



July 28, 2011

VIA ELECTRONIC MAIL

Secretariat of the
Committee on Payment and Settlement Systems
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Secretariat of the
Technical Committee of the International
Organization of Securities Commissions
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Re: Consultation Report: Principles for Financial Market Infrastructures (March 2011)

Dear Committee Members:

CME Group Inc. (CME Group), on behalf of its subsidiaries Chicago Mercantile Exchange Inc. (CME) and CME Clearing Europe Ltd. (CMECE), would like to express appreciation to the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) for the opportunity to comment upon their consultation report issued in March 2011 on *Principles for financial market infrastructures* (the FMI Report). CME's clearing house division (CME Clearing) offers clearing and settlement services for exchange-traded futures contracts, and for OTC derivatives through CME ClearPort. CME is registered with the U.S. Commodity Futures Trading Commission (CFTC) as a derivatives clearing organization. CMECE is authorized by the U.K. Financial Services Authority as a recognised clearing house. At present, CMECE offers clearing services for certain OTC commodity derivatives.¹

The FMI Report contains various principles intended to strengthen existing international standards for FMIs, including central counterparties (CCPs). The standards incorporate, among other things, additional guidance for CCPs that clear over-the-counter (OTC) derivatives. Given the importance of the FMI Report and international standards for CCPs in particular, we would welcome the opportunity to provide further comments before the Report is issued in final form.²

This letter focuses on those principles in the FMI Report that specifically affect CCPs. CME Group appreciates the importance to the financial system of regulatory regimes designed to ensure that each CCP stands ready to perform its role as a central counterparty, including fulfilling its financial obligations during periods of market stress. In that regard, CPSS-IOSCO's 2004 *Recommendations for central counterparties* (RCCP) have functioned effectively since their adoption, including during the recent financial crisis. We support current efforts to strengthen those principles, particularly in light of the growth of OTC clearing. We also recognize the importance of being mindful that the standards articulated in the FMI Report: (a) "are expressed as *broad principles* in recognition that FMIs can differ in organization, function design, and that there are often different ways to achieve a particular result"; and (b) "incorporate a specific *minimum requirement* ... to ensure a common *base-level* of risk management across FMIs and countries."³ It is with these things in mind that we provide the following comments and suggestions to the Committee Members.

¹ CMECE is a member of the European Association of CCP Clearing Houses (EACH), which is submitting a separate response to the FMI Report.

² The FMI Report does not address the manner in which CCPs should assess their standards against the final principles or be assessed against the principles, confining itself to the reference that CPSS-IOSCO "may conduct a full review of the market-wide standards in the future." FMI Report at 7. We believe that assessment on a national basis is appropriate, but would equally emphasize that the consistent adoption of high standards on an international plane is of increasing importance.

³ FMI Report at 5, ¶ 1.2.

Principle 2: Governance

Composition of risk committees

Explanatory Note 3.2.12 (Risk-management governance) says that "a risk committee should be chaired by a sufficiently knowledgeable independent board member and consist of a majority of board members that are independent of management." The meaning of the term "independent" as used in this context is not altogether clear. We assume that it refers to a board member who is not an officer or employee of the CCP and does not require the chairperson of the risk committee to be "independent" in the sense of not being an employee or officer of a member of the CCP. A critical characteristic of the chairperson (and every member) of a risk committee is that he or she be sufficiently knowledgeable with regard to CCP risk-management issues. Requiring that person to be a board member who is unaffiliated with any member of the CCP may undermine a CCP's ability to find a truly qualified candidate for the role of risk committee chairperson.⁴

For similar reasons, we recommend that Explanatory Note 3.2.12 be revised to require a CCP's risk committee to "consist of a majority of *committee* members that are independent of management", rather than mandating that a risk committee be comprised of a majority of *board* members that are independent of management. We appreciate the importance of a sufficient level of board involvement with a CCP's risk committee. Under CME rules, for example, the Clearing House Risk Committee must "have at least two co-chairmen, who shall be members of the Board, and at least seven additional individuals, five who shall be Clearing Member representatives and at least one who shall be a non-member."⁵ CMECE's risk committee comprises two board members, one of whom is the chairperson, and other committee members who are independent of management and work for clearing member firms in a risk-management capacity or for other market users. In order to effectively serve the function for which it is created, a risk committee must be composed of persons who, as a group: (a) are sufficiently knowledgeable in a range of risk-management issues in connection with the particular products and markets cleared by the CCP; and (b) represent a sufficient diversity of interests of the CCP's participants. These important goals would not be furthered by requiring every CCP risk committee to be comprised of a majority of board members.

Model validation

Explanatory Note 3.2.13 (Model validation) provides, in relevant part:

The board should ensure that there is adequate governance surrounding the adoption and use of *models*, such as counterparty credit, collateral, margining, and liquidity risk management systems. An FMI should validate, on an ongoing basis, the models and their methodologies used to quantify, aggregate, and manage the FMI's risks. The validation process should be independent of the development, implementation, and operation of the models and their methodologies, and the validation process should be subjected to *independent review* of its adequacy and effectiveness.

We are concerned that, as used in this context, the term "models" is overly broad. CCPs generally use the term "model" in the risk-management context to refer to initial margin models, and not to their collateral programs and other items listed in this Explanatory Note. While we agree that CCPs should have

⁴ This is particularly true for those CCPs that are part of a larger corporate group with a single board of directors.

