest exposures are covered by the guaranty-fund portion of the IRS Waterfall; defaults by clearing members creating the third and fourth largest financial exposures are covered by CME Clearing's assessment powers (utilizing the assumption that no assessments will be forthcoming from any of the defaulting clearing members).

CME Clearing's coverage standards for the IRS Waterfall surpass the obligations set forth in Commission Regulation 39.11(a)(1), which requires each DCO to maintain financial resources sufficient to meet the DCO's financial obligations to its clearing members "notwithstanding the default by the clearing member creating the largest financial exposure for the [DCO] in extreme but plausible market conditions…." In addition, the coverage provided by CME's IRS Waterfall satisfies the standards articulated in Principle 4 (Credit Risk) of the CPSS-IOSCO *Principles for Financial Market Infrastructures*,[14] which requires central counterparties with a more-complex risk profile to maintain sufficient financial resources to cover "the default of the two participants and their affiliates that would potentially cause the largest aggregate credit exposure to the CCP in extreme but plausible market conditions."

I. Margin Methodology

Pursuant to revised Rule 8G831 (Exhibit A), Interest Rate Futures residing with IRS in 4d(f) accounts will be subject to the margin model developed by CME Clearing for IRS.[15] This model is based on a Historical Value at Risk (HVaR) methodology with Exponentially Weighted Moving Average (EWMA) volatility forecasting. Detailed information regarding CME's IRS margin model is contained in Exhibit D.

CME Clearing's margin model for IRS covers at least 99 percent of potential losses over any five-day period in a large universe of portfolios, covering 99 percent of market moves. HVaR was selected both for its scalability across multiple currencies and its transparency to market participants: it is a standard, well-understood model and is easily replicable. CME Clearing has enhanced the multi-currency HVaR model to address risks arising from rate risk and FX conversion risks. The model is designed to mitigate the rate risks created by additional currencies, correlated yield curves, and differing liquidity profiles. The model also takes into account FX conversion rates and their implication on collateral liquidation for multi-currency losses. In addition, the HVaR model provides margin offsets for multi-currency portfolios.

Liquidity risk is calculated separately for each cleared currency, calibrated as a function of the margin associated with each currency's exposure. The liquidity charge is a multiplier applied to the margin calculated for each currency, with each multiplier defined for a specific range of margin, to account for the

[12] *See* Commission Regulation 22.15 (Treatment of Cleared Swaps Collateral on an Individual Basis).
[13] Clearing member assessment are not on deposit with CME Clearing. Rather, clearing members are required to pay assessments to CME Clearing when circumstances warrant pursuant to Rule 8G802.B.5.
[14] Available at http://www.bis.org/publ/cpss101a.pdf.
[15] CME Clearing staff has discussed its HVaR model for IRS with Commission staff on numerous occasions in connection with its prior launch of IRS clearing services. We will be happy to provide any additional materials the Commission may request regarding the HVaR model in connection with this rule submission.

potential cost of liquidating positions that are sufficiently large to trigger a liquidity charge. The multipliers and margin ranges are defined by CME Clearing and are progressive in nature.

CME's margin methodology allows for certain "inter-product" margin offsets between commingled Interest Rate Futures and IRS, based on stable price relationships evidenced by statistical analysis. This aspect of the model provides sufficient reactivity and adequate margin coverage for a wide variety of portfolios, as shown through a five-year back-testing period. In accordance with Commission Regulation 39.13(g)(4), CME Clearing will continue to monitor the ability of its IRS margin methodology to provide sufficient coverage for commingled customer portfolios, and will adjust the model parameters or adapt the methodology used to calculate margins, as necessary and appropriate, to ensure adequate margin coverage. Additional information regarding portfolio margining for IRS and Interest Rate Futures is contained in Exhibit B.

J. CME Clearing's Default Management Abilities with Respect to Commingled Positions

CME is confident in its abilities to manage a potential default with respect to Interest Rate Futures commingled with IRS in 4d(f) accounts. Any default involving such commingled positions would be covered by CME's IRS Waterfall, as explained in Section H above. In accordance with the proposed amendments to Rule 8G831 (Exhibit A), such commingled positions will be subject to CME's default management procedures for IRS products. Those procedures are discussed in the following section.

K. Procedures for Clearing Member and Customer Defaults Involving Commingled Positions

A default by an IRS FCM clearing member may involve Interest Rate Futures and IRS in 4d(f) accounts to the extent that such accounts need to be ported to another clearing member, and/or the FCM's default may have been triggered by a default by one or more of its cleared swaps customers with a commingled account. Because they would reside in 4d(f) accounts, the customer commingled Interest Rate Futures and IRS (and collateral associated therewith) would be part of the customer "cleared swaps" account class under the Commission's Part 190 Bankruptcy Rules,[16] and would be treated in accordance with the Commission's Part 22 LSOC regulations,[17] which become effective on November 8, 2012.

Any default by an IRS clearing member – including a default involving customer commingled positions – would also be governed by CME's rules and default management procedures for IRS. This includes Rules 8G802 (Protection of Clearing House), 8G814 (Mitigation of Loss), and 8G975 (IRS Emergency Financial Conditions). In extreme circumstances (*e.g.*, where the monetary impact of a default exceeds the IRS Waterfall), Rule 8G28 (Wind Up of IRS Clearing Operations) may also be implicated. These rules are available at http://www.cmegroup.com/rulebook/CME/index.html, and copies are enclosed as part of Exhibit G. CME's default management procedures for IRS are enclosed as Exhibit H (marked for Confidential Treatment).

