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June 30, 2009

**Questionnaire for CDS CCPs on Protection of Customer Initial Margin**

*This questionnaire has been prepared by an ad hoc group (comprising both buy-side and sell-side constituents)<sup>1</sup> to more fully understand the rights of “customers” – i.e., buy-side and other market participants proposing to clear CDS transactions through clearing members (“CM”) of a central CDS counterparty (“CCP”) – to initial margin (“IM”) posted in connection with the central clearing of certain CDS transactions.*

*The questions are divided into two sections. The first part solicits responses to several factual matters regarding the clearing structure of the CCP, the precise means by which IM is held by the CCP and CMs (and their custodians, if applicable), and the CCP's proposals as to segregation and portability of customer positions and initial and variation margin (and any associated contractual relationships).<sup>2</sup> The second part solicits responses as to the legal treatment of the CCP's proposed clearing structure. As the latter inquiry is largely dependent on the legal and contractual framework governing the CCP, the CMs and the customers (and the relationships between them), the questions in the second part should be considered under the laws of all jurisdictions relevant to the CCP (and its custodian, if applicable), the CMs (and their custodians, if applicable) and the customers. We note that although similar or identical questions are posed throughout certain portions of the questionnaire, this repetition arises from the need to consider the questions for each level at which IM is held: (i) IM held at the CCP (or the CCP's custodian) – referred to in this questionnaire as “CCP Margin”, and (ii) IM held at a CM (or the CM's custodian) – referred to in this questionnaire as “Dealer Margin”.*

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<sup>1</sup> This group was formed at the behest of the Federal Reserve Bank of New York, and consists of buy-side members Alliance Bernstein, Barclays Global Investors, Blue Mountain, Brevan Howard, D.E. Shaw, Goldman Sachs Asset Management, King Street and PIMCO, and sell-side members Barclays Capital, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, JPMorgan Chase, Morgan Stanley and UBS. ISDA, the Asset Managers Group of SIFMA, and Managed Funds Association are facilitating and observing the group's activities.

<sup>2</sup> If the CCP is envisioning a multi-step approach to implementation, please detail both the interim and final phases, and an approximate time frame for achievement of the latter. If customers or CMs may elect one of multiple options with respect to any aspect of the clearing structure, please describe all such options.

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**Overview of CME Clearing**

In overview, the CME Clearing structure protects market participants by acting as a counterparty to, and thereby guaranteeing performance of, every cleared trade, rigorously enforcing risk management discipline and appropriate collateralization, and supporting its performance guarantee with the resources of the world's largest clearinghouse mutualization structure.

CME Clearing is the counterparty to every CME cleared trade. In the event one CM defaults, all other CMs are protected because their counterparty is not the defaulting CM, but instead CME Clearing, again supported by the CME's \$8 billion mutualized financial safeguards package. CME faces only CME CMs as counterparties. CME CMs are subject to rigorous membership criteria and continuous risk assessment by CME Clearing's risk management group, with appropriate adjustment of counterparty, concentration and other risk limits. CME CMs are comprised of the world's leading diversified financial institutions and specialist derivative and commodity trading firms. In addition, CME enforces a rigorous system of performance bond requirements, collecting initial margin and, through its twice-daily mark-to-market of every position, variation margin, to ensure that all positions are continuously adequately collateralized. Because of this proactive and rigorous risk management process, the CME mutualization fund has never suffered a loss in its 110 year history.

The CM clearing structure provides the foundation for the protections and benefits afforded to end customers who are not CMs. Customers who are not CMs contract with a CM that is a registered Futures Commission Merchant ("FCM") to clear on their behalf. A customer's performance in positions in CME cleared products is guaranteed by that customer's CM, thus protecting the integrity of the Clearing House and the Clearing House's mutualization scheme. In the event that a CM defaults on its proprietary obligations, or declares bankruptcy, each individual customer of that CM is protected because its FCM has held the customer's initial margin and positions in accounts that are segregated from the accounts of the FCM and not subject to the FCM's bankruptcy. In the event of a CM default, CME Clearing immediately intervenes to facilitate the transfer of the defaulting CM's customer margin and position to other, non-defaulting CM's. Additionally, through Rule 975, CME Clearing has broad powers to act in an emergency situation. That is, CME Clearing can act to safeguard customer interests and market integrity before a technical state of clearing firm default exists. Through numerous challenges, including the recent collapses of Bear Stearns and Lehman Brothers, this structure has been proven to protect customer positions and margin, and the continuity of the markets in which these firms were active, again without loss to (but with the reassurance of performance afforded by) CME Clearing's mutualized financial safeguards package.

