VIA E-MAIL

October 22, 2012

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, DC 20219
regs.comments@occ.treas.gov

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
regs.comments@federalreserve.gov

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
comments@FDIC.gov


Ladies and Gentlemen:

CME Group Inc. ("CME Group"), on behalf of the Chicago Mercantile Exchange Inc. ("CME Inc."), clearing house division ("CME Clearing" or "CME") appreciates the opportunity to comment on the proposed regulatory capital rules that the Office of the Comptroller of the Currency ("OCC"), Board of Governors of the Federal Reserve System ("Board"), and Federal Deposit Insurance Corporation ("FDIC") (collectively, the "Agencies") published in several notices of proposed rulemakings ("NPRs") in the Federal Register on August 30, 2012. CME is among the largest central counterparty ("CCP") clearing services in the world. CME provides clearing and settlement services for exchange-traded contracts as well as for over-the-counter ("OTC") derivatives.¹ In 2011, CME processed and cleared approximately 3.4

¹ CME’s parent company (CME Group Inc.) operates four separate exchanges, including CME, the Board of Trade of the City of Chicago, Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX"), and the Commodity Exchange, Inc. ("COMEX") (collectively, the "CME Group Exchanges"). The CME Group Exchanges offer a wide range of benchmark products across all...
 billion contracts, averaging 13.4 million contracts per day. In its capacity as a CCP, CME is registered with the Commodity Futures Trading Commission ("CFTC") as a derivatives clearing organization ("DCO") and also has status as a Financial Services Authority Recognized Overseas Clearing House.

On July 18, 2012, the Financial Stability Oversight Council designated CME Inc. as a systemically important financial market utility ("designated FMU") under Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). Provisions within section 805 of the Dodd-Frank Act, enacted by the Board through Regulation HH Designated Financial Market Utilities ("Regulation HH"), require the Board to promulgate risk management standards for designated FMUs. Regulation HH grants authority to the CFTC to act as CME’s designated Supervisory Agency and prescribe regulations that integrate the CPSS-IOSCO Principles for Financial Market Infrastructures ("PFMIs") and existing prudential requirements when designing risk management standards. To recognize the systemic protections and robustness of designated FMUs who adhere to the PFMIs ("Qualified CCP" or "QCCP"), the NPRs invite capital incentives for exposures to a Qualified CCP relative to a non-Qualified CCP.

This response focuses on certain elements of the proposed capital framework that stand to motivate and influence the expansion of central counterparty clearing for derivatives. Bank capitalization requirements are a critical and fundamental element of the overall financial regulatory system. Consequently, the decisions of the Agencies concerning the capitalization framework will have a material impact on the evolution of central clearing. We believe it is particularly important that CME and other CCPs provide meaningful feedback to the Agencies at a time when crucial decisions over the future of financial regulation are being formulated.

CME recognizes the Agencies have largely adopted international capital standards proposed by Basel Committee on Banking Supervision ("BCBS"). CME actively participated in each consultative process administered by the BCBS related to Capital requirements for bank exposures to central counterparties. Within our responses we advocated for a framework that assures greater transparency, safety and efficiency in the global financial markets and encourages greater utilization of CCPs by market participants. However, we also raised several fundamental concerns related to the capitalization of exposures to CCPs that we believe will critically influence the migration towards central clearing.

To efficiently implement the objectives stated by the G20 and installment provisions of the Dodd-Frank Act and the European Market Infrastructure Regulation ("EMIR"), CME and important market participants across key jurisdictions agree that certain aspects of the proposed capital framework may require further refinement to properly reflect the risk management benefits of CCP clearing.

Provided below are targeted responses to certain inquiries and recommendations of the NPRs. With acknowledgement to footnote 42 of the Standardized Approach NPR, our comments reflect the expected inclusion of provisions stated in BCBS227 ("BCBS interim framework").

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2. See footnote 42 of the Standardized Approach NPR.

