CME Group

Craig S. Donohue
Chief Executive Officer

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VIA ELECTRONIC MAIL

David Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
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Re: Financial Resources Requirements for Derivatives Clearing Organizations – 75 Fed. Reg. 63113 (Oct. 14, 2010), RIN 3038-AC98, 3038-AD02

Dear Mr. Stawick:

CME Group Inc. ("CME Group") appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("CFTC" or the "Commission") notice of proposed rulemaking ("NPR") concerning: (1) requirements in proposed Regulation 39.11 that each derivatives clearing organization ("DCO") must satisfy in order to comply with DCO Core Principle B (Financial Resources), as amended by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or "DFA"); and (2) substantially higher financial resources requirements in proposed Regulation 39.29 for DCOs deemed to be "systemically important" under Title VIII of Dodd-Frank. CME Group is the parent of Chicago Mercantile Exchange Inc. ("CME"). CME's clearing house division ("CME Clearing") offers clearing and settlement services for exchange-traded contracts, and for over-the-counter derivatives transactions through CME ClearPort. CME is registered with the CFTC as a DCO, and is one of the largest central counterparty clearing services in the world.

CME Group appreciates the importance to the broader financial system of a regulatory regime designed to ensure that every DCO can perform its role as a central counterparty, including performance of its financial obligations during periods of market stress. In that regard, the Commission's DCO core principles have functioned admirably and effectively over the years, including during the 2008 financial crisis. CME Group supports proposed regulatory amendments that enhance the Commission's existing core principle system, while (as noted in the NPR) "strik[ing] an appropriate balance between establishing general prudential standards and prescriptive requirements."[1]

We are extremely concerned, however, with the proposed approach to change the existing core-principle system by setting a lower financial-resources bar for non-systemically important DCOs, an approach we believe will exacerbate rather than ameliorate systemic risk. As further explained below, we urge the Commission to adopt regulations which subject all DCOs to the same substantive financial resources

[1] 75 Fed. Reg. 63113.

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requirements, and to subject systemically DCOs to more frequent stress testing and reporting requirements. We believe this approach is better designed to achieve Dodd-Franks' objectives of promoting robust risk management, promoting safety and soundness, reducing systemic risk and supporting the broader financial system.

A. <u>Regulation 39.11: Financial Resources Requirements for DCOs</u>

Since implementation of the Commodity Futures Modernization Act of 2000, DCOs have been required to comply with the group of core principles in Section 5b of the Commodity Exchange Act ("CEA"). As amended by Dodd-Frank, Core Principle B states as follows:

> (i) IN GENERAL.—Each [DCO] shall have adequate financial, operational, and managerial resources, as determined by the Commission, to discharge each responsibility of the [DCO].
>
> (ii) MINIMUM AMOUNT OF FINANCIAL RESOURCES.—
> Each [DCO] shall possess financial resources that, at a minimum, exceed the total amount that would—
>
> > (I) enable the [DCO] to meet its financial obligations to its members and participants notwithstanding a default by the member or participant creating the largest financial exposure for that [DCO] in extreme but plausible market conditions; and
> > (II) enable the [DCO] to cover the operating costs of the [DCO] for a period of 1 year (as calculated on a rolling basis).

Prior to passage of Dodd-Frank, the CFTC did not promulgate regulations concerning compliance with the core principles but instead issued guidance for DCOs. Dodd-Frank amended Section 5b(c)(2) of the CEA to provide that, "*Subject to any rule or regulation prescribed by the Commission*, a [DCO] shall have reasonable discretion in establishing the manner by which the [DCO] complies with" the core principles. (Emphasis added.) The CFTC relies on this amended language in proposing Regulation 39.11, which would require each DCO to: (a) satisfy the general financial requirements of Core Principle B (*i.e.,* maintain financial resources sufficient to cover its obligations in the event of a default by the member creating its largest financial exposure and its operating costs for 1 year); (b) have available specified types of financial resources to satisfy those financial requirements; (c) perform monthly stress tests to calculate the resources it needs to satisfy those financial requirements; (d) value its financial resources at least monthly, pursuant to prescribed standards; (e) maintain financial resources that are sufficiently liquid to fulfill its obligations as a central counterparty; and (f) report certain information to the CFTC regarding its financial resources and compliance with the Regulation.[2]

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[2] The NPR inquires as to whether the CFTC should adopt minimum capital requirements for DCOs. CME Group believes that the financial resources requirements contained in Core Principle B are better suited to achieve the goal of ensuring adequate capitalization of DCOs, and that further capital requirements would be unnecessary and essentially duplicative.