⁵ CME Rule 403.A.

adequate governance for the adoption and use of policies and procedures for their collateral programs, counterparty credit risk and liquidity risk management systems, we do not believe that CCPs should be required to subject those programs and systems to independent review.

The FMI Report does not define the term "independent" or otherwise make clear whether the review must be conducted by a third party or could be conducted by employees of the CCP who were not responsible for developing, implementing or operating the models and methodologies that are under review. CME Group believes that, in appropriate circumstances, employees of the CCP should be permitted to conduct the reviews. Such an approach would be consistent with the May 2010 consultation report entitled *Guidance on the application of the 2004 CPSS-IOSCO recommendations for central counterparties to OTC derivatives CCPs* (the OTC CCP Report), which observed that a CCP's "margin methodology, and any material revisions, should be reviewed periodically by a qualified independent internal group or third party...."⁶

Principle 3: Framework for the comprehensive management of risks

Key Consideration 2 for Principle 3 states: "An FMI should provide the incentives and, where relevant, the capacity to participants and their customers to manage and contain their risks." Explanatory Note 3.3.4 (Information and control systems) further provides that "an FMI should employ robust information and risk-control systems to provide the FMI itself and, where relevant, its participants and their customers with the capacity to obtain timely information and apply risk-management policies and procedures." While we do not believe this is the intended interpretation, the term "capacity" could be construed to require CCPs to provide not just information but also risk-management systems, tools and other resources to their participants and participants' customers.

Footnote 29 more accurately reflects that an FMI should provide *timely information* to participants so that they can manage their risks (utilizing systems that the participants, and their customers, have obtained for themselves). We suggest that, in the final report, Key Consideration 2 should state that FMIs should provide, where relevant, the information necessary for participants and their customers to manage and contain their risks; and Explanatory Note 3.3.4 should state that "an FMI should employ robust information and risk-control systems to provide the FMI itself and, where relevant, its participants and their customers with timely information for the application of risk-management policies and procedures."

Principle 4: Credit risk

Principle 4 provides, in relevant part, that a CCP "should maintain additional financial resources to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the [one/two] participant[s] and [its/their] affiliates that would potentially cause the largest aggregate credit exposure[s] in extreme but plausible market conditions." The cover note to the FMI Report requests comment on "the pros and cons of establishing for credit risk (1) a 'cover one' minimum requirement for all CCPs; (2) a 'cover two' minimum requirement for all CCPs; and (3) either a 'cover one' or a 'cover two' minimum requirement for a particular CCP, depending upon on the risk and other characteristics of the particular products it clears, the markets it serves and the number and type of participants it has."

⁶ OTC CCP Report at 5.

Affiliates

As a preliminary matter, the inclusion of the term "affiliates" in Principle 4 would result in a standard that may be overly broad. While we acknowledge that the default of one clearing member may impact the ability of an affiliated clearing member to meet its financial obligations to the CCP, circumstances may exist in which a clearing member is sufficiently independent to continue operating notwithstanding a default by an affiliated clearing member. Moreover, a particular clearing member (Firm XYZ) may have affiliates that participate in a CCP's markets that are not clearing members themselves and that choose to conduct business through clearing members with whom they are not affiliated. This type of circumstance makes the inclusion of the term "affiliates" in Principle 4 inappropriate for two reasons. First and most significantly from a credit-risk perspective, should Firm XYZ and its affiliates become insolvent, the clearing members through which the affiliates of Firm XYZ conduct business would stand between the CCP and the credit risk of those affiliates. Second, from a practical perspective, the CCP may not be able to identify customers of other clearing members as affiliates of Firm XYZ. We therefore recommend removing the reference to "affiliates" from Principle 14 or, at a minimum, changing the reference to "affiliated clearing members."

Cover one/cover two

Moving to the issues presented by consideration of a "cover one" versus "a cover two" standard, we join other CCPs in noting our concern regarding CPSS-IOSCO's apparent preference for a cover-two minimum for all CCPs. Such an across-the-board change to the existing cover-one standard (which proved adequate in the recent financial crisis) would give rise to significant increased costs for market participants in the form of escalated initial margin and/or guaranty-fund requirements. This would conflict with the emphasis on efficiency in the OTC CCP 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.⁷

It is important to recognize that the CCP clearing-member community plays a critical role in risk management and systemic-risk containment. Achieving the goals of bringing additional clearing services to the OTC marketplace and reducing the concentration of risk with a few institutions requires regulatory regimes that ensure the existence of a well-capitalized and diversified set of CCP clearing members. The objective of strengthening international standards for CCPs (and other FMIs) must therefore be balanced with the objective of incentivizing qualified firms to act as clearing members and positioning them to offer cost-effective intermediation services to their customers.

Significant increases to initial margin and guaranty-fund requirements may decrease participation in the cleared-derivatives market: customers may be unable or unwilling to satisfy substantially increased margin requirements, and clearing members may be unable to recoup a substantial portion of these costs from customers. Consequently, smaller clearing members may be forced out of the business, larger clearing members may not be incented to stay in the business, and firms otherwise qualified to act as clearing members may be unwilling to do so if the risk and cost profile of the clearing-member model is adversely impacted by principles imposed on CCPs as "minimum" standards. This may lead to a larger concentration of customer exposures at fewer clearing members, thus exacerbating rather than ameliorating systemic risk. Rather than moving from a "cover one" to a "cover two" minimum without the

⁷ *Id.* at 22.

justification of any cost-benefit analysis, it would be more prudent to focus on the efficacy of a CCP's initial margin requirements and stress testing.

