CME Group

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VIA ON-LINE SUBMISSION

March 21, 2011

David Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Risk Management Requirements for Derivatives Clearing Organizations –
76 Fed. Reg. 3698 (Jan. 20, 2011), RIN 3038-AC98

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") regarding regulations intended to establish standards for a derivatives clearing organization ("DCO") to comply with DCO Core Principles C (Participant and Product Eligibility), D (Risk Management), E (Settlement Procedures), F (Treatment of Funds), G (Default Rules and Procedures) and I (System Safeguards). The NPR also contains proposed regulations with respect to the application process for DCOs. 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 futures contracts, and for over-the-counter ("OTC") 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.

A. Overview

The NPR addresses the critically important topic of risk management practices at DCOs. Greater use of DCOs for OTC derivatives heightens the importance of ensuring that risk management at every DCO is robust and comprehensive. The unique risk characteristics of OTC derivatives products and markets underscore the importance of DCOs retaining reasonable discretion and flexibility to adapt risk management practices as products and markets develop over time.

Risk management is not an assembly-line type of process that can be commoditized, codified and deployed in such a way as to ensure that risk management regimes of DCOs remain prudent and agile. Indeed, very few aspects of risk management can be standardized across all cleared markets to such an extent that a rules-based regime can describe each potential condition that can arise and the necessary actions that can and should be taken to mitigate risk. CME Group is therefore very concerned that certain provisions in the proposed regulations would diminish CME Clearing's ability to effectively manage risk by requiring each DCO to employ the same rigid, standardized risk management procedures.

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Consistent with the CFTC's approach in a number of other rulemakings, regulations proposed in the NPR further the CFTC's retraction of the highly successful principles-based regime that has permitted U.S. futures markets to prosper as an engine of economic growth for this nation, to a restrictive, rules-based regime that will stifle growth, innovation and flexibility in risk management. As we have noted in comment letters in response to other proposals, the CFTC's proposed action in this regard is contrary to both the letter and spirit of the Commodity Exchange Act ("CEA"). In fact, not only did Congress preserve principles-based regulation in the Dodd-Frank Act ("DFA"), it reinforced the vitality of that regime by expanding the list of core principles applicable to DCOs. Although DFA granted the CFTC the authority to adopt regulations with respect to core principles, it did not direct the CFTC to eliminate principles-based regulation. Rather, DFA made clear that DCOs were granted reasonable discretion in establishing the manner in which they comply with the Core Principles.

Furthermore, certain of the proposed prescriptive regulations would impose significant costs not only on DCOs and their clearing members, but on the CFTC, with little or no corresponding regulatory benefit. In that regard, CME Group is very concerned that the CFTC has not performed the required cost/benefit analyses with respect to the rulemaking proposals in the NPR. Aside from certain information provided in connection with recordkeeping and reporting requirements, the "cost/benefit analysis" with regard to the regulations proposed in connection with the Core Principles consists of little more than the following two assertions: (1) "With respect to costs, the Commission has determined that the costs to market participants and the public if these regulations are not adopted are substantial"; and (2) "With respect to benefits, the Commission has determined that the benefits of the proposed rules are many and substantial."[1] In requiring the CFTC to consider costs and benefits of its proposed actions, Congress requires an actual and concrete estimate of costs of agency action.[2] The mere uncertainty of cost estimates does not excuse the CFTC from issuing such an estimate.[3]

The performance of actual and concrete cost/benefit analyses is particularly important for any regulator proposing to adopt regulations that would increase the costs of central clearing of OTC derivatives. Recommendation 12 (Efficiency) of the 2004 *CPSS-IOSCO Recommendations for Central Counterparties* (the "RCCP") directs that, "While maintaining safe and secure operations, CCPs should be *cost-effective in meeting requirements of participants.*" In May 2010, a Consultative Report issued by a CPSS/IOSCO Working Group presented guidance on applying the RCCP to CCPs clearing OTC derivatives. As stated in the CPSS/IOSCO Consultative Report:

> The clearing of OTC derivatives products through a well designed CCP offers an effective means to reduce risks in the OTC derivatives market. It is therefore important that CCP services should be provided in an efficient manner to ensure that market participants are incentivised to make use of CCPs for their OTC derivatives transactions.[4]

CME Group is a staunch supporter of robust and comprehensive risk management practices throughout the cleared derivatives markets. As further explained below, we are supportive of those aspects of the proposed regulations that seek to implement appropriate and cost-effective measures to build upon the

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[1] 76 Fed. Reg. 3698, 3717 (Jan. 20. 2011).
[2] See *Public Citizen v. Federal Motor Carrier Safety Admin.*, 374 F.3d 1209, 1221 (D.C. Cir. 2004). ("The agency's job is to exercise its expertise to make tough choices about which of the competing estimates is most plausible, and to hazard a guess as to which is correct, even if . . . the estimate will be imprecise").
[3] *Id.* ("Regulators by nature work under conditions of serious uncertainty, and regulation would be at an end if uncertainty alone were an excuse to ignore a congressional command to 'deal[] with' a particular regulatory issue").
[4] CPSS/IOSCO Consultative Report, at 22.

principles-based regime the CFTC has overseen in recent years and that performed admirably during the recent financial crisis. It is that regime that should be extended to the cleared swaps markets, and not an untested rules-based regime that, at least in part, appears to be based upon arbitrary assumptions and rigid concepts about how DCOs should manage risk.

