CME Group

VIA E-MAIL

April 30, 2012

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

Re: Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies (Docket No. 1438 and RIN 7100-AD-86)

Dear Ms. Johnson:

CME Group Inc. ("CME Group"), on behalf of the clearing house division of the Chicago Mercantile Exchange Inc. ("CME"), appreciates the opportunity to comment on the rules proposed by the Board of Governors of the Federal Reserve System ("Board"), published in the Federal Register on January 5, 2012, implementing enhanced prudential standards required under section 165 of the Dodd-Frank Act ("Proposal").

CME Group is one of the world's largest and most diverse derivatives marketplaces. We operate 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 major asset classes, including derivatives based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products. The CME Group Exchanges serve the hedging, risk management, and trading needs of our global customer base by facilitating transactions through the CME Globex electronic trading platform, our open outcry trading facilities in New York and Chicago, and through privately negotiated transactions.

CME Group also operates the clearing house division of CME, CME Clearing. Among the largest central counterparty ("CCP") clearing services in the world, CME Clearing provides clearing and settlement services for exchange-traded contracts, as well as for over-the-counter ("OTC") derivatives transactions through CME ClearPort. In its capacity as a CCP, CME is registered with the Commodity Futures Trading Commission ("CFTC") as a derivatives clearing organization ("DCO"). In 2011, CME processed and cleared approximately 3.4 billion exchange-traded and OTC contracts, averaging 13.4 million contracts per day.

CME Group's comments below focus exclusively on the "single-counterparty exposure limits" portion of the Proposal and, in particular, Question 39 of the preamble, which asks: "Should margin posted and contributions to a CCP guaranty fund be considered a credit exposure for purposes of the proposed rule?" As discussed below, CME Group believes the final rule should exclude exposures to CCPs, other than guarantee fund contributions, from the calculation of net credit exposure for purposes of the single-counterparty exposure limits.

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I. Background: Role of CCPs

A CCP is a clearing house that interposes itself between counterparties, becoming the buyer to every seller and vice versa. Through counterparty substitution, a CCP effectively guarantees performance of cleared financial instruments. From the perspective of clearing members, a CCP eliminates the need to evaluate and monitor the creditworthiness of many counterparties at once. Instead, clearing members face only the CCP. CCPs operate in a wide variety of securities and derivatives markets, both exchange-traded and OTC.

a. Role of CCPs in Reducing Systemic Risk

Central clearing reduces systemic risk in two principal ways. First, by consolidating bilateral trades among many counterparties into a single trading partner, a CCP enables its clearing members to offset credit exposures across multiple counterparty relationships. Through multilateral netting, a clearing member might reduce its net exposure to all counterparties by more than ninety percent.[1] This reduction in credit exposure benefits individual clearing members and increases the stability of the financial system overall. It also promotes more efficient capital allocation by decreasing the amount of margin (i.e., collateral) necessary to cover the same number of open trades.

CCPs also are less susceptible to "runs" than other counterparties.[2] During the recent financial crisis, troubled financial institutions such as Lehman Brothers experienced precipitous withdrawals of funding and a sudden unwillingness of their trading partners to continue trading with them. Once begun, such runs became self-perpetuating and contributed to the failures or near-failures of several large firms. A CCP faces a significantly lower risk of counterparty runs, primarily because, as discussed below, the failure of a single clearing member does not threaten a CCP's ability to meet its obligations.[3]

b. Risk Management Practices of CCPs

A CCP's effectiveness in reducing systemic risk depends on the adequacy of its financial resources and risk management systems to absorb financial stress. To protect against clearing member defaults, CCPs impose membership requirements, margin requirements, and procedures to spread losses among the entire base of clearing members if necessary. More specifically, CCPs require clearing members to post daily variation margin against their net exposures to the CCP. Clearing members must also post initial margin, proportionate to their relationships with the CCP, to cover additional costs the CCP might incur in replacing trades should they default. Finally, clearing members must contribute proportionately to the CCP's guarantee fund, which is designed to mutualize extraordinary losses caused by defaults of other clearing members.

In the event of a clearing member's default, a CCP draws first on assets of the defaulting clearing member available to the CCP. These assets may include, among other things, initial and variation margin, guarantee fund contributions, and exchange memberships of the clearing member. If these

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[1] Douglas D. Evanoff, Daniela Russo, and Robert S. Steigerwald, "Policymakers, Researchers, and Practitioners Discuss the Role of Central Counterparties," in The Role of Central Counterparties, ed. Federal Reserve Bank of Chicago and the European Central Bank (July 2007), 7, available at http://www.ecb.int/pub/pdf/other/rolecentralcounterparties200707en.pdf.