CME Group believes that the existing "cover one" credit requirement is appropriate as a minimum standard for CCPs. We concur with the suggestion in the cover note to the FMI Report that characteristics of particular products and markets cleared by a CCP are relevant in determining whether something greater than a cover-one requirement may be the optimal approach for a particular CCP (or, for a CCP with multiple guaranty funds, a particular financial-safeguards package of the CCP). Generally speaking, characteristics of products and markets that weigh in favor of a cover-one standard include: (a) the CCP's knowledge and experience over a sufficient period of time to provide a high-level of confidence in its risk-management systems (including margining, backtesting and stress testing), including during periods of crisis; (b) a diverse and sufficiently numerous group of clearing members that are well known to the CCP; and (c) established price transparency and liquidity. The absence of one or more of these factors may lead to the conclusion that a credit-risk coverage standard of greater than one should be utilized.

Stress tests and reverse stress tests

Key Consideration 6 states:

In conducting stress testing, a CCP should consider a wide range of relevant stress scenarios, including peak historic price volatilities, shifts in other market factors such as price determinants and yield curves, multiple defaults over various time horizons, simultaneous pressures in funding and asset markets, and a spectrum of forward-looking stress scenarios in a variety of extreme but plausible market conditions. The stress-testing programme should include "reverse stress tests" aimed at identifying extreme market conditions for which the CCP's financial resources would be insufficient.

Rather than attempting to list or prescribe the elements that should comprise a CCP's stress-testing program, we believe this provision should state that a CCP should have a robust stress-testing program in place. This would be more in keeping with the fact that the standards in the FMI Report "are expressed as broad principles in recognition that FMIs can differ in organisation, function, and design, and that there are often different ways to achieve a particular result."⁸

The concept of reverse stress testing (which is further addressed in Explanatory Note 3.4.14 and which appears in Key Consideration 7 for Principle 7 and Explanatory Note 3.7.15) seems unnecessary for CCPs. The U.K. Financial Services Authority (FSA) has defined "reverse stress tests" as

...stress tests that require a firm to assess scenarios and circumstances that would render its business model unviable, thereby identifying potential business vulnerabilities. Reverse stress-testing starts from an outcome of business failure and identifies circumstances where this might occur. This is different to general stress and scenario testing which tests for outcomes arising from changes in circumstances.

....

Reverse stress-testing is primarily designed to be a risk management tool, encouraging firms to explore more fully the vulnerabilities and fault lines in its business model, including 'tail risks'.

⁸ FMI Report, at 5, ¶ 1.2.

While reverse stress testing may be advisable for banks and insurers (as the FSA recently began requiring), CCPs are already required to conduct robust stress testing to ensure that their financial resources are adequate to cover tail events in extreme but plausible market conditions. Further requiring CCPs to model hypothetical extreme scenarios that would go beyond what are considered extreme but plausible conditions and that would render their business models unviable would serve no clear useful purpose.

Backtesting

Explanatory Note 3.4.11 (Backtesting) states, in relevant part, that "[b]acktesting involves comparing observed outcomes *derived by a model* (using actual historical data, that is, what actually occurred) against forecasted outcomes." We suggest that the phrase "derived by a model" be removed. Appropriate backtesting is performed by utilizing actual outcomes. The use of outcomes derived from a model (even if based on historical data) would needlessly inject model risk into the backtesting process.

Principle 5: Collateral

Explanatory Note 3.5.2 (Acceptable collateral) states that:

... participants should not be allowed to post their own debt or equity securities, nor bonds or equity of companies closely linked to them as collateral. More generally, an FMI should avoid wrong-way risk by not accepting collateral that would likely lose value in the event that the participant posting the collateral defaults. To prevent such wrong-way risk, the FMI, when practicable, should monitor the correlation between a counterparty's creditworthiness and the collateral posted.

CME Group believes that the statements regarding collateral that an FMI should not accept veer in the direction of a prescriptive approach and undermine the principles-based approach of CPSS-IOSCO recommendations for FMIs in general and CCPs in particular. We support the statement the FMIs should monitor the correlation between counterparty creditworthiness and posted collateral as more appropriate and more reflective of the fact that the standards in the FMI Report "are expressed as broad principles in recognition that FMIs can differ in organisation, function, and design, and that there are often different ways to achieve a particular result."⁹

Principle 6: Margin

Initial margin and guaranty-fund deposits

Explanatory Note 3.6.2 (Margin requirements) states that, for purposes of the FMI Report, the separate concepts of margin and guaranty- or clearing-fund deposits are being conflated into the single phrase "margin requirements." Because the term "margin" has particular meaning to CCPs, we are concerned that this terminology may result in considerable confusion and misunderstanding. CCPs generally utilize very conservative coverage standards for initial margin in order to cover tail events associated with normal market conditions. A CCP's guaranty fund is then designed to cover potential risks that exist beyond the coverage of initial margin, which typically arise from tail events associated with extreme but plausible market conditions. A more suitable phrase to encompass both margin and guaranty-fund deposits is "financial resources" (which is utilized in the RCCP).