CME activated its rules and default management procedures in October 2010, when it launched IRS clearing. These rules and procedures are based on input from IRS clearing members and market participants and CME's depth of default management experience from many years as a derivatives clearing house. CME's default management rules and procedures are reviewed and updated as circumstances warrant. For example, when new types of IRS are listed for clearing (*e.g.*, IRS referencing non-USD interest rates), the procedures are revised to reflect new risks that may arise in connection with a default involving a multi-currency IRS portfolio. CME Clearing makes these updates in consultation with the IRS Risk Committee and the IRS Default Management Committee ("DMC").[18] The Risk Committee is comprised of people with diverse experience in IRS markets, including risk managers, buy-side and sell-side market participants, and independent committee members. The DMC – which advises on issues

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[16] 17 CFR § 190.01, *et seq.*
[17] 17 CFR § 22.1, *et seq.*
[18] *See* CME Rules 8G827 (IRS Risk Committee) and 8G25 (IRS Default Management Committee), available at http://www.cmegroup.com/rulebook/CME/index.html.

arising from a default of an IRS clearing member and manages the process of liquidation and/or transfer of the defaulter's portfolio – includes market participants with many years of relevant trading experience, under the direction of the president of CME Clearing.

A default by an IRS clearing member would immediately activate a subset of the DMC known as the Default Management Group ("DMG"), which would hedge the defaulting clearing member's portfolio to minimize risk. The hedging strategy would be dependent upon prevailing market conditions, with the goal of establishing a sufficiently risk-neutral portfolio to ensure a successful auction. Post hedging, the default portfolio would be auctioned among non-defaulting IRS clearing members, who are required to provide bids.[19] Default portfolios would be auctioned by currency, with only those IRS clearing members with open interest in each currency being required to bid on that particular currency subset.

A commingled portfolio of Interest Rate Futures and IRS (whether in a proprietary account or a customer account) reduces overall risk by taking two separate portfolios with directional risk and combining them into a commingled portfolio with less risk exposure. A commingled portfolio does, however, present certain different risks, such as convexity risk between Eurodollars and IRS, and swap spread risk between Treasury Futures and IRS. These risks will be monitored by CME Clearing, which would provide the DMC with information necessary for hedging purposes. The introduction of commingled portfolios also provides certain additional hedging and liquidation mechanisms. The most important additional liquidation mechanism for commingled portfolios is CME Globex, a source of significant liquidity and market depth (particularly with respect to short-dated yield curve risks). We believe Globex will be a cost- and time-efficient way of reducing the risk of a commingled portfolio in the event of default.

In a hypothetical scenario where the financial impact of an IRS clearing member default exceeded the size of the IRS Waterfall, CME would be entitled under Rule 8G28 to terminate all IRS contracts after a final mark-to-market cycle. If this were to occur, remaining commingled Interest Rate Futures of the defaulting clearing member would be liquidated and the mark-to-market gains of IRS participants would be haircut to make up for any shortfall. Commingled Interest Rate Futures of customers would remain in 4d(f) accounts until such time as the positions were liquidated or transferred to 4d(a) accounts at a non-defaulting clearing member.

L. <u>Arrangements for Obtaining Position Data for Interest Rate Futures and IRS in 4d(f) Accounts</u>

For IRS, positions are kept in CME's clearing system at the level of individually registered customer accounts. This is accomplished by requiring IRS clearing members to register their IRS customers with CME Clearing.[20] For each such customer, (i) a separate position account is created at the clearing level, and (ii) the clearing member specifies an account ID that is recorded when trades for that customer are submitted for clearing. Trades for which the customer account ID matches the registered value are posted to that customer's clearing-level position account. Interest Rate Futures will also flow into the relevant customer's clearing-level position account. Accordingly, CME Clearing will have daily position data at the individual customer level for IRS and Interest Rate Futures in 4d(f) accounts.

[19] In accordance with CME Rule 8G802.B.1 and CME's default management procedures, an IRS clearing member that fail to provide a bid, or submits a significantly off-market bid, would be penalized via the treatment of its guaranty fund contribution relative to other clearing members that comply with the requirement.
[20] *See* CME Rule 8F009 (Customer Registration), included as part of <u>Exhibit G</u>.

III. Conclusion

For the reasons stated above, CME respectfully requests that the Commission approve CME's rules to allow the commingling of customer positions in Interest Rate Futures, and any money, securities or property used to margin, guarantee or secure such positions, in 4d(f) accounts, and to allow margin offsets for such positions in accordance with CME Clearing's portfolio margining program.

CME certifies that the proposed rules comply with the Act and regulations promulgated thereunder. More specifically, the proposed commingling rules comport with: (1) DCO Core Principle G (Risk Management) and Regulation 39.13(g)(4) (Spread and Portfolio Margins), which provides, in pertinent part, that a DCO "may allow reductions in initial margin requirements for related positions if the price risks with respect to such positions are significantly and reliably correlated"; and (2) DCO Core Principle F (Treatment of Funds), and Regulation 39.15(b)(2) promulgated thereunder.

No substantive opposing views regarding the proposed commingling rules have been expressed to CME. CME certifies that this submission (without the exhibits that have been marked for Confidential Treatment) has been concurrently posted on its website at http://www.cmegroup.com/market-regulation/rule-filings.html.

Should you have any questions regarding this submission, please contact me at (312) 338-2483 or via e-mail at lisa.dunsky@cmegroup.com. Please reference our Submission No. 12-151 in any related correspondence

Sincerely,

Lisa Dunsky

Lisa A. Dunsky
Executive Director and Associate General Counsel

Enclosures

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