[2] *See, e.g.*, William C. Dudley, President and CEO, Federal Reserve Bank of New York, Remarks at the Harvard Law School's Symposium on Building the Financial System of the 21st Century, March 22, 2012, available at http://www.newyorkfed.org/newsevents/speeches/2012/dud120322.html; Darrell Duffie, Ada Li, and Theo Lubke, "Policy Perspectives on OTC Derivatives Market Infrastructure," Federal Reserve Bank of New York Staff Report (March 2010), 11-12, available at http://www.newyorkfed.org/research/staff_reports/sr424.html.

[3] An additional benefit of central clearing is a reduction in default-induced fire sales of open derivative positions and collateral, which might otherwise disrupt markets.

resources prove inadequate, the CCP relies on a "waterfall" of additional resources, generally in the following order:

1. First-loss capital of the CCP;
2. Guarantee fund contributions of non-defaulting members; and
3. After-the-fact assessments (subject to established limits) on non-defaulting members.

In no event would a CCP liquidate positions, variation or initial margin posted by a non-defaulting clearing member to cure the default of another clearing member.

The financial resources and risk management systems of CCPs must satisfy applicable legal and regulatory requirements. CCPs currently are regulated as "clearing agencies" by the Securities and Exchange Commission ("SEC") and/or DCOs by the CFTC, depending on the instruments they clear. In addition, Title VIII of the Dodd-Frank Act requires the Financial Stability Oversight Council to designate financial market utilities ("FMUs"), including CCPs, that are, or are likely to become, systemically important. CCPs designated as FMUs will be subject to heightened risk management standards prescribed by the SEC and/or CFTC,[4] with oversight by the Board, and subject to comprehensive supervisory examinations at least annually. In addition, CCPs are expected to comply with new international standards set forth in the Principles for Financial Market Infrastructures released in April 2012 by the Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions ("CPSS-IOSCO Principles"), including relevant financial resources and liquidity risk management requirements.

Notably, under sections 725(c) and 763(c) of the Dodd-Frank Act, a CCP that clears derivatives must possess sufficient financial resources to absorb a default by its largest member in extreme, but plausible, market conditions (a "cover one" standard). Under the CPSS-IOSCO Principles, a CCP that is involved in activities with a more-complex risk profile or that is systemically important in multiple jurisdictions will be required to maintain sufficient financial resources to absorb simultaneous defaults by its two largest clearing members in extreme, but plausible, market conditions (a "cover two" standard).[5] The CPSS-IOSCO Principles also will require CCPs to collateralize credit exposures to all clearing members fully with a high degree of confidence,[6] and, where applicable, conduct rigorous stress testing of initial margin and guarantee fund requirements.

c. *Dodd-Frank Act Clearing Mandate*

Section 723 of the Dodd-Frank Act generally requires central clearing of "clearable" OTC derivatives. Through the clearing mandate, Congress intended to shift OTC derivatives transactions to CCPs, thereby mitigating the systemic risk associated with bilateral trades.[7] As stated in the committee report of the Senate Committee on Banking, Housing, and Urban Affairs, "[i]ncreasing the use of central clearinghouses ... will provide safeguards for American taxpayers and the financial system as a whole.... With appropriate collateral and margin requirements, a central clearing organization can substantially reduce counterparty risk."[8]

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[4] Pursuant to section 805(c) of the Dodd-Frank Act, the Agencies may prescribe risk management policies and procedures, margin and collateral requirements, counterparty default policies and procedures, and capital and financial resource requirements for CCPs that are FMUs. To date, both Agencies have published proposed rules that would implement this authority.
[5] *See* CPSS-IOSCO, "Principles for financial market infrastructures" (April 2012), Principle 4, available at http://www.bis.org/publ/cpss101a.pdf.
[6] For example, CCPs must calibrate initial margin requirements using a confidence interval of at least 99 percent. *Id.* at p. 43.
[7] Almost all securities and derivatives currently traded on exchanges are centrally cleared.
[8] S. REP. NO. 111-176, at 32, 34 (2010) (report of the Senate Committee on Banking, Housing and Urban Affairs), available at

Passage of section 723 represented an important step toward implementing a commitment made at the 2009 G-20 Pittsburgh Summit that all standardized OTC derivatives should be cleared through CCPs by year-end 2012. More recently, the FSB has affirmed that national authorities should, pursuant to this commitment, "incentivise greater use of central clearing."[9]

II. Problems Posed by the Proposal

The Proposal would prohibit a covered company from having net credit exposure to any unaffiliated counterparty exceeding twenty-five percent of capital. For exposures between "major" covered companies, the Proposal would impose a ten percent limit. Under the Proposal, net credit exposure to a CCP would include, among other things:

- The exposure at default ("EAD") amount, calculated under the Board's capital guidelines, of derivative transactions subject to a qualifying master netting agreement;[10]
- Initial margin and excess variation margin posted by a covered company to a CCP; and
- Contributions of a covered company to a CCP guarantee fund.