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I. Capitalization of Bank Exposures to Central Counterparties

Question 12 of the Standardized Approach NPR and Question 5 of Advanced Approaches and Market Risk NPR request comment on whether the proposal provides an appropriately risk sensitive treatment of (1) a transaction between a banking organization that is a clearing member and its client and (2) a clearing member's guarantee of its client's transaction with a CCP treating these exposures as OTC derivative contracts.

The Agencies also request comment on whether the adjustment of exposure amount would address possible disincentives for banking organizations that are clearing members to facilitate the clearing of their clients' transactions. What other approaches should the Agencies consider?

Recommendation #1: To acknowledge certain practices and efficiencies afforded by central clearing, we support the recognition of shorter close-out periods for cleared transactions. We further encourage the Agencies to recognize varying close-out period conventions for specific cleared products that are commensurate with the risks, liquidity profiles, applicable close-out periods and further characteristics of these products as accredited within the CPSS-IOSCO Principles for Financial Market Infrastructures.

CME agrees that the final rules should incorporate shorter close-out periods for certain cleared and cleared-only derivative transactions relative to un-cleared bilateral transactions. To provide greater harmonization among various regulatory standards applicable to CCP clearing, we further recommend the Agencies utilize close-out period assumptions commensurate with the risks, liquidity and transparency, market composition and concentration characteristics of products that already exist in a cleared environment, relative to products recently introduced to centralized clearing. CME believes the BCBS interim framework's blanket assignment of a 5-day margin period of risk ("MPOR") for all cleared transactions lacks appropriate consideration for exchange traded derivatives and certain products that exemplify analogous features ("ETDs"), for instance, that exist in a central limit order book environment with substantial transaction volumes, with

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3 The NPRs make multiple references to banking organizations as clearing members. To date, CME has not accepted U.S. insured depository institutions as clearing members due to certain issues arising from the Federal Deposit Insurance Corporation's receivership and conservatorship procedures. Specifically, we understand that all counterparties of a bank—including any CCP that has accepted the bank as a clearing member—are subject to a one-business day stay in insolvency. We recommend an exception to this stay for CCPs. This would be consistent with the exception for clearing organizations in the Orderly Liquidation Authority provisions of Dodd-Frank Act, which states:

... if the receiver fails to satisfy any such margin, collateral, or settlement obligations under the rules of the clearing organization, the clearing organization shall have the immediate right to exercise, and shall not be stayed from exercising, all of its rights and remedies under its rules and applicable law with respect to any qualified financial contract of the covered financial company, including, without limitation, the right to liquidate all positions and collateral of such covered financial company under the company's qualified financial contracts, and suspend or cease to act for such covered financial company, all in accordance with the rules of the clearing organization.

§ 210(c)(8)(G). We also note that the Committee on Payment and Settlement Systems ("CPSS") and Technical Committee of the International Organization of Securities Commissions ("IOSCO") April 2012 Principles for Financial Market Infrastructures ("PFMIs") provide that a Financial Market Infrastructure ("FMI") (a term that includes CCPs) "should have a high degree of certainty that [actions taken under its default rules] will not be voided, reversed, or subject to stays, including with respect to resolution regimes applicable to its participants. Ambiguity about the enforceability of procedures could delay and possibly prevent an FMI from taking actions to fulfill its obligations to non-defaulting participants or to minimize its potential losses." See paragraph 3.1.9 (emphasis added).
I. Capitalization of Bank Exposures to Central Counterparties, cont.

commensurate historical price and liquidity characteristics that demonstrate a shorter close-out period is appropriate.

For instance, the evaluation of the market depth and product turnover draws further distinction between ETDs and over-the-counter ("OTC") derivatives. A TABB Group study\(^4\) performed in 2010 indicated that ETDs turned over almost 10 times more frequently than OTC derivatives over the course of a year, with OTC derivative notional values turning over 2.7 times per year whereas ETDs notional values turned over 25 times per year. In addition to the higher notional turnover demonstrated by the ETD market, the study further notes transaction volumes of 3 billion in the ETD market versus 16 million in the OTC market.