B. Core Principle C: Participant and Product Eligibility

1. Participant Eligibility

The CFTC proposes to adopt Regulation 39.12 to establish criteria each DCO must satisfy in order to comply with Core Principle C, which addresses participant and product eligibility. CME Group supports the regulatory objective of participation requirements that are risk appropriate without being unnecessarily restrictive in order to promote fair and open access, We also commend the CFTC for highlighting in the NPR that "more widespread participation [by clearing member firms] could reduce the concentration of clearing member portfolios[,] diversify risk" and "increase competition."[5] Several of our recent comment letters similarly underscored the critical importance of a diversified, qualified and well-capitalized group of FCM clearing members, who play a central role in risk management and systemic-risk containment.[6]

We are concerned, however, that certain components of proposed Regulation 39.12 would impose arbitrary constraints on a DCO's ability to establish appropriate admission and continuing eligibility standards for its clearing members. The CFTC proposes, in Regulation 39.12(a)(2)(iii), to prohibit DCOs from setting "a minimum capital requirement of more than $50 million for any person that seeks to become a clearing member in order to clear swaps." The CFTC seeks comment "on whether establishing a capital threshold is an effective approach to promoting fair and open access…, whether the $50 million figure is an appropriate amount and, if not, what alternative might be appropriate."[7]

Capital requirements are one aspect of an overall package of requirements for clearing membership, which also includes operational and risk management capabilities, product expertise and, for OTC derivatives, specific default management capabilities and demonstrated access to necessary market liquidity. Although the proposed Regulation would permit a DCO to scale its risk tolerance to clearing members in proportion to their respective capital levels, this does not fully address concerns regarding clearing members' ability to fulfill their obligations to participate in auctions or allocations in the event of another clearing member's default. Recommendation 2 (Participation Requirements) in the RCCP provides that a CCP "should require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the CCP."

With respect to applying Recommendation 2 to OTC derivatives in particular, the CPSS/IOSCO Consultative Report states:

> ***If it cannot be reasonably ruled out that the relevant market for the cleared product becomes illiquid in times of stress, an OTC derivatives CCP may need to consider having participants sign up ex ante to bid in an auction of the defaulting participant's portfolio, and, in extremis (ie if the auction process fails), accept an allocation of the portfolio to surviving participants***. * * * Where

[5] 76 Fed. Reg. 3698, 3701 (Jan. 20, 2011).
[6] Letter from CME Group Inc. (Craig Donohue, Chief Executive Officer) to the CFTC (Jan. 18, 2011), at 3-4; Letter from CME Group Inc. (Craig Donohue, Chief Executive Officer) to the CFTC (Dec. 2, 2010), at 2.
[7] 76 Fed. Reg. at 3701.

> an OTC derivatives CCP uses procedures which introduce specific roles for its participants in the default procedures, it may need to consider if and to what extent additional participation requirements are necessary in order to ensure that the participants are able to perform their roles as expected….[8]

In certain cleared swap markets where portfolio size and associated risk may be significant, clearing members may require minimum capital in excess of $50 million in order to fulfill their obligations to take an active part in the DCO's default procedures. We expect that the amount of minimum capital (as well as operational and risk management capabilities) that a DCO will require from its OTC clearing members will evolve over time as cleared OTC markets evolve. It is therefore critical for each DCO to have reasonable discretion to determine appropriate capital requirements for its clearing members, based upon the DCO's analysis of the particular characteristics of the swaps that it clears and the DCO's participation requirements, including clearing members' obligations to take part in default proceedings. CME Group urges the CFTC to refrain from imposing a "one size fits all" cap on clearing member capital requirements, which may severely hamper a DCO's ability to comply with CPSS/IOSCO recommendations.

Pursuant to proposed Regulation 39.12(a)(2)(i), a clearing member's financial resources requirements could include the member's capital, a credit facility funding arrangement, or a guarantee from the member's parent company. The CFTC requests comment on whether credit facility funding arrangements and parent guarantees are "sufficiently reliable and liquid such that [each] should be considered as a resource that would be available to meet obligations arising from participation in a DCO in extreme but plausible market conditions."[9] We support the inclusion of parent guarantees and credit facility funding arrangements as acceptable financial resources for clearing members, provided that each DCO retains the flexibility to determine the particular terms and conditions of such arrangements that it may deem acceptable with respect to financial resources for its clearing member firms.

Proposed Regulation 39.12(a)(1)(iii) would preclude a DCO from excluding or limiting clearing membership "of certain types of market participants unless the [DCO] can demonstrate that the restriction is necessary to address credit risk or deficiencies in the participants' operational capabilities that would prevent them from fulfilling their obligations as clearing members." In addition to credit risk and deficiencies in operational capabilities, legal risk should be included in the text of this Regulation as a basis upon which a DCO may exclude or limit clearing membership of certain types of participants. This approach is consistent with new DCO Core Principle R (Legal Risk) and proposed Regulation 39.27, pursuant to which a DCO may determine, for example, that market participants in certain foreign jurisdictions may not become clearing members of the DCO.

2. Product Eligibility

As proposed, Regulation 39.12(b)(4)(ii) would require a DCO that clears swaps to adopt rules providing that, upon acceptance of a swap by the DCO for clearing, "the original swap is replaced by equal and opposite swaps *between clearing members and* the DCO." This provision appears to presume the use of a "principal" model for all cleared swaps, including those that an FCM clears on behalf of its customers. However, an FCM clearing customer business acts as an agent for undisclosed principals (*i.e.,* the FCM's customers) vis a vis CME Clearing and guarantees its customers' performance to CME Clearing. This is codified in CME Rule 8F005 (Substitution), which states that a clearing member is deemed the principal

[8] CPSS/IOSCO Consultative Report, at 17 (emphasis in original).
[9] 76 Fed. Reg. at 3701.

to a swap transaction executed *for its own account*, but is the guarantor and "agent when [the transaction is] executed by the clearing member for the account of an authorized customer of that Clearing Member." The Rule further provides that, once the transaction is accepted for clearing, there are "two equal and offsetting over-the-counter transactions as follows: one between the buyer and the Clearing House, as seller; and an equal and offsetting transaction between the Clearing House and the seller."