⁹ *Id.*

Key Consideration 1 for Principle 6 states that a "CCP should establish margin levels that are commensurate with the risks and unique attributes of each product, portfolio, and market it serves, *taking into account potential increases in liquidation times in stressed markets.*" Key Consideration 3 provides that a CCP "should adopt initial margin models and parameters that are risk-based and generate margin requirements *sufficient to cover potential future exposure to participants in the interval between the last margin collection and the close out of the positions following a participant default.*" Key Consideration 6 states that, in reviewing its margin models, a CCP "should take into account a range of scenarios, *including scenarios that capture the most volatile periods that have been experienced by the markets it serves* and develop forward-looking scenarios to anticipate risks." These statements incorrectly suggest that the purpose of initial margin is to cover all potential future exposures, including those arising from extreme tail events associated with extreme but plausible market conditions. Those events are covered by a CCP's guaranty fund, not by initial margin.

Furthermore, Key Consideration 6 would require CCPs to stress test their margin models at least monthly, a theme that is echoed in Explanatory Notes 3.6.14 and 3.6.15 (Testing margin coverage), and 3.4.13 (Stress testing). Stress testing, however, is performed on a CCP's guaranty fund to determine if adequate coverage exists for scenarios involving extreme but plausible market conditions.¹⁰ Stress testing is not utilized in connection with initial margin coverage, which should instead be subjected to back testing.

Confidence levels

Key Consideration 3 states that "[i]nitial margin should meet an established *single-tailed confidence level* of at least 99 percent for each product that is margined on a products basis, each spread within or between products for which portfolio margining is permitted, and for each clearing member's portfolio losses." References to a single-tailed confidence level also appear in Explanatory Notes 3.6.12 (Portfolio margining) and 3.6.14, and 3.4.9 (Managing credit risk). Because CCPs are necessarily exposed to both long and short positions in the markets that they clear, we believe that a two-tailed test is more appropriate.

CPSS-IOSCO has requested comment on whether a minimum confidence level of 99 percent is appropriate for all products cleared by CCPs. As a general matter, we believe that regulators should not prescribe a one-size-fits all confidence level for cleared products, but should instead give each CCP reasonable discretion to determine appropriate confidence levels based on particular characteristics (including but not limited to liquidity) of the products it clears. CPSS-IOSCO has appropriately reflected the liquidity issue with regard to margin coverage in Key Consideration 3, which observes that initial margin models should reflect, among other things, "adequate time horizons for the close out of the particular types of products cleared by the CCP." We do not believe that 99 percent is inappropriate as a minimum standard.

Validation of margin models

Explanatory Note 3.6.4 (Price information) would require a CCP to have its valuation models "validated annually at a minimum by a qualified and independent party...." Explanatory Note 3.6.8 (Initial margin methodology) would similarly require a CCP to have its margin models "independently validated at least on a yearly basis." As noted above, CME Group believes that, in appropriate circumstances, employees of a CCP should be permitted to conduct these reviews. In addition, we do not believe that independent validation of margin models should be required merely due to the passage of time, but should be done when a CCP makes a material change to the model.

¹⁰¹⁰ This concept is correctly reflected in key consideration five for Principle 4, which states: "Stress tests to check the adequacy of the total financial resources available in the event of a default in extreme but plausible market conditions should be performed at least monthly...."

Harmonization of risk-management programmes

Key Consideration 5 states, in relevant part: "Where two or more CCPs are authorised to offer cross-margining, they must have appropriate safeguards and *harmonise their overall risk-management programmes.*" Explanatory Note 3.6.13 (Cross margining) further states that "harmonization is especially relevant in terms of selecting an initial margin methodology, setting margin parameters, segregation of accounts and collateral, and in establishing default management arrangements." The emphasis on harmonization suggests that CCPs with a cross-margining arrangement in place must have risk-management programs that are, in large part, identical. While it is critical for any CCP to review and understand another CCP's overall risk-management program before entering into a cross-margining arrangement, and throughout the life of such arrangement, they need not have the same overall risk-management programs in order for such arrangements to be appropriate from a risk perspective.

Assessment powers

We are troubled by CPSS-IOSCO's apparent change of heart regarding the inclusion of assessment powers as valid financial resources for CCPs. The FMI Report is silent on the subject, whereas the RCCP recognizes that a CCP's financial resources "can include contingent claims on non-defaulting participants.... For example, CCP rules may require non-defaulting participants to provide additional funds to it in the event of default."¹¹ The RCCP further explains that "[a] CCP should include only those resources that it can reliably draw on in the event of a default in evaluating the adequacy of its resources,"¹² and that "[o]nly the value subject to the appropriate haircuts should be counted as part of the financial resources of a CCP."¹³

As a matter of sound risk-management practice and good form, in evaluating its reliance on assessment powers, a CCP should of course exclude the potential defaulting firm's assessment liability in calculating its available financial resources. However, a blanket assumption that a CCP cannot rely on *any* of its assessment powers would be misguided, particularly in light of regulations that would require CCPs to have rules mandating that clearing members can meet an assessment within the time frame of a normal variation settlement cycle, and to "monitor, on a continual basis, the financial and operational capacity of its clearing members to meet potential assessments."¹⁴ We believe that the wholesale removal of assessment powers from a CCP's arsenal of financial resources will weaken rather than strengthen CCP resiliency.

¹¹ RCCP at 25, ¶ 4.5.6.

¹² *Id.*, ¶ 4.5.8.

¹³ *Id.*, ¶ 4.5.9.

¹⁴ CFTC proposed regulation 39.11(d), 75 Fed. Reg. 63113 (Oct. 14, 2010).