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1. Standards for Identifying a DCO's Largest Financial Exposure

Proposed Regulation 39.11(a)(1) provides that, for purposes of identifying the member that presents a DCO's largest financial exposure, "if a clearing member controls another clearing member or is under common control with another clearing member, the affiliated clearing members shall be deemed to be a single clearing member…." As an initial matter, we note that the term "affiliated clearing members" is subject to various interpretations and we suggest that the Commission adopt a definition of that term to avoid potential ambiguity.

The Commission requests comment on whether another approach may be warranted, noting that each affiliated clearing member may be "treated as a separate entity by the DCO, with separate capital requirements, separate guaranty fund obligations, and separate potential assessment liability."[3] This is, in fact, how affiliated clearing members are treated within CME Group. That is, although one clearing member may be affiliated with another, each is treated as a separate entity by CME Clearing, with separate capital and membership requirements, separate guaranty fund obligations and separate potential assessment liability. Furthermore, CME Clearing recently established a separate default fund for its cleared-only OTC interest rate swaps ("IRS"). Pursuant to CME rules, a non-defaulting IRS clearing member's deposit to the IRS guaranty fund may only be applied to mitigate any loss to CME Clearing attributable to IRS contracts and may not be applied to losses in any other product classes.[4] Additional separate guaranty funds may be used in the future in connection with other asset classes of cleared-only OTC products.

While we acknowledge that the default of one affiliate may impact the ability of another affiliated clearing member to meet its financial obligations to the DCO,[5] circumstances may exist in which a clearing member is sufficiently independent to continue operating notwithstanding a default by an affiliate. As one hypothetical example, a bank that is a self-clearing member for IRS contracts (a category of CME clearing membership that has higher capital requirements) may be sufficiently independent to continue operating if a futures-only, FCM affiliate were to default. Alternatively, an FCM/broker-dealer may continue operating notwithstanding a default by an affiliate with some form of self-clearing membership at a DCO. For these types of reasons, CME rules allow – but do not require – emergency action to be taken against a clearing member based upon the financial or operational condition of an affiliate (whether or not that affiliate is also a clearing member).[6] We urge the Commission to take a similar approach by revising the language

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[3] 75 Fed. Reg. at 63114.

[4] CME Rule 8G802.A.

[6] CME Rule 975 (Emergency Financial Conditions) states, in pertinent part:

> If the President of the Exchange or the President of the Clearing House determines that the financial or operational condition of a clearing member or one of its affiliates is such that to allow that clearing member to continue its operation would jeopardize the integrity of the Exchange, or negatively impacts the financial markets by introducing an unacceptable level of uncertainty, volatility or risk, whether or not the clearing member continues to meet the required minimum financial requirements, he may empanel the Chief Executive Officer, the President of the Exchange, Chairman of the Board, the Chairman of the Clearing House Risk Committee and the President of the Clearing House…. Such panel shall be duly authorized and, upon a unanimous vote of the panel, be empowered to order (a) an immediate position limitation, (b) an immediate suspension of the clearing member, (c) that all open trades of said clearing member be for liquidation only, (d) the liquidation or transfer of all or a portion of the open positions of the clearing member, (e) additional performance bond to be deposited with the Clearing House and/or (f) any other action necessary to protect the financial integrity of the Clearing House….

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of proposed Regulation 39(a)(1) to state that "if a clearing member controls another clearing member or is under common control with another clearing member, the affiliated clearing members *may* be deemed to be a single clearing member…."

2. Valuation of Assessment Powers

Under proposed Regulation 39.11(d), for purposes of determining available financial resources to cover a default by the member creating its largest financial exposure, a DCO would have to: (1) "apply a 30 percent haircut to the value of potential assessments"; and (2) "only count the value of assessments, after the haircut, to meet up to 20 percent of" the financial resources required to cover such default. The stated basis for a 30-percent haircut on the value of potential assessments is that

> … in the event of a default, the defaulting clearing member would not be able to pay its assessment and other clearing members might also be unable or unwilling to pay. Based on the significant percentage of total margin that may be attributable to a few of the largest clearing members, failure to pay assessments could approach the 30 percent level.[7]

This statement suggests that the proposed 30-percent haircut is based, in part, on the defaulter's inability to pay an assessment. As a matter of sound risk management practice and good form, in evaluating its reliance on assessment powers, a DCO should be required to completely exclude the potential defaulting firm's assessment liability in calculating its available assessment resources. Regarding a haircut to remaining assessment powers (*i.e.,* those attributable to non-defaulting clearing members), we note that Regulation 39.11(d) requires a DCO to have in place rules requiring that clearing members can meet an assessment within the time frame of a normal variation settlement cycle, and to "monitor, on a continual basis, the financial and operational capacity of its clearing members to meet potential assessments." In light of these regulatory requirements – and the fact that nonpayment of an assessment would result in the non-paying firm itself being in default to the DCO – we do not believe that a further haircut is necessary, and we are aware of no valid reason to cap the use of assessments at 20 percent as proposed.