Use of the FCM-customer agency model is critical because it facilitates portability of customer positions, as well as customer segregation protections and favorable capital treatment for FCMs. It also facilitates operational simplicity and efficiency by avoiding the necessity of an FCM booking a string of back-to-back transactions between the FCM and the DCO, and the FCM and its customers. The agency model also improves systemic risk protection by providing bankruptcy protections and certainty to the DCO in the event of an FCM clearing member default. In order to preserve the agency model for customer cleared swaps, the CFTC should revise Regulation 39.12(b)(4)(ii) to provide that, upon acceptance of a swap for clearing, "the original swap is replaced by equal and opposite swaps *with* the DCO."

C. Core Principle D: Risk Management Requirements

1. General Requirements

The CFTC proposes to adopt Regulation 39.13 to establish criteria each DCO would be required to satisfy in order to comply with Core Principle D, which addresses risk management requirements. Proposed Regulation 39.13(b) would require the Board of Director's of a DCO to approve the written policies, procedures and controls that establish the DCO's risk management framework. This should be revised so that either the Board *or the DCO's Risk Management Committee* can make the requisite approvals. In addition to providing for a divisional approach to DCOs (as with CME Clearing, which is a division of CME and not a standalone corporation), this revision would be consistent with proposed Regulation 39.13(c), which requires the DCO's Chief Risk Officer to make "appropriate recommendations to the DCO's Risk Management Committee or Board of Directors, as applicable, regarding the DCO's risk management function."

2. Margin Requirements

a. "Normal Market Conditions"

Proposed Regulation 39.13(g)(1) would require a DCO's initial margin requirements to be "sufficient to cover potential exposures in normal market conditions." The CFTC has not defined the term "normal market conditions" but has observed that "international recommendations define 'normal market conditions' as 'price movements that produce changes in exposures that are expected to breach margin requirements or other risk control mechanisms only 1% of the time, that is, on average on only one trading day out of 100.'"[10] The CFTC seeks comment on whether it should include a definition of "normal market conditions" in the Regulation. Rather than codifying one meaning for the term "normal market conditions", the CFTC should give each DCO reasonable discretion to determine the manner in which it will define "normal market conditions" for the particular products it clears. Providing DCOs with such discretion is particularly important given the advent of OTC clearing and the unique risk characteristics of OTC derivatives products and markets.

[10] *Id.* at 3704.

b. Methodology and Coverage

Proposed Regulation 39.13(g)(2)(i) would require a DCO that clears CDS to address jump-to-default risk in setting initial margins. The CFTC identifies no other specific risks in the Regulation that a DCO must consider, given the fact that such risks would be product-specific and portfolio-specific. The CFTC seeks comment regarding whether other specific risks that should be identified and addressed in the Regulation. We agree with the CFTC's proposed approach and do not believe it would be beneficial to attempt to identify additional specific risks that a DCO must address in determining initial margins.

For purposes of calculating initial margin requirements, proposed Regulation 39.13(g)(2)(ii) would require a DCO to "use a liquidation time that is a minimum of five business days for cleared swaps that are not executed on a designated contract market [DCM]…and a liquidation time that is a minimum of one business day for all other products that it clears…." The CFTC notes that "[s]everal clearing organizations currently use a five-day liquidation time in determining margin requirements for certain cleared swaps",[11] and requests comment on whether the proposed minimum liquidation times are appropriate.

Rather than prescribing minimum liquidation times based upon execution venue (*i.e.,* DCM versus non-DCM), the CFTC should give each DCO reasonable discretion to determine liquidation times for the products it clears based on more salient factors such as observable liquidity, which may change over time. As stated in the CPSS/IOSCO Consultative Report, "appropriate liquidation time horizon may vary among products."[12] For some swaps, a liquidation time of five business days may be a dramatically conservative assumption, while for other swaps it may be insufficient. In cases where a five-day standard is overly conservative, the proposed Regulation would hinder market efficiency, and in cases where a five-day standard is insufficient, the proposed Regulation may facilitate a "race to the bottom" as a DCO that uses the five-day standard would be in compliance with the Regulation but would inject additive risk into the financial system. We therefore urge the CFTC to avoid codifying inflexible assumptions with respect to minimum liquidation times based solely on execution mechanism.

Proposed Regulation 39.13(g)(2)(iii) would require a DCO's margin models to meet a 99% confidence level for each product, spread, account held by the clearing member (by customer origin and house origin), and each swap portfolio by beneficial owner. The CFTC notes that "while some DCOs generally apply a 99% confidence level to some or all products that they clear, other DCOs apply a confidence level between 95% and 99% with respect to certain products."[13] The CFTC seeks comment "regarding whether a confidence level of 99% is appropriate with respect to all applicable products, spreads, accounts and swap portfolios." CME Group believes that the CFTC should not prescribe one specific confidence level for all products, spreads, account and swap portfolios cleared by DCOs, but should instead continue to give each DCOs discretion to determine the appropriate confidence levels based on particular characteristics of the products and portfolios it clears.

[11] *Id.*
[12] CPSS/IOSCO Consultative Report, at 15.
[13] 76 Fed. Reg. at 3704.

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c. Independent Validation

Under proposed Regulation 39.13(g)(3), a DCO's margin models would have to be "reviewed and validated by a qualified and independent party, on a regular basis." The CFTC would expect such reviews to be conducted "prior to implementation of a new margin model and when making any significant change to a model that is in use by the DCO."[14] The CFTC has not defined the term "qualified and independent party", and it requests comment as to whether a qualified and independent party must be a third party or whether, in certain circumstances, an employee of the DCO could be considered to be a qualified and independent party for purposes of the Regulation.