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Principle 7: Liquidity risk

Cover one/cover two

Key Consideration 3 for Principle 7 states that a CCP "should have sufficient liquid resources to meet required margin payments and effect the same-day close out or hedging of the [one/two] participant[s] and [its/their] affiliates with the largest potential liquidity need[s] in extreme but plausible market conditions." For the same reasons set forth above in connection with Principle 4, CME Group is concerned with the use of the term "affiliates" in this provision and recommends that it be removed or, at a minimum, amended to "affiliated clearing members." Similarly, for many of the same reasons described above regarding credit risk, we believe that a cover-one requirement is also appropriate as a minimum standard for liquidity risk.

Our final comment regarding the quoted language from Key Consideration 3 is that the reference to "required margin payments" is somewhat unclear. We assume that what is intended in that regard is that the CCP should have sufficient liquid resources to meet the largest participant's settlement obligations to other participants. We suggest that the language be revised accordingly.

Liquid resources

The first sentence of Key Consideration 5 states:

For the purposes of this principle, liquid resources include cash at the central bank of issue and creditworthy commercial banks, as well as highly marketable collateral held in custody and investments that are readily available on a same-day basis and that are also convertible into cash with prearranged funding arrangements including committed liquidity lines, foreign exchange swaps, repos, or pledges.

Nothing in the FMI Report indicates that sovereign debt, including U.S. Treasury securities (Treasuries), would not constitute "highly marketable collateral" for purposes of Principle 7.¹⁵ Nevertheless, because statements have been made in the course of discussing the FMI Report to suggest otherwise, we will address the liquidity of the Treasuries market.¹⁶

Notwithstanding the current uncertainties associated with U.S. government discussions on the debt ceiling and deficit reduction, the Treasuries market is the most liquid fixed-income market in the world. Buyers and sellers of Treasuries are able to transact business in quantity and at a fair price because the market is so active and has so many participants. The average daily trading volume for Treasuries in 2010 was \$528.2 billion. Discussions with potential liquidation agents regarding market capacity for liquidating Treasuries for same-day cash indicate more than sufficient capacity to liquidate Treasury collateral to cover liquidity needs.

¹⁵ We note that the liquidity-risk rules for Basel III define Level 1 or "highly liquid" assets to include "marketable securities representing claims on or claims guaranteed by sovereigns", provided that they meet certain conditions, including being "traded in large, deep and active repo or cash markets characterized by a low level of concentration" and having a "proven record as a reliable source of liquidity in the markets (repo or sale) even during stressed market conditions...." We also note that, under U.S. law, loans or extensions of credit fully secured by the current market value of Treasuries are not subject to lending limits. 12 C.F.R. § 32.3(c)(3)(i).

¹⁶ CME Clearing plans to utilize liquidation-agent agreements with experienced market participants to facilitate same-day liquidation for "highly marketable collateral" such as Treasuries. Particularly because loans secured by Treasuries are not subject to bank lending limits, 12 C.F.R. § 32.3(c)(3)(i), we believe such arrangements increase the flexibility that agents have for providing liquidity for Treasuries. To the extent that a payment-in-kind option for Treasuries to facilitate a clearing-member liquidation would further increase flexibility, we would be amenable to including appropriate provisions in our rule books to provide for this option.

In times of stressed market conditions, including during the recent financial crisis, liquidity in the Treasuries market is even greater due to "flight to safety" shifts in portfolio composition away from riskier securities and toward investments in safe and liquid markets, particularly U.S. Treasury securities.¹⁷ As staff from the Federal Reserve Bank of St. Louis have observed, Treasuries

... are widely regarded to be the safest investment because they lack significant default risk. Therefore, it is no surprise that investors turn to U.S. Treasuries during times of increased uncertainty as a safe haven for their investments. This happened once again during the recent financial crisis. In fact, the increased demand for Treasuries was sufficiently large so that prices actually rose with an increase in the supply of government securities.¹⁸

We view the uncertainties associated with the U.S. government discussions on the debt ceiling and deficit reduction as problematic but resolvable. Upon resolution, we envision Treasuries as continuing to play an important role in collateral policy at CME Clearing. Any suggestion that Treasuries are not "highly marketable collateral" for purposes of Principle 7 does not square with the facts, and may lead to a problematic overreliance on committed lines of credit. As stated in Explanatory Note 3.7.2 (Sources of liquidity risk), "an FMI may face additional risk from entities that have multiple roles within the FMI (for example, a participant that also serves as the FMI's ... liquidity provider)." Such wrong-way risk would be exacerbated if CCPs were required to rely in large part on lines of credit as liquidity resources. Furthermore, if committed lines of credit were viewed as the primary vehicle for CCPs to satisfy liquidity-resource requirements, it is far from clear that the group of banks that generally subscribe to CCP lines would have sufficient lending capacity to satisfy the resulting aggregate liquidity needs.

Principle 8: Settlement finality

Explanatory Note 3.8.3 (Same-day settlement) provides as follows:

An FMI's processes should be designed to, at a minimum, *complete final settlement no later than the end of the value date*. This means that any payment, transfer instruction, or other obligation that has been submitted to and accepted by an FMI, in accordance with its risk-management and other relevant acceptance criteria, should be settled on the intended value date. *An FMI that does not provide final settlement on the value date (or same-day settlement) would not satisfy this principle even if the settlement date of the transaction is adjusted back to the value date after settlement....*

With regard to contracts that may be settled by physical delivery, the above language is too strict because it does not reflect the possibility that market participants may fail to deliver the underlying commodity or financial instrument by the end of the value date. We therefore recommend that this language be revised.