Customers further benefit from the CME Clearing framework because the initial and variation margin assessed by CME Clearing on its CMs is consistent and transparent, and published so that all market participants can estimate their own margin requirements. While CMs may assess a

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higher margin level on their customers (to account for CMs' counterparty risk assessment of their customers, or for other reasons), the CME's published margin levels serve as a benchmark to which all market participants can refer. In addition, CME Clearing publishes settlement prices daily; these prices form the basis of the margin assessments it makes on its CMs. Again this affords all market participants a consistent and transparent basis for understanding the margin they are assessed, and for estimating their prospective requirements.

The framework outlined here is described in more detail in the CME Clearing Financial Safeguards publication set out at

<http://www.cmegroup.com/clearing/files/financialsafeguards.pdf>.

CDS products cleared by CME enjoy the full benefits of this framework, including the CME's default management processes and the full support of the CME's \$8 billion mutualized financial safeguards package. Customers similarly enjoy the full benefits of bankruptcy-protected segregation and portability in respect of their CDS accounts, as more specifically addressed in the answers to the questions on these topics below.

***Please also find an attached memorandum from CME Group analyzing the treatment of customers of futures commission merchants under Subchapter IV of Chapter 7 of the U.S. Bankruptcy Code 11 U.S.C.A. §761 in respect of their over-the-counter ("OTC"), credit default swap contracts ("CDS") that are cleared through a futures commission merchant ("FCM") by the Chicago Mercantile Exchange Clearing House.***

**I. Factual Matters****A. Composition and Structure of the CCP, CMs, Custodians and Customers****Structure of the CCP**

1. *Please describe the legal structure (e.g., entity type, jurisdiction, governing structure, etc.) of the CCP. Include references to any required licenses or registration orders obtained in connection with the establishment of the CCP.*

CME Clearing is the clearing house division of Chicago Mercantile Exchange Inc. (CME), a Delaware corporation, which is wholly owned by CME Group, Inc. ("CME Group"), a publicly traded Delaware corporation. CME Group was formed by the merger of Chicago Mercantile Exchange Holdings Inc. and CBOT Holdings, Inc. in 2007, and subsequently merged with NYMEX Holdings, Inc. in 2008. CME Group is the parent of: (1) CME; (2) the Board of Trade of the City of Chicago ("CBOT"); (3) New York Mercantile Exchange, Inc. ("NYMEX"); and (4) Commodity Exchange, Inc. ("COMEX"). Products listed by the CME Group Designated Contract Markets ("DCM")

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and cleared by CME Group's Derivatives Clearing Organization ("DCO") DCOs include exchange-traded futures and options, as well as over-the-counter (OTC) derivatives listed for clearing only by CME Group DCOs.

In its capacity as a DCO, CME Clearing provides clearing services for all of the CME DCMs and DCOs. CME Clearing is the largest DCO in the world. In 2008, it cleared approximately 3.2 billion transactions in exchange traded futures and options and clearing-only OTC derivatives products listed by CME Group DCMs and DCOs. For all contracts that it accepts for clearing – whether exchange-traded futures and options or cleared-only OTC derivatives – CME Clearing is substituted as the counterparty, significantly mitigating credit risk for market participants by guaranteeing performance of each cleared contract.

2. *Please list all relevant regulatory and supervisory authorities of the CCP.*

CME Group is the parent of: (1) CME; (2) the Board of Trade of the City of Chicago ("CBOT"); (3) New York Mercantile Exchange, Inc. ("NYMEX"); and (4) Commodity Exchange, Inc. ("COMEX"), each of which is registered with the Commodity Futures Trading Commission ("CFTC") as a designated contract market ("DCM") and the first three of which are registered with the CFTC as a derivatives clearing organization ("DCO"). Products listed by the CME Group DCMs and DCOs include exchange-traded futures and options, as well as over-the-counter (OTC) derivatives listed for clearing only by CME Group DCOs.