In appropriate circumstances, employees of a DCO should be permitted to conduct the required reviews. Such an approach would be consistent with the CPSS/IOSCO Consultative Report, which observes that a CCP's "margin methodology, and any material revisions, should be reviewed periodically by a qualified, *independent internal group* or third party…."[15] It would also be consistent with proposed Regulation 39.18(j)(2), which allows employees of a DCO to conduct the required testing of the DCO's business continuity and disaster recovery systems, provided that such employees are not the persons responsible for developing or operating the systems being tested.

d. Customer Margins

As proposed, Regulation 39.13(g)(8)(i) mandates collection of "initial margin on a gross basis for each clearing member's customer account equal to the sum of initial margin amounts that would be required by the DCO for each individual customer within that account if each individual customer were a clearing member", and prohibits a DCO from netting positions of different customers against one another. The absence of a cost/benefit analysis from the CFTC is particularly problematic with regard to this proposal, where costs would be high and potential benefits are questionable.

In proposing this Regulation, the CFTC ignores the fact that DCOs do not receive position-level information for each individual customer of their clearing members, particularly with respect to futures and options on futures. At CME Clearing, clearing firms utilize PCS (an automated system) to report data with respect to ending positions on an omnibus basis in each origin (*i.e,* house and customer). Any requirement for clearing firms to report to DCOs position-level data for each and every customer account would entail significant, costly and time-consuming changes to systems infrastructure at both the clearing firm level and the DCO level.[16] DCOs also would have to expend significant amounts to process the information received from FCMs in order to calculate margin requirements on hundreds of thousands of individual customer accounts on a daily basis. In addition, it is unclear how DCOs would be expected to treat customer omnibus accounts of non-clearing FCMs and foreign brokers (in which the clearing firm carrying the account generally does not know the individual customers within the omnibus account) under the proposed Regulation.

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[14] *Id.* at 3705.
[15] CPSS/IOSCO Consultative Report, at 5 (emphasis added).
[16] A significantly enhanced reporting system for FCMs to provide DCOs with position-level information for each customer account would also be required if the CFTC were to follow through with its proposal to amend proposed Regulation 39.19(c)(1)(iv) "to additionally require a DCO, for the customer origin, to report [to the CFTC] the gross positions of each beneficial owner." 76 Fed. Reg. at 3706.

Moreover, in accordance with existing rules and regulations, FCMs accept a wider variety of collateral from their customers than what CME Clearing and other DCOs accept from their clearing members. If FCM clearing members were required to pass through to DCOs essentially every dollar of margin they collect from their customers, FCMs would need to subject their customers to the more limited standards (and concentration limits) for DCO-acceptable collateral. In a cleared OTC environment with increased margin requirements, significant pressure already exists on the available collateral pool for customers to use in order to access important risk management benefits from cleared derivatives. The CFTC should not impose such additional and costly constraints on market participants in the absence of significant and demonstrable benefits.

CME Group strongly urges the CFTC to amend proposed Regulation 39.13(g)(8)(i) so that DCOs are not required to calculate and collect initial margin on a gross basis for each individual customer. DCOs should retain the flexibility to create margin regimes that are effective from a risk perspective and avoid imposing unnecessary costs on market participants. For example, today DCOs have the option to perform a version of gross margining that allows clearing firms to submit positions as spreadable for those accounts that have recognized calendar spreads or spreads between correlated products. This version of gross margining will sometimes lead to less than aggregate gross margins as a result of optimal spreading that occasionally occurs between accounts. Nevertheless, it approximates aggregate gross margins without imposing significant costs on the industry. Concerns relating to the collection of adequate margins at the clearing level are best addressed through back-testing and stress-testing requirements, which are set forth in proposed Regulations 39.13(g)(7) and 39.13(h)(3), respectively.

3. Other Risk-Control Mechanisms

a. Risk Limits

Proposed Regulation 39.13(h)(1)(i) would require each DCO to "impose risk limits on each clearing member, by customer and house origin, in order to prevent a clearing member from carrying positions for which the risk exposure exceeds a specified threshold relative to the clearing member's and/or the DCO's financial resources." The Regulation would give DCO's "reasonable discretion" to determine the method of computing risk exposure, applicable thresholds and applicable financial resources.

Risk limits are one part of an overall risk management program, and are imposed when a DCO determines they are warranted by the particular circumstances at hand. Requiring DCOs to impose risk limits for every clearing member, by customer and house origin, is overly prescriptive and unnecessary. Provided that a DCO collects adequate margin, and its stress-test results regarding the clearing member's exposures are acceptable, and it employs concentration margining (whereby the DCO sets a level of risk at which it would begin to charge higher margins based on indicative stress-test levels),[17]

[17] The CPSS/IOSCO Consultative Report emphasizes the importance of concentration risk and utilizing concentration margining in appropriate circumstances, particularly in connection with OTC derivatives products:

> ***An OTC derivatives CCP should continually monitor the risk associated with the concentration in participants' positions.*** Concentration risk can be addressed in a variety of ways. For example, ***a CCP might have limits on the degree of concentration that a participant may reach. It may also address the concentration risk through additional or escalating margin requirements or it may use other techniques***.

CPSS/IOSCO Consultative Report, at 14 (emphasis in original).

mandatory risk limits should not be imposed. We urge the CFTC to remove this provision from the proposed Regulation.

b. Portfolio Compression

Proposed Regulation 39.13(h)(4) would require each DCO to "offer multilateral portfolio compression exercises, on a regular basis, for its clearing members that clear swaps, to the extent that such exercises are appropriate for those swaps that it clears." Clearing members would be required "to participate in all such exercises, to the extent that any swap in the applicable portfolio is eligible for inclusion in the exercise, unless including the swap would be reasonably likely to significantly increase" the clearing member's risk exposure. We commend the CFTC for recognizing in its regulations the importance of portfolio compression exercises as an important risk management tool.