¹⁷ Carol C. Bertaut and Laurie Pounder, *The Financial Crisis and U.S. Cross Border Financial Flows*, Federal Reserve Bulletin, Nov. 2009, at A147.

¹⁸ Bryan North and Rajdeep Sengupta, *Flight to Safety and U.S. Treasury Securities*, The Regional Economist, July 2010, at 18.

Principle 9: Money settlements

Key Consideration 1 for Principle 9 provides that FMIs should conduct money settlements "in central bank money, where practical and available, to avoid liquidity and credit risks." Explanatory Note 3.9.2 further states: "Central banks have the lowest credit risk and highest liquidity with regard to their currency of issue. Indeed, one of the fundamental purposes of central banks is to provide a safe and liquid settlement asset." We do not believe that all central banks are inherently superior to commercial banks for the purpose of conducting money settlements. A CCP's decisions regarding money settlements should be based on various risk-management considerations, which may or may not lead a particular CCP to conclude at a particular point in time that money settlements should be conducted in central bank money.

Explanatory Note 3.9.5 (Commercial bank money) states that an FMI should take steps "to limit its credit exposures and liquidity pressures by diversifying the risk of a commercial settlement bank failure, where reasonable, through the use of multiple commercial settlement banks and the use of concentration limits." The meaning of the phrase "concentration limits" as used in this provision is unclear. As the Explanatory Note further observes, the number of commercial settlement banks that meet appropriate criteria for creditworthiness and operational reliability may be limited. We therefore believe it would be unwise to encourage CCPs to impose artificial limits on the number of clearing members or the size of clearing-member accounts at a particular settlement bank. The Explanatory Note also states that "[a]n FMI should closely *control* the full range and concentration of exposures to commercial settlement banks and assess its potential losses and liquidity pressures as well as those of its participants in the event that the commercial settlement bank with the largest share of activity were to fail." We believe that "monitor" is more appropriate than "control" in this context.

Principle 14: Segregation and portability

Differences in applicable law

CME Group strongly agrees with Key Consideration 1 for Principle 14, which states that CCPs "should have segregation and portability arrangements that protect customer positions and collateral *to the greatest extent possible under applicable law*, particularly in the event of a default or insolvency of a participant." Explanatory Note 3.14.4 (Legal framework) emphasizes that the law applicable to a particular CCP "will influence how the segregation and portability arrangements are designed, and, therefore, what benefits can be achieved." Given the (in some cases vast) differences in insolvency regimes and other laws applicable to CCPs and their clearing members from country to country (as recently demonstrated in the insolvency proceedings of various Lehman Brothers entities throughout the world),¹⁹ we do not believe that CPSS-IOSCO can, as a practical matter, compile meaningful international "best practices" with regard to segregation and portability.

We are concerned that certain explanatory notes regarding omnibus customer accounts versus individual customer accounts seem to overlook that applicable law may require CCPs to utilize a particular customer account structure. Explanatory Note 3.14.10 (Customer accounts), for example, states that CCPs "should consider offering individual customer account segregation given the additional customer protection benefits." In the United States, however, regulations promulgated by the CFTC under the Commodity Exchange Act call for an omnibus account structure for customer accounts at the clearing level for exchange-traded derivatives. We note that this system (which also includes the portions of the U.S. Bankruptcy Code that apply to commodity brokers) has performed admirably over the years, with no U.S. futures customers suffering losses as a result of a commodity broker's bankruptcy or default, including the recent insolvency of Lehman Brothers, Inc. (a clearing member of CME and its affiliated exchanges, the

¹⁹ See, e.g., *Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets*, Technical Committee of the International Organization of Securities Commissions (March 2011).

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Chicago Board of Trade, or CBOT, and the New York Mercantile Exchange, or NYMEX). The CFTC has proposed regulations that would extend the omnibus account structure to cleared customer OTC swaps in a somewhat revised form. The explanatory notes should better reflect the constraints of local regulatory regimes by stating that, *if permitted under applicable law*, a CCP should consider offering individual account segregation.

Costs associated with individually segregated customer accounts

We are also concerned with the statement in Explanatory Note 3.14.10 that, if a CCP offers individual customer accounts, it "should offer them at reasonable cost and in an unrestrictive manner and require direct participants to offer those accounts to their customers at a reasonable cost and in an unrestrictive manner." As observed in Explanatory Note 3.14.6, "[m]aintaining individual accounts ... can be operationally and resource intensive for the CCP or its custodian in settling transactions and ensuring accurate bookkeeping. This approach could impact the overall efficiency of the CCP's operations." Accordingly, CCPs may not be able to offer individual customer accounts at what would be universally viewed as "a reasonable cost", and they may need to limit such accounts to certain types of customers (e.g., pension funds or investment advisers with fiduciary duties to their clients) in order to be able to offer them at all.

In order to aid in better understanding the categories of increased operational costs that may arise from switching from an omnibus-account structure to an individual-account structure for all customers (assuming that such an account structure is permissible under the laws and regulations governing a CCP), we note that an omnibus structure for customer accounts enables CCPs to net all pays and collects across all accounts of each clearing member into one net pay or collect amount. CME Clearing relies on this structure to facilitate financial stability in large part by removing debt obligations among market participants as they occur. This is accomplished by independently determining a marking price at the close of each settlement cycle daily for each contract and marking all open positions to that price. Each business day, CME Clearing performs two full settlement cycles, marking to the market once in the late morning (for exchange-traded futures and options) and once in the late afternoon. Actual settlement of the late morning mark-to-market occurs at mid-day and actual settlement of the late afternoon mark-to-market occurs in the early morning hours of the next day.