Moreover, the clearing for ETDs is characterized as "positional" in nature as compared to the "transactional" nature of clearing for OTC derivatives. Positional-based clearing provides natural and automatic compression for long and short positions of the same contract that are novated into a single open position whereas transactional-based clearing maintains each open trade as an individual gross position. Although compression is available for some market participants in the OTC cleared environment, it remains a highly specialized and at times manual process that may challenge the efficiency for porting and liquidation. Therefore, the more compressed nature of ETDs provides greater efficiency, transparency and access to price and volume information in liquidation scenarios due to the breadth of the central limit order book. This further motivates and allows access to a broader group of market participants to partake in auctions whereby they can efficiently manage or liquidate the resulting exposure. As of 2010 the Tabb Group study estimates the number of market participants in the ETD market to be 5 million as compared to 30,000 in the OTC market.

Further, broad market participation within the ETD market further demonstrates efficient management of positions in both stressed and default scenarios. CME has encountered several scenarios in which large central limit order book product portfolios were liquidated in less than one day at a cost within margin requirement. For example, following the bankruptcy of Lehman Brothers Inc. in 2008, CME took control of Lehman's positions and conducted an auction that was completed the same day with a liquidation value well within the portfolios' $2.3 billion USD margin requirement.

CME maintains extensive historical price data that further demonstrates the adequacy of data in establishing margin levels and the appropriate exposure period to capture. For instance, we maintain price data for some of the most liquid exchange traded products dating back to 1982 for the first S&P 500 index contract, 1981 for Eurodollar futures, and 1977 for the first Treasury bond futures contract. With regard to daily volume, CME's Eurodollar, S&P and Treasury contracts combine for an average daily volume of approximately 7 million contracts in 2012, accounting for approximately 60% of CME's total average daily volume.\(^5\)

\(^4\) A TABB Group Study: The Global Risk Transfer Marker: Developments in OTC and Exchange-Traded Derivatives, November 2010

\(^5\) CME Group data October 19, 2012 YTD
I. Capitalization of Bank Exposures to Central Counterparties, cont.

With consideration to the above arguments, we recommend the Agencies provide greater consideration to the distinct characteristics of ETDs in establishing the appropriate MPOR and agree that for cleared swaps that aforementioned certain liquidity characteristics of ETDs a 5-day MPOR is appropriate.

In addition to demonstrable characteristics evidencing shorter close-out periods for ETDs, we call further attention to international guidance issued by CPSS-IOSCO and adopted by the Fed through Regulation HH with regard to designated FMU’s adherence to the PFMI’s. Consistent with key considerations detailed in Principle 6: Margin of the PFMI’s, CME prescribes initial margin requirements that are, along with additional risk-based considerations, commensurate with the risk, liquidity, and close-out periods applicable to the variety of products and asset classes transacted on our exchanges. As described in Principle 6: Margin Requirements 3.6.3 “… OTC derivatives require more-conservative margin models because of their complexity and the greater uncertainty of the reliability of price quotes. Furthermore, the appropriate close-out period may vary among products and markets depending upon the product’s liquidity, price and other characteristics.”

Further consistent with Principle 6: Margin Close-out period 3.6.7, in establishing initial margin requirements, CME provides extensive consideration to historical price and liquidity data that are further stressed and meticulously back-tested to ensure the appropriate exposure period is adopted. Proper appreciation for certain products that demonstrably adhere to the PFMI’s and demonstrate a risk profile that does not require a 5-day MPOR would ensure that capital disincentives aren’t introduced that undermine the efforts and sensible conclusions of other broad-based regulatory efforts (not least the Dodd-Frank Act and EMIR). As currently proposed, the capital framework appears inconsistent with various frameworks governing margin requirements for cleared exchanged-traded derivatives and therefore invites disproportionate capital requirements that are in conflict with clearing incentives.