The CFTC seeks comment on whether portfolio compression exercises should be offered monthly, quarterly, or at some other interval, and whether the frequency of such exercises should vary for different categories of swaps. CME Group believes that each DCO is best positioned to determine the optimal frequency of portfolio compression exercises for the swaps that it clears, based on the unique characteristics of the particular products and markets, and we suggest that the CFTC refrain from prescribing the frequency of such exercises.

c. Clearing Member's Risk Management Policies and Procedures

Proposed Regulation 39.13(h)(5) would require each DCO to adopt rules to require clearing members to maintain written policies and procedures regarding risk management, and to "review the risk management policies, procedures, and practices of each of its clearing members on a periodic basis and document such reviews." The CFTC requests comment as to whether it should require DCOs to conduct risk reviews of clearing members on an annual basis or within some other time frame; whether it should require such reviews to be conducted in a particular manner (*e.g.*, mandatory on-site visits, particular tests required); and whether DCOs should be permitted to vary the method and depth of such reviews based on the nature, risk profiles, or other regulatory supervision of particular clearing members.

As the CFTC is aware, many firms are clearing members of multiple DCOs. If every DCO were required to conduct annual, on-site reviews of each of its clearing members, certain firms would likely have one or more DCOs on their premises conducting reviews at all times. Risk reviews generally entail, among other things, interviews of clearing member staff responsible for implementing the firm's risk management practices. Continual on-site risk reviews by DCOs could easily become overly burdensome and distracting for clearing member firms. We therefore urge the CFTC to give each DCO reasonable discretion to appropriately craft the frequency and manner in which it conducts risk reviews of its clearing members, taking into account various factors including other regulatory supervision of particular firms.

D. Core Principle E: Settlement Procedures

1. Intraday Settlements

The CFTC proposes to adopt Regulation 39.14 to establish criteria each DCO would be required to meet in order to comply with Core Principle E, which addresses settlement procedures. Proposed Regulation 39.14(b) would require each DCO to conduct settlements with each clearing member at least once each

business day, and would require each DCO to "have the authority and operational capacity to effect" intraday settlements. CME Group is a long-time proponent of robust mark-to-market practices, including intraday settlements, which are vital in order to ensure that accumulated debt obligations are removed from the system, and that a DCO holds sufficient collateral to protect against anticipated losses that clearing members and their customers may accumulate before the next settlement cycle. Each business day, CME Clearing performs two full settlement cycles, marking to the market once in the late morning (for futures) and once in the late afternoon. CME Clearing's mark-to-market settlement system stands in direct contrast to traditional settlement systems implemented by many other financial markets which are not centrally cleared, including OTC markets in which participants regularly assume credit exposure to each other.

The NPR does not mention the CFTC's advanced notice of proposed rulemaking ("ANPR") regarding potential "individual segregation" models for collateral posted by customers to secure swaps that are cleared by a DCO.[18] As explained in our comment letter regarding the ANPR, if the CFTC were to adopt the "Full Physical Segregation" model (in which each customer's cleared swaps account, and all property collateralizing that account, are kept separately for and on behalf of that customer at the FCM, at the DCO, and at each depository), a DCO's operational capacity to conduct intraday settlements would be severely hampered.[19] For this reason, and for the other reasons set forth in our comment letter in response to the ANPR, we urge the CFTC not to adopt a Full Physical Segregation model for customer cleared swaps.

2. Settlement Banks

As proposed, Regulation 39.14(c)(3) would require each DCO to "monitor the full range and concentration of its exposures to its own and its clearing members' settlement banks and assess its own and its clearing members potential losses and liquidity pressures in the event that the settlement bank with the largest share of settlement activity were to fail." The Regulation would further require each DCO to:

"(i) Maintain settlement accounts at *additional settlement banks*;
(ii) Approve *additional settlement banks* for use by its clearing members;
(iii) Impose *concentration limits* with respect to its own or its clearing members' settlement banks; *and/or*
(iv) Take any other appropriate actions, if any such actions are reasonably necessary in order to eliminate or strictly limit such exposures."

Several aspects of this Regulation are unclear. At the outset, the use of the phrase "and/*or*" (disjunctive), rather than the term "and" (conjunctive), to connect subparts (i)-(iv) suggests that a DCO is not required to comply with each subpart but has discretion to take appropriate actions it deems reasonably necessary to limit the exposures of the DCO and its clearing members in the event an approved settlement bank were to fail. We support this interpretation and request that the CFTC clarify this aspect of the proposed Regulation. Such clarification is particularly important given the CFTC's separate rulemaking proposal that would require each DCO to submit an annual compliance report detailing the manner in which the DCO complies with the core principles and CFTC regulations, and to certify *under penalty of law* that the compliance report is accurate and complete.[20]

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[18] 75 Fed. Reg. 75162 (Dec. 2, 2010).
[19] Letter from CME Group Inc. (Craig Donohue, Chief Executive Officer) to the CFTC (Jan. 18, 2011), at 10.
[20] 75 Fed. Reg. 77576 (Dec. 10, 2010).

It is also unclear what a DCO would have to do in order to comply with the requirement to have accounts at "additional settlement banks" and to approve "additional settlement banks" for use by its clearing members. At present, CME Clearing has six approved settlement banks that maintain accounts for multiple clearing members, and CME maintains settlement accounts at each such bank. The requirement to approve "additional settlement banks" (plural) seems to suggest that CME Clearing must approve, and maintain accounts with, at least two more settlement banks.

CME Group understands that it may be desirable, in theory, for clearing members to have relationships with multiple settlement banks. However, the number of banks that are qualified and willing to serve as settlement banks is limited, and many existing settlement banks have a limited appetite to take on additional clearing members as customers. Although CME Clearing would be happy to approve additional qualified settlement banks for clearing members, we do not believe the CFTC should *require* clearing members to have accounts at multiple settlement banks, which may prove to be an impossible (and/or extremely costly) requirement to satisfy.