Two distinct processes occur during a settlement cycle. Initially, at each settlement cycle, all new trades are captured, cleared and marked-to-market. All open positions are also marked-to-market at that time. Cash settlement occurs for the mark-to-market on open futures positions and the option premium associated with new options positions, known as settlement variation. Simultaneously, forward looking collateral requirements are re-evaluated for all open positions. The combination of these two processes – the cash payments that move between CME Clearing and its clearing members and the resetting of performance bond (or margin) coverage – ensure that all accumulated debt obligations are removed from the system, and that CME Clearing holds sufficient collateral to protect against anticipated losses that clearing members and their customers may accumulate before the next settlement cycle. In times of extreme price volatility, CME Clearing has the authority to perform additional mark-to-market calculations on open positions and call for immediate payment of settlement variation. 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.

CME Clearing has worked with the industry over time to develop a cost-effective, flexible collateral program. Our current collateral program presumes use of the existing omnibus structure prescribed by CFTC regulations. Switching to a system of individually segregated accounts for each customer of each clearing member would require the establishment of a multiplicity of customer accounts at each clearing member, CCP, bank, and other depository of customer funds, across asset types. At a minimum, this would involve a substantial increase in customer banking and custody fees.

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Consider a scenario where just 10,000 customer accounts (a small fraction of the total number of customer accounts of CME, CBOT and NYMEX clearing members) pledge the following currently accepted asset types, necessitating approximately ten accounts per customer: cash, U.S. Treasuries, European Sovereigns, high-grade corporate bonds, foreign exchange, equities and various money-market funds. In order to replicate existing functionality, CME Clearing would have to assess the staffing, systems, and compliance work necessary to support the establishment and maintenance of approximately 100,000 separate customer custody accounts. In assessing these implications, CME Clearing would have to consider issues such as standard operational account maintenance, daily reconciliations, coupon interest and dividend processing, daily deposits and withdrawals, and the potential for different obligations associated with tax reporting. These overheads would likely drive the CFTC-regulated cleared derivatives industry to a "cash with interest and Treasuries only" model. This would have a profoundly negative impact to the standard revenue model of most of our clearing members.

Under a regime of individually segregated accounts for every customer, CME Clearing would be unable to net pay and collect amounts across all customer accounts of a particular clearing member into a single net pay or collect. This would likely undermine certain aspects of CME Clearing's current settlement system. At present, settlement banks approve payments based on the clearing member's status with the bank. If each customer had separately segregated accounts, however, approval of settlement payments may no longer remain among the settlement bank, clearing member and CCP, but may shift to being among the settlement bank, CCP and each customer of each clearing member. We believe this would substantially delay the settlement process and may eliminate the ability to perform intra-day settlements, thereby introducing significant risk into the system. Foregoing an intra-day mark-to-market process for futures contracts may further necessitate moving to two-day margin rather than one-day margin coverage for such products, which would increase margins by a substantial amount.

Additionally, in order to deal with the multiplicity of separate customer accounts created under a full individual-account regime, CME Clearing would be required to rebuild many of its existing systems and increase staff in all departments, including but not limited to the Financial Unit, the Audit Department and Risk Management. We anticipate that such cost increases would be material.

Using the Audit Department as an example, its current practices under the existing omnibus-account structure are to review all customer-segregated bank accounts to ensure they are properly titled and covered by the requisite segregation acknowledgement letter. Auditors "tie out" every line item included on clearing members' month-end financial computations, as of the audit date. This includes tracing balances to third-party documents such as bank accounts, trade registers, carrying-broker statements and equity runs. CME Clearing auditors reconcile clearing members' daily segregation computations as of the audit date to the official month-end financial statement submitted to CME Clearing to ensure that each clearing member has appropriate daily procedures and internal controls. They also review sampling of daily customer-segregation statements to ensure the statements are being completed in a timely fashion, to check for any significant variances, and to ensure that excess segregation is maintained.

Adopting an across-the-board individual-account structure for customers would have a dramatic impact on CME Clearing's Audit Department and the financial and regulatory oversight functions it performs (with parallel impacts on its clearing member firms). Each customer account at each clearing member would be required to have its own segregation computation (rather than a "pooled" computation under the existing omnibus regime); its own account at each CCP, bank and other depository; and its own acknowledgement letter from each depository. Consequently, CME Clearing would have to perform the steps noted above under the omnibus model separately for each of the tens or hundreds of thousands of customer accounts, rather than reviewing approximately 50 customer-segregation computations and 50 bank and CCP reconciliations under an omnibus-account model (i.e., one for each clearing member that carries customer accounts).