In addition to being registered with the CFTC, as a DCO, CME Clearing is registered with the UK Financial Services Authority (FSA) as a Recognized Overseas Clearing House (ROCH). CME is also notice registered with the Securities and Exchange Commission (SEC) as a special purpose national securities exchange for the purpose of trading securities futures products.

Pursuant to the Commodity Exchange Act (CEA), CME is required to comply with the 18 DCM core principles and 14 DCO core principles articulated in the CEA and CFTC regulations and enforced by the CFTC. The CFTC conducts regular audits and risk reviews of CME to ensure compliance with all of these core principles. Among other things, the DCO core principles mandate that CME Clearing:

- Have adequate financial, operational and managerial resources.
- Manage its risks through the use of appropriate risk management tools and procedures.
- Complete settlements in a timely manner.
- Have standards, rules, procedures or programs designed to:

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- Protect and ensure the safety of clearing member collateral and funds;
- Ensure the daily processing, clearing and settlement of transactions in the event of an emergency;
- Allow for efficient, fair and safe management in the event of a clearing member's insolvency or default; and
- Ensure its systems function properly and have adequate capacity and security.

DCO Core Principle C (Participant and Product Eligibility) states as follows:

*The applicant shall establish (i) appropriate admission and continuing eligibility standards (including appropriate minimum financial requirements) for members of and participants in the organization; and (ii) appropriate standards for determining eligibility of agreements, contracts, or transactions submitted to the applicant.*

In addressing Core Principle C, applicants and registered derivatives clearing organizations may describe or otherwise document:

- 1) Member/participant admission criteria:
  - a. How admission standards for its clearing members/participants would contribute to the soundness and integrity of operations; and
  - b. Matters such as whether these criteria would be in the form of organization rules that apply to all clearing members/participants, whether different levels of membership/participation would relate to different levels of net worth, income, and creditworthiness of members/participants, and whether margin levels, position limits and other controls would vary in accordance with these levels.
- 2) Member/participant continuing eligibility criteria:
  - a. A program for monitoring the financial status of its members/participants; and
  - b. Whether and how the clearing organization would be able to change continuing eligibility criteria in accordance with changes in a member's/participant's financial status.
- 3) Criteria for instruments acceptable for clearing:
  - a. The criteria, and the factors considered in establishing the criteria, for the types of agreements, contracts, or transactions it will clear; and
  - b. How those criteria take into account the different risks inherent in clearing different agreements, contracts, or transactions and how they affect maintenance of assets to support the guarantee function in varying risk environments.

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4) The clearing function for each instrument the organization undertakes to clear

CME Clearing, with direction from the Clearing House Risk Committee, has established appropriate admissions and continuing eligibility standards for its clearing membership. These criteria are reviewed, as necessary, by the Clearing House Risk Committee.

In addition, each DCM and DCO performs as a self regulatory organization (“SRO”) with respect to its members and clearing members, and in the case of CME, its SRO functions are performed by its Market Regulation, Audit, and Clearing Departments.

As part of its system of regulatory oversight, the CFTC reviews the controls and tools utilized by CME Clearing, including: (1) appropriate membership standards and continuing oversight of clearing members; (2) collection of position reports from large traders; (3) daily mark-to-market of all open positions; (4) collection of an appropriate amount of performance bond (sometimes referred to as “margin”), which serves to cover any losses that cannot be met by the market participant; (5) periodic stress testing of open positions; (6) an ability to liquidate all of a market participant’s open positions quickly; and (7) availability of other financial resources for use by the clearing house to cover any member default. While CME Clearing does not need pre-approval from the CFTC to clear OTC derivatives, any such initiatives are required to comply with the relevant DCO core principles. In addition, the CFTC must pre-approve requests from CME Clearing to commingle funds associated with cleared-only OTC derivatives with customer segregated funds related to futures and options contracts listed for trading on a DCM.

The CME Group committee with primary oversight responsibility of CME Clearing is the Clearing House Risk Committee (“CHRC”), comprised of twelve representatives, including clearing firms and financial institutions<sup>3</sup>. The CHRC has primary oversight over the clearing house rules, risk management policies, financial safeguards structure, clearing membership requirements, margin models and enforcement authority over clearing member compliance with regulatory requirements and CME rules. The board of directors of CME Group is ultimately responsible for and in control of CME Clearing business strategy.