The meaning of the term "concentration limits" as used in the proposed Regulation is also unclear. We believe it would be unwise to impose artificial limits on the number of clearing members or the size of clearing-member accounts at a particular settlement bank. As noted above, there is only a limited number of qualified settlement banks in the markets that DCOs serve.

E. Core Principle F: Treatment of Funds

1. Commingling of Customer Futures, Options on Futures and Swaps and Related Collateral

The CFTC proposes to adopt Regulation 39.15 to establish criteria each DCO would be required to satisfy in order to comply with Core Principle F, which addresses treatment of funds. Proposed Regulation 39.15(b)(2)(i) contains a dozen categories of information and analyses a DCO would be required to include in a rule submission before the DCO and its clearing members may be permitted to commingle customer positions in futures, options and swaps, and related collateral, in a customer "cleared swap account" subject to section 4d(f) of the CEA. Proposed Regulation 39.15(b)(2)(ii), on the other hand, contains the requirements for a DCO to obtain an order from the CFTC allowing the DCO and its clearing members to commingle customer futures, options on futures and swaps, and related collateral, in a customer "futures account" subject to section 4d(a).

In proposing Regulation 39.15(b)(2)(i)-(ii), the CFTC is exercising its authority to grant an exemption under section 4(c):

> In this regard, the DCO and its clearing members would be exempt from complying with the segregation requirements of section 4d(a) when holding customer segregated funds in a cleared swap account subject to section 4d(f) of the CEA, instead of a futures account; and similarly, the DCO and its clearing members would be exempt from complying with the segregation requirements of section 4d(f) when holding customer funds related to cleared swap positions in a futures account subject to section 4d(a) of the CEA, instead of a cleared swap account.[21]

[21] 76 Fed. Reg. at 3716.

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The CFTC seeks comment on whether the proposed Regulation satisfies the requirements for exemption under section 4(c). CME Group supports the CFTC's conclusion that, in appropriate circumstances, the commingling of customer positions in futures, options on futures and cleared swaps can achieve important benefits with respect to greater capital efficiency resulting from margin reductions for correlated positions.[22] Having positions in a single account can also enhance risk management practices and systemic risk containment by allowing the customer's portfolio to be handled in a coordinated fashion in a transfer or liquidation scenario. We therefore concur with the CFTC's conclusion that adoption of a regulation allowing such commingling to occur would be consistent with the "public interest", in accordance with section 4(c).

The CFTC requests comment as to "whether it should take the same approach (rule submission or petition for an order) with respect to the futures account and the cleared swap account and, if so, what that approach should be."[23] We believe it would be logical to apply the same methodology in both circumstances, and that a rule submission would be the most efficient and, thus, the optimal approach.

The CFTC also requests comment on whether the informational requirements enumerated in subparts (A) through (L) of proposed Regulation 39.15(b)(2)(i) "fully capture the relevant considerations for making a determination" as to whether commingling should be permitted.[24] As proposed, subpart (L) would require a DCO's submission to the CFTC to include: "A description of the arrangements for obtaining daily position data *from each beneficial owner* of futures, options on futures, and swaps in the account." DCOs generally do not obtain position-level data at the individual customer or beneficial-owner level, particularly with respect to futures and options on futures. We therefore urge the CFTC to revise subpart (L) of the proposed Regulation to require the DCO submission to include: "A description of the arrangements for obtaining daily position data with respect to futures, options on futures, and swaps in the account."

With this suggested revision, subparts (A) through (L) of proposed Regulation 39.15(b)(2)(i) would more than adequately cover the CFTC's informational needs. Furthermore, proposed Regulation 39.15(b)(2)(iii) would allow the CFTC to "request additional information" from a DCO in support of a rule submission or petition (as the case may be) seeking to commingle customer futures, options on futures, and cleared swaps in an account. This will allow the CFTC to obtain further information, as warranted, on a case-by-case basis. Nothing further is needed.

While the CFTC has not raised this issue, it is important to note that the ANPR regarding potential models for segregation of collateral posted by customers to secure swaps that are cleared by a DCO raises the specter of adopting a form of "individual segregation" for customer cleared swap accounts, while maintaining the existing futures segregation regime (or the "Baseline Model") for customer futures accounts. The concept of commingling customer futures and customer swaps in one account origin is seemingly inconsistent with – or, at a minimum, operationally problematic in light of – the notion of utilizing disparate segregation regimes for each type of customer account. As we did in our comment letter in response to the ANPR,[25] CME Group again urges the CFTC to utilize the Baseline Model for both categories of customer accounts.

2. Funds and Assets Accepted for Initial Margin

[22] *Id.*
[23] *Id.* at 3710.
[24] *Id.*
[25] Letter from CME Group Inc. (Craig Donohue, Chief Executive Officer) to the CFTC (Jan. 18, 2011).

As proposed, Regulation 39.15(c)(1) would prohibit DCOs from "accept[ing] letters of credit as initial margin." The purpose of letters of credit is to provide an absolute assurance of payment to a seller. So long as the documents presented comply with the terms of credit, and presentation has been duly made before expiration of the credit, the issuing bank must honor the demand even if the beneficiary (in this case, the DCO) had breached its duty to the applicant (in this case, the clearing member), and even if the applicant is unable to reimburse the bank for its payment. Letters of credit have proven to be an especially useful and flexible form of collateral for clearing members to post as collateral for late-day margin calls, and provide clearing members with important risk-management flexibility. We are unaware of any instances in the cleared derivatives industry in which the beneficiary of a letter of credit posted as collateral has sought to draw upon the letter of credit and has not been promptly paid by the issuing bank.