The Agencies may attach confidence in the applied methodologies through a CCP’s adherence to the PFMI that, among other considerations, prescribe stringent confidence intervals, exposure coverage, back-testing analysis and independent model validations for margin models. CME notes that adherence to such principles, in addition to other PFMI’s, is necessary to be considered a Qualified CCP, a designation we aspire to achieve.

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7 PFMI Principle 6: 3.6.7. Close-out period. A CCP should select an appropriate close-out period for each product that it clears and document the close-out periods and related analysis for each product type. A CCP should base its determination of the close-out periods for its initial margin model upon historical price and liquidity data, as well as reasonably foreseeable events in a default scenario. The close-out period should account for the impact of a participant’s default on prevailing market conditions. Inferences about the potential impact of a default on the close-out period should be based on historical adverse events in the product cleared, such as significant reductions in trading or other market dislocations. The close-out period should be based on anticipated close-out times in stressed market conditions but may also take into account a CCP’s ability to hedge effectively the defaulter’s portfolio. Further, close-out periods should be set on a product-specific basis because less-liquid products might require significantly longer close-out periods. A CCP should also consider and address position concentrations, which can lengthen close-out timeframes and add to price volatility during close outs.
I. Capitalization of Bank Exposures to Central Counterparties, cont.

Question 13 of the Standardized Approach NPR and Question 6 of the Advanced Approaches and Market Risk NPR request comment on the proposed calculation of risk-based capital requirements for exposures to a QCCP. The Agencies question if there are specific types of exposures to certain QCCPs that would warrant an alternative risk-based capital approach.

Recommendation #2: To acknowledge the protections afforded to client accounts under regulations of the SEC and CFTC and to further distinguish additional client protections asserted by certain account structures, we request the Agencies confirm, through adoption, the stated eligibility criteria as provided for on page 52906 and 52988 of the Standardized Approach NPR and Advanced Approaches and Market Risk NPR, respectively.

Throughout the NPRs the Agencies draw distinction between typical CCP account structures where the clearing member acts as a financial intermediary (“principle model”) and where the clearing member guarantees the performance of the client (“agency model”). As referenced in prior comment letters, greater credence should be afforded to QCCPs that employ an agency model whereby the clients’ trades are effectively a trade between the client and the CCP, not least to appreciate the client protection scheme promulgated by the SEC and CFTC. In the event of a clearing member default, the structure of an agency relationship between the clearing member and its clients would facilitate various operational efficiencies including, but not limited to, the protection and portability of client positions and collateral. This agency relationship is fundamental to the operation of CME and is imbued throughout the rules of CME Group and the Commodity Exchange Act as well as the regulations of the CFTC.

CME supports the Agencies’ statement within the preamble that the omnibus account structure in the United States would satisfy this requirement due to customer protections afforded under existing Securities and Exchange Commission (“SEC”) and CFTC regulations including the CFTC’s Part 190 Bankruptcy Rules (17 C.F.R. Part 190). To provide further clarity and provide assurance, we request the Agencies explicitly adopt the preamble’s position in the final standards.

Recommendation #3: To recognize the distinction among the various components of trade exposure, we recommend the Agencies decouple the link between risk weights assigned to collateral trade exposure and those assigned to other components of trade exposure.

Under proposed sections _35(b)(3)(i) and _133(b)(3)(i), if collateral posted to a QCCP by a client is not protected from losses in a joint default scenario, the client’s entire trade exposure—including collateral, current exposure, and potential future exposure—is ineligible for the 2 percent risk weight. CME believes that this result improperly conflates collateral-related exposure with other components of trade exposure. While protections against joint default may affect the safety of client collateral, such protections are demonstrably disconnected from the risk associated with current credit exposure and potential future exposures. Accordingly, CME recommends that the Agencies decouple the risk weight for client collateral from the risk weight for other components of a client’s trade exposure.
II. Capitalization of Default Fund Contributions to Central Counterparties

Question 13 of the Standardized Approach NPR and Question 6 of the Advanced Approaches and Market Risk NPR request comment on the proposed calculation of risk-based capital requirements for exposures to a QCCP. The Agencies question if there are specific types of exposures to certain QCCPs that would warrant an alternative risk-based capital approach.