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<sup>3</sup> Included on the Clearing House Risk Committee are representatives from:

- Morgan Stanley & Co., Inc.
- Goldman Sachs & Co.
- J.P. Morgan.
- Fortis Clearing Americas LLC
- Citigroup Global Markets, Inc.
- SMW Trading Company, Inc.
- TENCO, Inc.
- BMO Capital Markets Corp

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With respect to credit default swaps (CDS) in particular, the CFTC, the SEC and the Federal Reserve have thoroughly reviewed CME Clearing's CDS offering, including applicable risk-management methodologies, and have approved the clearing of CDS by CME Clearing. The CME Group Risk Committee also approved the extension of CME Clearing's industry leading \$8 billion guarantee to CDS contracts. Furthermore, after substantial diligence on the CME CDS margin methodology, the Financial Industry Regulatory Authority (FINRA) established an interim pilot program with respect to margin requirements granting an exception to broker-dealers clearing CDS executed by FINRA member broker-dealers and cleared by CME Clearing (FINRA Rule 4240, Margining for Credit Default Swaps, see <http://www.sec.gov/rules/sro/finra.shtml>). The SEC has also approved FINRA Rule 4240.

- 3. Please detail any legal or regulatory segregation requirements applicable to customer IM held at the CCP.*

CME is seeking approval from the CFTC to hold in the 4d or customer segregated account customer funds and property for CME cleared CDS.

Section 4d(a)(2) of the CEA provides that:

It shall be unlawful for any person to engage as a futures commission merchant or introducing broker in soliciting orders or accepting orders for the purchase or sale of any commodity for future delivery, or involving any contracts of sale of any commodity for future delivery, on or subject to the rules of any contract market or derivatives transaction execution facility unless ... (2) such person shall, if a futures commission merchant, . . . treat and deal with all money, securities, and property received by such person to margin, guarantee, or secure the trades or contracts of any customer of such person, or accruing to such customer as the result of such trades or contracts, as belonging to such customer. Such money, securities, and property shall be separately accounted for and shall not be commingled with the funds of such commission merchant or be used to margin or guarantee the trades or contracts, or to secure or extend the credit, of any customer or person other than the one for whom the same are held.

Section 4d(b) of the CEA further provides that:

It shall be unlawful for any person, including but not limited to any clearing agency of a contract market or derivatives transaction execution facility and any depository, that has received any money, securities' or property for deposit in a separate account as provided in paragraph (2) of this section, to hold, dispose of, or use any such money, securities, or property as belonging to the depositing futures commission merchant or any person other than the customers of such futures commission merchant.

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CME is seeking its order from the CFTC pursuant to section 4d(a)(2) of the CEA which provides, in pertinent, part:

That in accordance with such terms and conditions as the Commission may prescribe by rule, regulation, or order, such money, securities, and property of the customers of such futures commission merchant may be commingled and deposited as provided in this section with any other money, securities, and property received by such futures commission merchant and required by the Commission to be separately accounted for and treated and dealt with as belonging to customers of such futures commission merchant.

The CFTC has previously issued 4d orders permitting CME and its clearing members to commingle customer funds used to margin, secure or guarantee certain cleared-only OTC swaps (*e.g.*, ethanol, grains) with other funds held in segregated accounts related to exchange-traded futures contracts, subject to terms and conditions specified by the CFTC.

Until such time as the CFTC issues the requested 4d order, CME Rule 8F03 requires customer funds and property for OTC Derivatives (including CDS contracts) to be held in a 30.7/secured account. Similar to regulations relating to customer funds held under 4d segregation, funds held pursuant to Regulation 30.7 must be held in a location/account that clearly identifies the funds as held for the benefit of customers. These funds cannot be commingled with the firm's own funds or 4d funds, and firms must calculate their obligations to customers on a daily basis.

Regulation 30.7 offers FCMs a choice in how to calculate the amount of their set-aside obligations with respect to customer funds to which the Regulation applies. Most firms choose to calculate their 30.7 obligations under the "net liquidating method", which is identical to how firms calculate their 4d segregation obligations (*i.e.*, all funds received from customers are held in a segregated account). However, Regulation 30.7 provides for an "alternative method" that allows a firm to calculate its 30.7 obligations based on the margin needed for its customers' trading plus or minus unrealized gains or losses on such trading. If this alternative method is chosen by the customer's FCM, any excess amount over that sum may be used by the FCM for purposes other than the transactions of that customer, such as a margin payment for the positions of another customer with positions in the 30.7 account. For OTC derivatives held in the 30.7 account, CME rule will require CMs to use the net liquidating method and not the alternative method. Similar to regulations relating to customer funds held under 4d segregation, funds held under Regulation 30.7 must be held in a location/account that clearly identifies the funds as held for the benefit of customers. These funds cannot be commingled with the firm's

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own funds or 4d funds. Firms must calculate their obligations to customers on a daily basis.