Furthermore, CME Clearing will only accept as collateral those letters of credit that comply with CME Clearing's specified terms and conditions (including payment within one hour of notification of a draw). In order to ensure that appropriate standards of creditworthiness are satisfied, CME Clearing will only accept letters of credit from issuing banks that it has reviewed and approved (which approval may be revoked at any time) and that meet its criteria for issuing banks. CME Clearing enforces these criteria through, among other things, periodic reviews of approved banks. CME Clearing also utilizes caps and concentration limits in connection with letters of credit as collateral. No reasoning has been provided to support a blanket prohibition against DCOs accepting letters of credit as initial margin, and we urge the CFTC to strike this prohibition from the Regulation.

Proposed Regulation 39.15(c)(4) would require a DCO to "apply appropriate limitations on the concentration of assets posted as initial margin, as necessary" and to "evaluate the appropriateness of any such concentration limits *on at least a monthly basis*." We do not believe the CFTC should prescribe the frequency of such reviews and we urge the CFTC to revise the proposed Regulation to require DCOs to "evaluate the appropriateness of any such concentration limits *on a regular basis.*"

F. <u>Core Principle G: Default Rules and Procedures</u>

1. <u>Default Procedures</u>

The CFTC proposes to adopt Regulation 39.16 to establish criteria each DCO must meet in order to comply with Core Principle G, which addresses default rules and procedures. Regulation 39.16(c)(2)(vi) would require DCOs to include in their rules "a provision that *proprietary margins posted by a defaulting clearing member* shall be applied in the event of a customer default, if the relevant customer margin is insufficient to cover the shortfall." The term "proprietary margins posted by a defaulting clearing member" is too narrow in scope. In the event of a clearing member default (whether originating in the customer origin or the house origin), a DCO would likely liquidate positions in the defaulting clearing member's house account. Following such liquidation, the DCO would apply excess funds – not proprietary margins – in the defaulting clearing member's house account to cure the default. Accordingly, Regulation 39.16(c)(2)(vi) should be revised to refer to "proprietary margins, positions and any other assets in the account of the defaulting clearing member."

2. <u>Clearing Member Insolvencies</u>

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As proposed, Regulation 39.16(d) would require DCOs, "upon receipt" of notice from a clearing member that it is the subject of a bankruptcy petition (or similar proceeding), to take various actions with respect to the clearing member, such as suspending its membership and liquidating or transferring positions. The requirement that DCOs perform these actions "upon receipt" of such notice ignores the fact that it is generally in the best interests of market participants for DCOs to initiate such actions *before* the clearing member is the subject of a bankruptcy petition.

For example, the SIPA liquidation proceeding of Lehman Brothers Inc. ("LBI") was filed on September 19, 2008, several days after LBI's parent company, Lehman Brothers Holdings, Inc. ("LBHI"), filed for bankruptcy on September 15, 2008. After LBHI's bankruptcy filing, but before initiation of LBI's SIPA proceedings, CME Clearing took various steps, in accordance with CME Rules and CFTC Regulations, to ensure that, among other things, positions and collateral of LBI's customers were transferred to other clearing members and LBI's house portfolio was liquidated. To preserve a DCO's right to take such appropriate steps *before* a clearing member files for or is placed into bankruptcy, the CFTC should amend proposed Regulation 39.16(d)(2)-(3) to require DCOs to take appropriate actions "*no later than* upon receipt" of notice that the clearing member is the subject of a bankruptcy petition or similar proceeding.

G. <u>Core Principle I: System Safeguards</u>

The CFTC proposes to adopt Regulation 39.18 to establish criteria that every DCO must satisfy in order to comply with Core Principle I, which addresses systems safeguards, including business continuity and disaster recovery ("BC-DR") programs. CME Group is a strong proponent, and acknowledges the importance, of a robust BC-DR program. CME Clearing has worked diligently to develop and continually improve its BC-DR systems, and we support efforts to enhance systems safeguards of DCOs to minimize market disruptions.

Proposed Regulation 39.18(h)(2) would require each DCO to provide the CFTC with "timely advance notice" of all "planned changes to the DCO's program of risk analysis and oversight." This is an extraordinarily broad requirement, and we urge the CFTC to consider a more measured and practical approach that appropriately considers context and relative risks. In addition, Regulation 39.18(k)(4) would require each DCO to ensure that its BC-DR program "takes into account the plans of its providers of essential services, including telecommunications, power, and water." While we obtain representations that our major vendors have disaster recovery plans, CME Clearing does not control, or generally have access to, the details of the proprietary plans of these service providers.

Proposed Regulation 39.30 would establish enhanced BC-DR program requirements for systemically important DCOs ("SIDCOs"). More specifically, proposed Regulation 39.30(a) would impose on SIDCOs a recovery time objective ("RTO") of 2 hours following any disruption (as compared to an RTO of the next business day for other DCOs). Moving to a 2-hour RTO would impose enormous costs on SIDCOs, and the CFTC has provided no cost/benefit analysis in connection with this aspect of the proposed Regulation.

The genesis of the proposed 2-hour RTO is the *Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial Markets* (the "Sound Practices Paper"), which was issued by the Federal Reserve, the SEC and the Office of the Comptroller of the Currency in the wake of the events of

September 11, 2001.[26] Significantly, the 2-hour RTO for core clearing organizations in the Sound Practices Paper is a *guideline*, not a statutory requirement. Furthermore, the Sound Practices Paper also contains a 4-hour RTO (again, as a *guideline*, not a statutory requirement) for banks and broker-dealers identified as firms that play a significant role in a critical financial market. These dual RTO guidelines of 2 and 4 hours underscore the fact that it makes little sense to determine the proper RTO for a core clearing organization without also considering the proper RTO for significant market participants. Additionally, the core clearing organizations and significant market participants were given a period of *years* to substantially implement, on a *voluntary* basis, the suggested RTOs and other guidelines in the Sound Practices Paper. We urge the CFTC to utilize the same approach here rather than codifying a 2-hour RTO for SIDCOs.