As discussed below, including the EAD amount and margin posted to a CCP (collectively, "CCP trade exposures") in net credit exposure would unnecessarily constrain the ability of clearing members to use CCPs. This constraint is unnecessary because CCPs are distinguishable from "single" counterparties in general. It is also inconsistent with the spirit of the clearing mandate, since it would reduce incentives to use CCPs.

a. Including CCP Trade Exposures in Net Credit Exposure Would Materially Constrain the Ability of Clearing Members to Use CCPs

As a preliminary matter, the problems discussed in this section are not merely academic. CME estimates that at least two clearing members currently have trade exposures to CME at levels near or in excess of the proposed twenty-five percent limit. CME expects that more clearing members will approach the proposed limit in the foreseeable future. Significantly, the Dodd-Frank Act clearing mandate has not yet taken effect. CME Clearing only began clearing interest rate swaps in 2011. The clearing mandate will effect an ongoing shift of OTC derivatives activities toward CCPs, causing more clearing members to approach or reach their net exposure limits to CME and other CCPs under the Proposal. In addition, further consolidation in the cleared derivatives industry could result in more clearing members exceeding their limits under the Proposal. This result would be perverse because, as discussed below, CCPs generally reduce systemic risk.

b. CCPs Are Distinguishable from "Single" Counterparties

By design, a CCP insulates each clearing member from the risks associated with default of an individual counterparty. As noted by the Basel Committee on Banking Supervision, "CCPs mitigate counterparty credit risk because the impact of the failure of a major counterparty is absorbed by the CCP's default protection schemes."[11] Similarly, the Financial Services Authority has observed that a CCP acts as a "circuit breaker to systemic risk on a major participant's failure."[12] As noted above, non-defaulting

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http://banking.senate.gov/public/_files/Comittee_Report_S_Rept_111_176.pdf.

[9] "Implementing OTC Derivatives Market Reforms," Financial Stability Board (Oct. 25, 2010), available at http://www.financialstabilityboard.org/publications/r_101025.pdf.

[10] The EAD amount would incorporate both current credit exposure and potential future exposure.

[11] BCBS, "Capitalisation of bank exposures to central counterparties," Consultative Document (Nov. 25, 2011), ¶ 9, available at http://www.bis.org/publ/bcbs206.htm.

[12] Financial Services Authority and HM Treasury, "Reforming OTC Derivative Markets: A UK Perspective" (Dec. 2009), ¶ 6.8, available at http://www.fsa.gov.uk/pubs/other/reform_otc_derivatives.pdf.

clearing members' positions and margins are insulated from the default of other clearing members and in no event would be used by a CCP to cure such a default. Several of the largest clearing members would have to fail around the same time for a non-defaulting member to suffer losses beyond its guarantee fund contribution (and perhaps its share of any post-default assessment). By treating CCP trade exposures as credit exposures to a "single" counterparty, the Proposal overlooks these structural aspects of CCPs.

c. Including CCP Trade Exposures in Net Credit Exposure Would Weaken the Effectiveness of the Clearing Mandate

Inclusion of CCP trade exposures in net credit exposure would also reduce incentives to centrally clear trades. This would, in turn, frustrate the purpose of the clearing mandate. Central clearing, by its nature, concentrates exposures into a single counterparty (the CCP). These exposures would otherwise be dispersed more widely among bilateral trading partners. Accordingly, the failure of a CCP, while highly unlikely, presents systemic risk. However, central clearing reduces overall systemic risk for the reasons discussed in section 1.a, above. In particular, central clearing enables clearing members to reduce net exposures through multilateral netting and to mutualize extraordinary losses. The clearing mandate represents a legislative decision to promote these overarching benefits.