Structure of CMs

4. *Please describe the legal structures applicable to the CMs.*
  - a. *Does the CCP restrict either the (i) organizational type (e.g., banks, broker-dealers, futures commission merchants, unregulated entities, etc.) or (ii) jurisdictions of organization of CMs? (Note: This will be key, as much of the legal analysis will depend on the insolvency laws applicable to the CMs.)*

While CME has few restrictions on the country of origin of a CM because of bankruptcy law considerations, we do require that all banking, involving settlements of variation margin ("mark-to-market"), premium pay/collect, and performance bond ("margin") call/release, be performed in either the US or the UK. Additionally, because of regulatory considerations, our rules require that all customer business subject to CFTC customer segregation rules be cleared by an FCM registered with the CFTC. Due to differences in bankruptcy regimes, customers should perform due diligence regarding the customer protection mechanisms in the CM's home jurisdiction.

CMs that are FCMs can be located outside the US. In the past we have had clearing members practicing operational remote clearing from various locations and currently one clearing member does remote clearing from London, with banking operations involving settlements (i.e., variation margin, premium pay/collect, and performance bond call/release) performed in the US.

CME policies provide a significant amount of operational flexibility. CMs can maintain multiple clearing accounts with CME Clearing to accommodate affiliated entities (or parent) of the FCM CM. Under this relationship, the affiliate entity (or parent) can perform the operational aspects of the clearing process with the FCM legal entity facing the clearing house the legal holder of protected customer funds and positions.

For non-FCM entities in the US that actually book bi-lateral OTC transactions with non-dealer customers, the customers will need to have an account relationship with the CM FCM. However, for those non-FCMs which are offshore, they can facilitate clearing via a customer omnibus account on the books of its CM FCM without interfering with the bi-lateral trade booking processes or systems.

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Generally, the affiliate (or parent) of the FCM entity that enters into a bi-lateral OTC transaction with a non-dealer customer can facilitate the clearing of such a transaction through a customer omnibus account on the books of its affiliated FCM. The flexibility of such an arrangement allows affiliates (or parents) to leverage their current bi-lateral trade booking processes or systems.

5. *Please list all relevant regulatory and supervisory authorities applicable to the CMs.*

All CME CMs carrying customer positions and funds that are required to be segregated under the CEA must be registered with the CFTC as futures commission merchants ("FCM"s) and members of the National Futures Association ("NFA"). FCMs are subject to significant regulation by the CFTC and NFA, including regulatory capital and financial reporting and recordkeeping requirements, customer segregated funds requirements, audit by the NFA, and the CFTC's bankruptcy rules.

CME rules provide for operational access for clearing members to perform their business functions from most established jurisdiction, subject to applicable rules and regulations. CME rules also provide for full remote clearing (including the financial functions) from the UK because of our protected status in a bankruptcy under CME Clearing's Registered Overseas Clearing House status with the FSA.

A CM that is an FCM can be located outside the US. Such foreign FCMs must comply with certain US-based requirements, however, including (among other things) following NFA rules that require registrants to produce books and records here (in English) within 72 hours of an audit request. It is common for FCMs domiciled in other countries to have an office in the US but if books and records aren't in the US, they have to be in an approved country under the CFTCs Part 30 Rules (eg, UK, Canada). In addition, financial reports (eg, 1-FRs) must be calculated in US dollars and use US accounting standards.

6. *Please detail any legal or regulatory segregation requirements applicable to customer IM held at the CM.*

CMs clearing customer transactions must be registered with the CFTC as an FCM to provide customer protection under CFTC regulations.

Section 4d(a) of the CEA requires FCMs to segregate customer funds from their own funds, but permits them to commingle the funds of their individual customers for convenience and deposit such funds in accounts at banks or trust companies. CFTC Regulation 1.20 also provides that "customer funds when deposited with any bank, trust company, clearing organization or another futures commission merchant shall be

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deposited under an account name which clearly identifies them as such and shows that they are segregated as required by the Act and this part.”