H. DCO Registration

The CFTC proposes new requirements for DCO registration, ostensibly "to achieve greater efficiency for both applicants and" the CFTC and to "streamline the DCO registration process."[27] These proposed requirements include Form DCO, a two-part submission consisting of (i) a five-page questionnaire designed to elicit basic information about the applicant, and (ii) a series of accompanying exhibits to demonstrate the applicant's compliance with DCO core principles. The CFTC requests comment on the proposed content of Form DCO and the exhibits thereto.

CME Group believes that certain information a DCO applicant would be required to furnish in connection with proposed Form DCO is overly burdensome and unnecessary, and that if implemented as proposed, Form DCO will decrease rather than increase the efficiency of the registration process for both applicants and the CFTC. We note that Form DCO would require the applicant to create and submit to the CTFC approximately 100 documents, including 44 separate numbered exhibits and various documents within the exhibits. We question whether CFTC staff will be able to meaningfully review all of these materials within the six-month timeframe contemplated in the proposed regulations.

Moreover, we seriously question the need for certain documentation and information a DCO applicant would be required to submit. For example:

- The applicant would be required to identify and list all outside service providers and consultants, including accountants and legal counsel. It is unclear what, if any, benefits the CFTC would gain from this information.

- Exhibit A-1 would require the applicant to produce a chart demonstrating in detail how its rules, procedures and policies address each DCO core principle. However, Form DCO effectively replaces the need for the chart as the completed Form and various exhibits thereto contain all of the information that would be set forth in the chart.

- Exhibit A-6 would require the applicant to provide the CFTC with the telephone numbers, mobile phone numbers and e-mail addresses of all officers, managers and directors of the DCO. The CFTC has not explained why such information is necessary or how the CFTC would utilize it.

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[26] 68 Fed. Reg. 17812 (Apr. 11, 2003).
[27] 76 Fed. Reg. at 3699, 3700.

- Exhibit A-7 would require the applicant to list all jurisdictions where the DCO *and its affiliates* are doing business and any registration status of the DCO *and its affiliates*. The CFTC offers no explanation as to why it needs such information with respect to affiliates of the applicant.

- Exhibit B-3 would require the applicant to provide proof that each of its physical locations meets all building and fire code and has running water and HVAC. The CFTC's need for this level of information is questionable, at best, and it is unclear the manner in which an applicant would be able to prove these facts.

- Exhibit B-3 would require the applicant to prove it has adequate office technology, including fax machines. The CFTC seems to be unnecessarily codifying technology requirements which, in the not-too-distant future, may become obsolete.

- Exhibits C and C-2 would require an applicant to provide a list of current *and prospective* clearing members, and to forecast expected volumes and open interest at launch date, and six months and one year thereafter. We struggle to understand the value in requiring a DCO applicant to furnish such speculative information.

- Exhibit D would require an applicant not only to describe its margin methodology, but to explain why that methodology was chosen over other potential methodologies and to include a comparison of margin levels that would have been generated by using other potential methodologies. The CFTC offers no analysis of any potential benefits to be gained from requiring applicants to fulfill such incredibly burdensome requirements in order to obtain DCO status.

Furthermore, a DCO applicant would be required to represent that its Form DCO submission is true, correct and complete. The CFTC should modify this language so that the applicant is required to certify that, to the best of its knowledge, its Form DCO submission is true, correct and complete in all material respects. Similarly, the CFTC proposes to require an existing DCO, when amending its registration status, to file a new application containing a representation that all information previously submitted by the DCO is true, correct and complete. This requirement overlooks the fact that the CFTC will be requiring DCOs to report an enormous amount of information to the CFTC with respect to virtually every aspect of the DCO's business on an ongoing basis. The CFTC will therefore know which information in a DCO's initial application has changed, and it should refrain from imposing duplicative and unnecessary requirements on its registrants.

I. <u>Effective Dates</u>

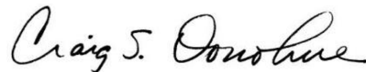
The CFTC proposes to make Regulations 39.12 through 39.16 and 39.18 effective 180 days from the date on which the final regulations are published in the Federal Register. The CFTC "believes that a period of 180 days would give DCOs adequate time to implement any additional technology and enhanced procedures that may be necessary to fulfill the proposed requirements related to participant and product eligibility, risk management, settlement procedures, treatment of funds, default rules and procedures, and system safeguards (insofar as they would apply to all DCOs)."[28] We respectfully disagree.

[28] *Id.* at 3715.

If the CFTC issues final regulations that require DCOs to calculate, collect and/or report margins on a gross basis for every customer account of every clearing member, various new systems will have to be created throughout the industry. This, by itself, would require substantially more than 180 days to implement. In order to comply with the myriad other new requirements in the proposed regulations, DCOs would have to engage in a tremendous amount of work, including but not limited to: (a) amending their existing rules and/or adopting new rules (in a system where self-certification of DCO rules may no longer be allowed); (b) adjusting margin models to meet the prescriptive standards set forth in the regulations; (c) ensuring that any letters of credit currently accepted as initial margin are replaced by other forms of collateral; (d) finding, approving and opening accounts with "additional settlement banks"; (e) if the DCO is systemically important, taking all of the steps necessary to comply with enhanced BC-DR requirements; and (f) taking actions necessary to come into compliance with the CFTC's numerous other new DCO regulations. It is neither realistic nor prudent to expect DCOs to accomplish all of these tasks in a six-month time frame (or the one-year time frame for SIDCOs to comply with proposed Regulation 39.30). If these overly prescriptive regulations are adopted as proposed, a more realistic implementation period would be no less than 24 months.

CME Group thanks the CFTC for the opportunity to comment on this matter. We would be happy to discuss any of these issues with CFTC 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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