This would place a severe burden on the Audit Department's resources and engender delays in completing financial reviews and audits of clearing member firms. On a related note, clearing members would be required to work with firms that furnish their back-office accounting software to make system changes necessary to support separate segregation statements for each customer account, which we expect would be a costly and time-intensive endeavor. Some have estimated upfront operational costs to each clearing member of \$33 million and ongoing operational costs of \$136 million.²⁰ The significant operational costs associated with switching from an omnibus structure to a full individual-account structure were an important factor in leading to the CFTC's recent determination not to impose a "Full Physical Segregation" model for customer cleared-swap accounts.²¹

Principle 17: Operational risk

Key Consideration 5 for Principle 17 provides that a CCP's business continuity plan "should ensure that critical information technology (IT) systems can resume operations within two hours following disruptive events." CME Group is a strong proponent, and acknowledges the importance, of a robust business continuity program. The CME Group CCPs have worked diligently to develop and continually improve their business continuity systems, and we support efforts to enhance systems safeguards of CCPs to minimize market disruptions. Nevertheless, we are concerned with a minimum international standard that would require every CCP to ensure resumption of operations within two hours of a disruptive event. This would impose enormous costs on CCPs that currently are not required to comply with a two-hour standard. We also question whether any type of cost-benefit analysis was conducted prior to deciding to impose a minimum standard of a two-hour recovery time requirement on all CCPs.

We understand that, following the events of September 11, 2011, the Federal Reserve, the Securities Exchange Commission and the Office of the Comptroller of the Currency issued the *Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial Markets* (the Sound Practices Paper), which proposed – as a guideline – a two-hour recovery-time objective (RTO) for certain CCPs. We also understand that CCPs were given a period of years to substantially implement the suggested RTOs on a voluntary basis. If CPSS-IOSCO implements a two-hour RTO as a minimum standard for CCPs, we strongly suggest that the final report make clear that CCPs have an appropriate period of time to come into compliance. Otherwise, given that the final CPSS-IOSCO document is scheduled for the beginning of 2012, CCPs would have an unrealistically short period of time to achieve compliance.

Principle 18: Access and participation requirements

Introductory Note 1.26 (Interoperability) observes that interoperability "is not the focus of any specific principle" but is addressed in various parts of the FMI Report, including Principle 18. Key Consideration 1 for Principle 18 states that "[a] FMI should allow for fair and open access to its services, including by direct and, where relevant, indirect participants *and other FMIs*, based on reasonable risk-related participation requirements." Explanatory Note 3.18.2 (Fair and open access to payment systems, CSDs, SSSs and CCPs) similarly provides that "[a]n FMI's participation requirements should therefore encourage broad access, including access by participants, *other market infrastructures*, and where relevant services providers, in all relevant jurisdictions, based on reasonable risk-related participation requirements."

²⁰ Letter from International Swaps and Derivatives Association (Robert Pickel, Executive Vice Chairman) to the U.S. Commodity Futures Trading Commission (Jan. 18, 2011), at 10.

²¹ 76 Fed. Reg. 33818, 33828 (June 9, 2011).

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CME Group supports *voluntary* linkage arrangements between CCPs, but we caution CPSS-IOSCO against including any language in the FMI Report that may be construed as *requiring* interoperability between CCPs. Mandatory interoperability or linkage arrangements between CCPs (i.e., requiring one CCP to expose itself to the credit risk of another CCP) would increase systemic risk, running counter to a fundamental goal of financial regulatory reform legislation. Because each CCP has different credit profiles, margining, collateral and risk-management practices, forced interoperability arrangements among CCPs would pose substantial credit and operational risks. When one side of a matched trade is transferred to another CCP, the original CCP would automatically become exposed to the risk of the other CCP. Failure by one CCP to pay another CCP could create liquidity risks for the CCP that is owed money, which could prevent it from meeting its obligations to its clearing member participants. This could create a domino effect of failures and significant systemic risk. We therefore suggest that Principle 18 should focus more specifically on access and participation requirements for CCP members.

Principle 20: FMI links

Explanatory Note 3.20.13 (CCP-CCP links) addresses potential risks that a CCP may face from another linked CCP, and includes the following statement: "Another source of risk may emerge if a link arrangement treats the linked CCP differently from other participants, such as setting less strenuous participation requirements for the linked CCP than for other participants." This statement overlooks the fact that CCPs play a unique role as compared to other participants (i.e., clearing members), which makes it prudent – not problematic – to subject a linked CCP to different participation requirements. As one example, while every participant must have appropriate risk-management systems in place, the risk-management approach of a linked CCP takes on a heightened importance in terms of participation requirements. Conversely, capital requirements for other participants may, for good reason, be higher than capital requirements for a linked CCP, where the focus is better placed on the linked CCP's financial resources package and liquidity facilities.

Principle 22: Communication procedures and standards

Key Consideration 1 for Principle 22 and Explanatory Note 3.22.2 (Communication procedures) provide that an FMI should use or accommodate the use of "international accepted communication procedures that can support *interoperability* between the FMI, its participants, their customers and other users...." We are concerned with the use of the term "*interoperability*" here, which is commonly used to refer to the concept of open positions being transferred from one exchange or CCP to another. To avoid potential confusion, we suggest that the language be revised to reference "*interoperability between the information systems of the FMI, its participants, their customers and other users....*"

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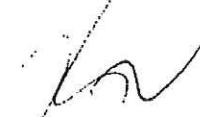
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Again, we appreciate this opportunity to provide the Committee members with our comments. If you have any comments or questions about our submission, please feel free to contact Kim Taylor, President of CME Clearing, at 312-930-3156 or kim.taylor@cme.com, or Andrew Lamb, Chief Executive Officer of CME Clearing Europe, Ltd., at 44-207-796-7170 or andrew.lamb@cme.com.

Very truly yours,



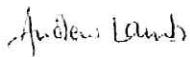
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