In addition, Regulation 1.20 provides that each FCM “shall obtain and retain in its files...a written acknowledgement from such bank, trust company, clearing organization, or futures commission merchant, that it was informed that the customer funds deposited therein are those of commodity or option customers and are being held in accordance with the provisions of the Act and this part.” Regulation 1.20 further provides that “customer funds may be invested in instruments described in [Rule] 1.25.”

Similarly, customer funds held by FCMs for futures and options traded on foreign boards of trade pursuant to CFTC Regulation 30.7 (along with other CFTC “non-regulated” transactions held in the 30.7 or “secured” account, including certain cleared-only OTC derivatives) must be segregated from the FCMs’ own funds in accordance with the terms of Regulation 30.7. Regulation 30.7 requires, among other things, that secured accounts “must be maintained under an account name that clearly identifies them as such” with the following depositories: (i) a bank or trust company in the U.S., (ii) a bank or trust company outside the U.S. with either more than \$1 billion in excess regulatory capital or certain forms of commercial paper or long-term debt, (iii) an FCM registered with the CFTC, (iv) a DCO, (v) a member of a foreign board of trade, or (vi) such member’s or DCO’s designated depositories. FCMs must obtain, and retain for at least 5 years, an acknowledgement from each such depository that it was informed that the assets in the secured account are held for customers and are being held in accordance with Regulation 30.7.

CFTC regulations permit customer funds to be held by CM affiliates due to the protections afforded through segregation acknowledgement letters, where the bank agrees that the funds are held for the benefit of customers and will not offset any obligations of the CM to the bank with customer funds.

### Structure of Custodians (If Applicable)

7. *Please describe the legal structures applicable to the custodians used by the CCP and CMs to hold IM.*
  - a. *Does the CCP restrict either the (i) organizational type or (ii) jurisdictions of organization of entities that may serve as custodians of the CCP or CMs to hold IM? Are there any restrictions on whether such custodians may be affiliated with the CCP or CMs? (Note: This will be key, as much of the legal analysis will depend on the insolvency laws applicable to the respective custodians, to the extent IM is held by custodians.)*

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Custodians utilized by CME include banks, trust companies, and other service agents applicable to certain collateral management programs. CME's selection standards for margin settlement banks includes a review of the current relationship (if applicable), their credit ratings, capital adequacy, liquidity, recent year earning, and operational capabilities.

Generally, CM's may use any intermediary for custodial services as long as the custodian meets the regulatory criteria as a "good location". See Appendix for criteria. In addition to the requirements for recognition as a "good location" (see Appendix for criteria), CFTC Regulation 1.49 also specifies certain conditions that allow FCMs to deposit customer segregated funds in offshore depositories.

No custodian utilized by CME is affiliated with CME. Some custodians are affiliated with existing CME clearing firms. Both CMs and CME may hold accounts at custodians affiliated with CMs. Any accounts of CME held by custodians, affiliated with a CM or not, are held in the name of CME specifically, and are subject to applicable regulatory requirements. Any CME accounts holding customer funds are also subject to the segregation letter acknowledgement by the depository of no right of setoff against any obligations of the CM or CME, as applicable, to such depository.

8. *Please list all relevant regulatory and supervisory authorities applicable to the custodians.*

Relevant supervisory authorities include the Fed, the SEC, OCC, FDIC, CFTC and the State Banking Authorities.

9. *Please detail any legal or regulatory segregation requirements applicable to customer IM held at the custodians.*

All custodians, regardless of supervisory authority, are required to sign "segregation acknowledgement letters" which states that, "Accordingly, funds deposited in the Account shall be separately accounted for and segregated as belonging to the commodity customers of Clearing Members; no portion of the funds in the Account may be obligated to any person (including your Bank), except to purchase, margin, guarantee, secure, transfer, adjust or settle trades, or contracts of commodity customers; and no person (including your Bank) may hold, dispose of, or use any funds in the Account as belonging to any person other than commodity customers. Without limiting the generality of the foregoing, the funds in the Account will not be subject to any lien or offset or liability which may now or hereafter be owing to your Bank by the Exchange or

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any other person other than customers, and such funds shall not be applied by your Bank upon any such indebtedness or liability”.