3. Stress Testing Requirements

Proposed Regulation 39.11(c) would require each DCO to perform monthly stress tests to make a reasonable calculation of the financial resources required to cover: (1) a default by the member creating its largest financial exposure; and (2) its operating costs over a 12-month period.[8] The CFTC "requests comment on whether monthly tests are appropriate for purposes of calculating required financial resources."[9] Because operating costs are generally static, CME Group believes that annual stress testing

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[7] 75 Fed. Reg. at 63115-16.

[8] Proposed Regulation 39.11(c) would give each DCO "reasonable discretion in determining the methodology used to compute such requirements," with the Commission reserving the right to "review the methodology and require changes as appropriate." CME Group encourages the Commission to form a working group that includes derivatives clearing organizations from around the world to develop "best practices" for stress tests that adequately address extreme but plausible risks based on historical events and hypothetical scenarios.

[9] 75 Fed. Reg. at 63115.

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would suffice for operating costs. With regard to default coverage, we believe that stress testing should be done no less than monthly. As discussed below in Section B, for DCOs that are deemed systemically important, we strongly believe that more frequent requirements with respect to stress testing and reporting is the optimal approach to achieve the goals of Dodd-Frank rather than having substantively different financial requirements for different DCOs, an approach we believe will *increase* systemic risk and *undermine* Dodd-Frank.

4. Liquidity Requirements

Proposed Regulation 39.11(e) addresses liquidity requirements, and the pertinent portions of subsections 1 and 2 of thereof state as follows:

> (1) …. The financial resources allocated by the [DCO] to meet the requirements of paragraph (a)(1) of this section shall be sufficiently liquid to enable the [DCO] to fulfill its obligations as a central counterparty during a one-day settlement cycle. The [DCO] shall have sufficient capital in the form of cash to meet the average daily settlement variation pay per clearing member over the last fiscal quarter. If any portion of the remainder of the financial resources is not sufficiently liquid, the [DCO] may take into account a committed line of credit or similar facility for the purpose of meeting this requirement.
>
> (2) The financial resources allocated by the [DCO] to meet the requirements of paragraph (a)(2) of this section must include unencumbered, liquid financial assets (i.e., cash and/or highly liquid securities) equal to at least six months' operating costs. If any portion of such financial resources is not sufficiently liquid, the [DCO] may take into account a committed line of credit or similar facility for the purpose of meeting this requirement.

As used in proposed Regulation 39.11(e)(1), the phrase "average daily settlement variation pay per clearing member over the last fiscal quarter" is somewhat ambiguous. We assume that the Commission intends to refer to the average daily variation pay for a *single* clearing member (an amount which, for CME Clearing, would at present be in the tens of millions of dollars), and that the Commission does not intend to refer to the average daily settlement variation pay for *all* clearing members (an amount which, for CME Clearing, would at present be in the billions of dollars). In addition to being supported by logic, this assumption is supported by the statement in the NPR that, "[i]n the event of *a* clearing member defaulting on a payment to the DCO during the intra-day settlement cycle, the DCO would need access to liquid assets easily convertible to cash."[10] To address this potential ambiguity, we suggest that the Commission revise the cited language to reference "*the average daily settlement variation pay for a clearing member over the last fiscal quarter*."

The Commission seeks comment on whether the proposed liquidity requirement should cover more than a one-day settlement cycle. CME Group believes that, for these purposes, coverage for a one-day settlement cycle is sufficient. However, we do not agree with the portion of the calculation methodology set forth in the NPR stating that: "If the clearing member had a pay in its house account and a collect in its

[10] *Id.* at 63116 (emphasis added).

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customer account, the amount would be that of the house pay."[11] We suggest instead that, if the clearing member had a pay in its customer account and a collect in its house account, the amount should be the greater of (i) the customer pay minus the house collect, or (ii) zero. If the result in such case were zero, that day's variation settlement should not be included in the calculation.