Recommendation #4: To recognize the robust and proven risk management models employed by Qualified CCPs, compliant with CPSS-IOSCO Principles for Financial Market Infrastructures and onward by prudential regulators, the Agencies should permit Qualified CCPs to apply approved Internal Models to quantify exposures related to CCP default fund contributions.

CME continues to champion the installation of a risk sensible approach to quantify capital requirements arising from clearing member default fund contributions. This position is supported by overwhelming industry feedback and by initial results of Quantitative Impact Studies administered by the BCBS. The current framework should be recalibrated to best appreciate the varying structures, practices, credit quality and financial resources afforded by a Qualified CCP. The primary components employed by CCPs to mitigate counterparty credit exposures, in addition to enterprise risk management practices, are funded initial margin, variation margin and clearing member default fund contributions; additionally, some CCPs contribute their own resources to the default waterfall, which should be taken into consideration as well (collectively, “aggregate CCP resources”).

We were encouraged to hear the BCBS interim framework contemplated an alternative methodology; however we remain apprehensive that this method, method two, prudently considers aggregate CCP resources, a similar shortfall observed in superseded versions of method one, and might introduce incentives that are adverse to the intention of the capital standards. Similarly, we maintain that method one is risk insensitive and stands to create a variety of perverse incentives for clearing members to reduce both default fund contributions and margins or increase margins at the expense of reduced default fund contributions.

We further understand that the BCBS and CPSS-IOSCO have formed a working group to reconsider the interim methodologies and other certain aspects of the BCBS interim framework. CME supports exploring alternative solutions and would encourage the opportunity to discuss and jointly assess how each alternative translates into regulatory capital requirements to ensure a sensible and risk prudent measure is ultimately adopted. We encourage the Agencies to adopt a method that holistically considers the aggregate CCP resources (and corresponding conformance to the PFMIs) to ensure fair consideration is accorded to CCPs that employ varying methodologies when sizing margin and default fund requirements.

Consistent with the practices of the current bank capital framework, the Agencies should permit Qualified CCPs to utilize approved internal models. Further to QCCA adherence to the PFMIs, the use of internal models could be conditioned on observance to applicable CFTC and SEC (or other applicable) regulations and supervisory requirements governing risk modeling. To the extent the Agencies require review of any QCCA internal models, the Agencies could arrange an examination in coordination with Title VIII designated FMU review procedures. Acknowledging certain QCCPs may not maintain a level of expertise to qualify for internal models, the Agencies could prescribe a fallback to the prevailing interim methodologies.
III. Additional Recommendation

Recommendation #5: To better recognize acceptable collateral standards employed by certain Qualified CCPs, the Agencies should consider adjusting holding period assumptions under certain models to better align with the liquidity characteristics of such collateral.

The standard supervisory market price volatility haircuts described in the Standardized Approach NPR, as originally designed for the bilateral market, however, applicable to certain cleared transactions, prescribes a 10-day holding period assumption in computing the applicable haircut. We are concerned that these haircuts lack consideration to the profile and characteristics of collateral policies adopted by CCPs and that are further governed by prudential regulation. For example, the overwhelming majority of collateral on deposit at CME can be liquidated to cash on a same day basis under stressed market scenarios. CME routinely conducts liquidation drills with qualified, independent third parties to assess the liquidity profile of its collateral holdings. To complement our liquidity resources, CME maintains a committed, secured credit facility sized with consideration to assets that could challenge same day liquidation in a stressed market environment. The facility gives CME access to proceeds of a draw within 60 minutes of borrowing. Additionally, CME contracts with liquidation agents to facilitate prompt liquidation of collateral in a clearing member default. We therefore request the Agencies consider adjusting the holding period assumptions or allow CCPs to utilize alternative methods to compute appropriate haircuts for cleared transactions.