As drafted, the Proposal would limit the potential benefits of central clearing by effectively forcing large counterparties to clear trades through multiple CCPs. As Federal Reserve Bank of New York President William C. Dudley recently stated, in an overly fragmented CCP system, "many of the risk-reducing benefits from CCPs could be lost or severely attenuated. That is because fewer offsetting positions would likely be cleared through any particular CCP and this would reduce the scope for reducing large gross exposures into much smaller net positions."[13]

According to a study by John P. Jackson and Mark J. Manning of the Bank of England, consolidation of separate, single-product CCPs into one multi-product CCP reduces credit exposure by more than thirty percent.[14] An overly fragmented CCP system also entails higher operational costs and risks, since it could force some institutions to acquire memberships in additional CCPs (including foreign CCPs) and thereby incur higher costs from, among other things, additional guarantee fund contributions and decreased margin efficiencies. In short, application of single-counterparty exposure limits to CCP trade exposures would significantly influence the shape of the CCP industry, but in a rather haphazard way—effectively short-circuiting a more fulsome consideration of the costs and benefits of CCP consolidation. CME Group does not believe this rulemaking presents the proper vehicle to determine the optimal level of consolidation in the CCP industry.

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[13] *See* Dudley, *supra* note 2. *See also* Darrell Duffie and Haoxiang Zhu, "Does a Central Clearing Counterparty Reduce Counterparty Risk?", Review of Asset Pricing Studies 1(1) (2011), 74-95, at 75 ("…counterparty risk is always reduced by merging the clearing activities of multiple CCPs into a single CCP"), available at http://raps.oxfordjournals.org/content/1/1/74.full.pdf+html.

[14] John P. Jackson and Mark J. Manning, "Comparing the pre-settlement risk implications of alternative clearing arrangements," Bank of England Working Paper No. 321 (April 2007), 23-24, available at http://www.bankofengland.co.uk/publications/Documents/workingpapers/wp321.pdf.

III. Recommendation: CCP Trade Exposures Should Not Count Toward the Single-Counterparty Exposure Limit

Question 39 of the preamble asks: "Should margin posted and contributions to a CCP guaranty fund be considered a credit exposure for purposes of the proposed rule?" We urge the Board, in answering this question, to consider the broader question: what is the best way to address the systemic risk associated with the potential failure of a CCP? U.S. financial regulators have multiple tools at their disposal, including: risk-based capital requirements;[15] other risk-management requirements imposed on all CCPs by the SEC and/or CFTC; designation and supervision of CCPs as FMUs under Title VIII of the Dodd-Frank Act; and, of course, single-counterparty exposure limits.

CME Group submits that single-counterparty exposure limits represent the least suitable tool for this purpose. As discussed above, CCPs do not fit neatly into the conceptual framework of "single" counterparties. Forcing CCPs into this framework would limit the potential benefits of CCPs, which are themselves designed to mitigate systemic risk associated with the default of a single trading counterparty. The Board should avoid formulating the exposure limit rules in a way that pursues the same goal yet, in practice, operates at cross-purposes with the clearing mandate. Instead, the Board should preserve incentives to clear centrally while working together with the SEC and CFTC to ensure that CCPs remain, in the words of Mr. Dudley, "bullet proof."[16]

Therefore, CME Group believes the Board should use its exemptive authority to exclude CCP trade exposures—including EAD amounts, initial margin, and excess variation margin—from the single-counterparty exposure limits. Again, these amounts are not at risk in the event of the default of another clearing member; they are only at risk if the clearing member itself defaults to the CCP. CME Group recognizes, however, that different treatment may be appropriate for guarantee fund contributions.[17] Unlike CCP trade exposures, guarantee fund contributions are integral to a CCP's default protection scheme. These contributions provide a buffer against potential default by other clearing members and, thus, carry greater risk of loss.

IV. Conclusion

For the foregoing reasons, CME Group recommends that the Board exclude CCP trade exposures from the calculation of single-counterparty exposure limits. CME Group thanks the Board for the opportunity to comment on this matter. We would be happy to discuss any of these issues with Board staff. If you have any comments or questions regarding this submission, please feel free to contact me by telephone at (312) 930-3088 or by e-mail at Phupinder.Gill@cmegroup.com; or Lisa Dunsky, Executive Director and Associate General Counsel, by telephone at (312) 338-2483 or by e-mail at Lisa.Dunsky@cmegroup.com.

Sincerely,

Phupinder S. Gill

Phupinder S. Gill

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[15] The Basel Committee on Banking Supervision has proposed a two percent risk weight on trade exposures to qualifying CCPs. For guarantee fund contributions to qualifying CCPs, the BCBS has proposed a more complex formula approach. BCBS, *supra* note 7, ¶¶ 19-20, 22.
[16] *See* Dudley, *supra* note 2.
[17] In the event the Board decides to include CCP margin, fully or partially, in the calculation of credit exposure, CME Group requests that the Board clarify the scope of the proposed exemption for CCP margin held in a "segregated account at a third party custodian."