Furthermore, proposed Regulation 39.11(e) appears to suggest that a DCO must have sufficient *cash* on hand to cover "the average daily settlement variation pay per clearing member over the last fiscal quarter," and may not rely on a liquidity facility to satisfy that aspect of its liquidity requirements. We do not believe this approach is warranted given the potential amount of cash at issue and the reliability of liquidity facilities for short-term cash needs. We suggest that the Commission revise the last sentence of Regulation 39.11(e)(1) to state as follows: "*If any portion of such financial resources is not sufficiently liquid, the derivatives clearing organization may take into account a committed line of credit or similar facility for purposes of meeting these requirements*."

The Commission requests comment on "what standards might be applicable to" a liquidity facility. "For example, should the Commission require that there be a diversified set of providers or that a line of credit have same-day drawing rights?"[12] As noted in the NPR, DCOs often use committed lines of credit to provide liquidity. CME Clearing, for example, has had a liquidity facility in place for nearly 20 years. The agreement that governs CME Clearing's liquidity facility is renegotiated annually, and the facility is subject to drills to ensure adequacy of performance by the providers. Documents relating to CME Clearing's liquidity facility are subject to review by CFTC staff during regular DCO audits, and as otherwise requested. CME Group believes that such reviews and evaluations by CFTC staff are a sufficient check on the adequacy and soundness of a committed line of credit, and that the Commission should not attempt to prescribe the terms and conditions of a DCO's liquidity facility.

B. <u>Regulation 39.29: Additional Requirements for Systemically Important DCOs</u>

Title VIII of Dodd-Frank tasks the Financial Stability Oversight Council (the "Council") with designating those "financial market utilities"[13] that it determines "are, or are likely to become, systemically important."[14] With respect to DCOs, Title VIII defines the term "systemically important" as "a situation where the failure or a disruption to the functioning of [the DCO] … could create, or increase, the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the financial system of the United States."[15] In determining whether a DCO is systemically important, Title VIII directs the Council to consider:

- the aggregate monetary value of transactions processed by the DCO;
- the aggregate exposure of the DCO to its counterparties/clearing members;

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[11] *Id.*
[12] *Id.* at 63116.

[13] Section 803(6) of DFA defines "financial market utility" as "any person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities or other financial transactions among financial institutions or between financial institutions and the person."

[14] Section 804(a)(1) of DFA.

[15] Section 803(9) of DFA.

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- the relationship, interdependencies or other interactions of the DCO with other financial market utilities;
- the effect that the failure of, or a disruption to, the DCO would have on critical markets, financial institutions or the broader financial system; and
- any other factors the Council deems appropriate.[16]

Title VIII further provides that the CFTC "may…prescribe regulations, in consultation with the Council and the Board of Governors [of the Federal Reserve System],containing risk management standards, taking into consideration relevant international standards and existing prudential requirements", governing a systemically important DCO's "operations related to payment, clearing and settlement activities."[17] The stated objectives and principles for such risk management standards are to (i) promote robust risk management, (ii) promote safety and soundness, (iii) reduce systemic risk, and (iv) support the broader financial system.[18]

The CFTC relies on Title VIII of Dodd-Frank in proposing Regulation 39.29, which would require a DCO that is deemed systemically important (a "SIDCO") to comply with substantially *different* and *higher* financial resources requirements than any DCO that the Council does not designate as systemically important. As proposed, Regulation 39.29 would: (1) require a SIDCO to maintain financial resources sufficient to meet its financial obligations notwithstanding a default by the *two* clearing members creating its largest financial exposures; (2) limit a SIDCO's use of assessment powers to cover financial resources requirements relating to a default by the clearing member creating its *second* largest financial exposure; and (c) for purposes of valuing its assessment powers, require a SIDCO to apply the same 30-percent haircut and 20-percent post-haircut cap on assessments as proposed for non-systemically important DCOs in Regulation 39.11(d). CME Group's views with respect to valuation of assessment powers are set forth in Section A.2 above and we incorporate them here by reference.

The CFTC requests comment on "the potential competitive effects of imposing higher standards on a subset of DCOs" that the Council deems to be systemically important.[19] Inherent in this request is the conclusion that a subset of DCOs will *not* be systemically important under the standards set forth in Title VIII. The NPR sheds no light on the basis for that conclusion, but we presume it arises, at least in part, from the fact that some DCOs (i) have lower aggregate exposures to their clearing members, and (ii) process transactions with a lower aggregate monetary value.