CME recognizes that the standard haircut schedule was designed to achieve a balance between simplicity and risk-sensitivity. However, for instance, the standard supervisory haircut table assigns mutual funds the most punitive haircut applicable to any security in which the funds invest. For money market funds (“MMFs”), that generally invest in short-term government securities, certificates of deposit, commercial paper, and other low-risk securities, the haircut table could assign a 25 percent haircut that appears to discount the enhanced standards and criteria relative to other mutual funds. In the U.S., it is accepted market practice to utilize MMFs to meet margin requirements; however, punitive haircut treatment could invite collateral inefficiencies to clearing. The distinctive features of MMFs, as governed and further enhanced in response to the 2008 credit crisis by SEC rule 2a-7, provide a principled basis to distinguish MMFs from all other mutual funds.

We believe, the Agencies can effectuate this distinction without fundamentally altering the table. CME recommends that the Agencies bifurcate the “mutual funds” row of the standard supervisory haircut table into two rows, one labeled “money market funds” governed by SEC rule 2a-7 and the other labeled “other mutual funds.” This treatment would parallel the current separation of equities into “main index equities” and “other publicly-traded equities.” For MMFs, CME suggests a risk weight that reflects the cash-like characteristics of these instruments. As a starting point, the Agencies might consider the haircut assigned by the Federal Reserve Discount Window to the instruments that money market funds

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SEC Rule 2a-7 provides that MMFs may invest only in securities rated in one of the two highest short-term rating categories or, if unrated, of comparable quality to such securities; must invest at least 97 percent of their assets in securities rated in the highest short-term rating category or, if unrated, of comparable quality to such securities; must maintain a maximum weighted average maturity of 60 days and a maximum weighted average life of 120 days; and cannot invest more than 0.5 percent of their total assets in securities of a single issuer that is rated in the second-highest short-term rating category or, if unrated, of comparable quality to such securities.
invest in, namely Certificates of Deposit, Bankers’ Acceptances, Commercial Paper, and Asset Backed Commercial Paper (currently 3 percent).\footnote{CME also notes that the baseline 25 percent haircut proposed for corporate debt securities regardless of credit quality or maturity is unusually severe compared to the Agencies’ existing rules and both existing and proposed international agreements. Under the Agencies’ current Internal-Ratings-Based and Advanced Measurement Approaches rules, only \textit{below-investment-grade} corporate debt receives a 25 percent haircut. Short-term corporate debt that is investment grade currently receives a haircut in the low-to-mid single digits. Likewise, under Basel II, Basel III, and the recently-published BCBS consultative document \textit{Margin requirements for non-centrally-cleared derivatives} (July 2012), short-term, high quality corporate debt is assigned standard supervisory haircuts in the low-to-mid single digits.}

\section*{IV. Conclusion}

CME reiterates our support of the Agencies’ efforts to provide greater incentives for central clearing, consistent with CPSS-IOSCO standards, and the need for careful evaluation of the motivations inspired by the proposed adjustments to the capital framework.

CME would like to thank the Agencies for the opportunity to provide these comments. We would be happy to further discuss and clarify any of the above issues with agency staff. If you have any comments or questions regarding this submission, please feel free to contact Tim Doar, Managing Director and Chief Risk Officer by telephone at (312) 930-3162 or by e-mail at Tim.Doar@cmegroup.com.

Sincerely,

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Tim Doar  
Managing Director and Chief Risk Officer, CME Clearing  
Chicago Mercantile Exchange, Inc.  
20 South Wacker Drive  
Chicago, IL 60606