Significantly, setting a lower bar for non-systemically important DCOs with regard to financial resources requirements (and, presumably, for certain other DCO core principles, including Core Principle D regarding risk management) would allow those DCOs to offer lower guaranty fund and margin requirements. In addition to putting SIDCOs at an unfair competitive disadvantage, this approach would likely attract additional volume to at least some non-systemically important DCOs and transform them into *de facto* SIDCOs. However, until such time as they were designated SIDCOs by the Council and given

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[16] Section 804(b)(2) of DFA.

[17] Section 805(a)(2)(A) of DFA. We are unaware of any consultation between the CFTC, the Council and the Board of Governors in connection with the NPR, as Section 805 mandates.

[18] Section 805(b) of DFA.

[19] 75 Fed. Reg. at 63117.

sufficient time to come into compliance with the higher requirements for SIDCOs,[20] they would be operating under the lower and less costly standards for non-systemically important DCOs. This would contravene Title VIII's stated objectives of promoting robust risk management, promoting safety and soundness, reducing systemic risk and supporting the broader financial system.

CME Group therefore urges the Commission to subject all DCOs to the same substantive financial resources requirements.[21] We suggest that, rather than adopting Regulation 39.29 as proposed, the Commission should adopt a regulation that subjects SIDCOs to more frequent stress testing and reporting requirements than any DCOs the Council does not designate as systemically important. For example, a SIDCO might be required to conduct bi-monthly stress tests of its ability to cover its default obligations (rather than monthly stress testing, as proposed for all DCOs), and to submit to the Commission the reports required under proposed Regulation 39.11(f) on a monthly basis (rather than a quarterly basis, as proposed for all DCOs). This alternative approach comports with the Council's recent statement that systemically important financial market utilities should be "subject to enhanced examination, supervision, enforcement and reporting standards and requirements."[22]

C. <u>Implementation Period</u>

Finally, the Commission seeks comment on an appropriate effective date for the final regulations on Core Principle B, once adopted. The issues presented in the NPR are, to a degree, intertwined with the Commission's eventual regulations on protection of cleared swaps customers before and after commodity broker bankruptcies. As observed in the Advanced Notice of Proposed Rulemaking for those separate regulations, "the use of fellow-customer collateral [pursuant to the current model for protecting futures customer collateral] is included in existing DCO models for dealing with member defaults."[23] If the Commission were to adopt a new and different model for customer swaps segregation, the amount of financial resources DCOs are required to maintain may increase dramatically, particularly if the Commission were to adopt new Regulations 39.11 and 39.29 as currently proposed. With a number of critical elements changing simultaneously, it is difficult to predict with any certainty the amount of time DCOs may require to come into compliance with new financial resources requirements. CME Group's best estimate, given the current circumstances, is that an implementation period of no less than 180 days would be appropriate.

[20] "Under the provisions of the DFA, the Council generally must provide a financial market utility with advance notice that it proposes to make a determination, and the financial market utility has up to 30 days to request a hearing. The Council must schedule the hearing within 30 days of the request. After holding the hearing, the Council has up to 60 days to make a final determination." Advance Notice of Proposed Rulemaking Regarding Authority to Designate Financial Market Utilities as Systemically Important (footnotes omitted).

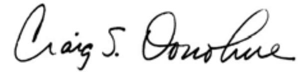
[21] As observed in footnote 1 of the NPR, CPSS and IOSCO are reviewing their recommendation that a central counterparty ("CCP") must maintain sufficient financial resources to withstand, at a minimum, a default by its single largest net debtor. We understand that recommendation may be revised to require a CCP to have sufficient financial resources to withstand defaults by: (i) its two largest net debtors, or (ii) defaults by the greater of the largest net debtor or the next two largest net debtors (or some combined standard that leads to more than one, but less than largest two). We suggest that any new recommendation adopted by CPSS and IOSCO would apply to *all* DCOs (including any DCO that is not deemed "systemically important" under Title VIII of Dodd-Frank).

[22] Advance Notice of Proposed Rulemaking Regarding Authority to Designate Financial Market Utilities as Systemically Important .

[23] 75 Fed. Reg. 75162, 75163 (Dec. 2, 2010).

CME Group thanks the Commission for the opportunity to comment on this matter. We would be happy to discuss any of these issues with Commission staff. If you have any comments or questions, please feel free to contact me at (312) 930-8275 or Craig.Donohue@cmegroup.com; or Lisa Dunsky, Director and Associate General Counsel, at (312) 338-2483 or Lisa.Dunsky@cmegroup.com.

Sincerely,



Craig S. Donohue

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