*Structure of the Customers*

*10. Please describe the legal structures applicable to the customers.*

- a. Does the CCP restrict either the (i) organizational type or (ii) jurisdictions of organization of customers? (Note: This may be important, as some of the legal analysis may depend on the insolvency laws applicable to the customers.)*

There are no restrictions imposed by CME Clearing on either the organizational type or the jurisdiction for the end customers. That is a decision for each CM. The only requirement is that a customer trading OTC derivatives, including CDS, must be an “eligible contract participant” (see appendix for definition) (or, for certain agricultural swaps, an eligible swap participant). It is the responsibility of the CM to ensure the customer satisfies those requirements, although CME further requires customers to represent and warrant (in either the Clearing 360 Agreement, CME ClearPort Exchange User License Agreement, or CMDX Participant Access Agreement) that they meet these requirements.

In addition, CMs must register each customer with CME Clearing for risk management purposes, even if those customers are cleared through an omnibus arrangement with the CM. Customers may be located in any jurisdiction, and are subject to the Anti Money Laundering restrictions imposed by their CM. CME Clearing does not have a direct claim against customers intermediated by a CM.

*11. Please list all relevant regulatory and supervisory authorities applicable to the customers.*

Customers may or may not be subject to supervision by a regulatory authority. This will depend on the type of business in which they participate, and the jurisdiction in which they conduct their business. Regulatory oversight could be provided by the CFTC, SEC, Fed, FSA, state banking and insurance commissions.

*Expansion/Restriction of Permitted Entity Types*

*12. In weighing the relative benefits and drawbacks of expanding or restricting the entity types and jurisdictions of the CMs, customers and custodians, what factors did the CCP consider in its analysis? For example, to what extent did the CCP consider the following issues in reaching its proposed structure?*

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In structuring our clearing offering, in general, CME considered the following factors to be key decision factors:

1. Structuring services that were consistent with our obligations under the core principles of the CFTC DOC registration status – our primary regulatory status
2. Offering fair and open access to clearing services both for direct clearing participants and end user customers
3. Providing the highest degree of customer funds protection and bankruptcy portability for customers available under the various available legal structures
4. Maximizing the capital efficiency and risk diversification benefits available to clearing participants by facilitating a combined financial safeguards package enabling the marketplace to benefit from CME's existing \$2 billion default fund
5. Ensuring prudent risk management protections in line with the risk profile of the CDS product set
6. Maximizing the legal certainty of the clearing regime by accessing a well developed regulatory structure
7. Obtaining the highest degree of bankruptcy and systemic risk protection for the CCP services including the unfettered rights to collateral and position liquidation and close out netting

In terms of delineating the rules and requirements around clearing membership, CME provides for fair and open access for fully qualified market participants (those with ability to demonstrate broad expertise in the trading and risk management of cds products). CM's must also maintain sufficient capital to appropriately fund their business and weather adverse market conditions and prove themselves capable of actively participating in our daily mark to market pricing process, our default procedures and our hedging activities in a default situation to be able to face the clearing house directly for purposes of self clearing their business. We do not impose arbitrary organizational restrictions on clearing members or rely on highly restrictive minimum capital requirements as a primary risk management tool. Rather, we engage in active risk management of our clearing members and ensure that all of our financial and market expertise requirements scale with the size and nature of the clearing member's exposures.

Although our rules do not preclude non-dealer clearing members, experience has shown us that very few non-dealer participants are actually interested in self clearing. So it was critical to our structure that there be both fair and open access for clearing membership and sound customer protections for market participants who choose to use an intermediary to access the cleared cds products.

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As noted above, CME will be providing clearing services in its DCO capacity using existing rules and legal structures, which approach offers clearing members and customers substantial advantages. Most importantly, it offers CMs and their customers the backing of CME's existing financial safeguards package of nearly \$8 billion, without the requirement of separate capitalization of a new clearinghouse.

Consequently, the entity requirements for CMs are governed by CME's existing rules, CFTC requirements, requirements imposed by the SEC in its Order that are consistent with CFTC requirements for CMs, and specific requirements imposed by CME with respect to CDS clearing. Specifically, in addition to the CFTC requirements and SEC requirements, CME requires that CMs clearing CDS for solely their own account or fir customers, to maintain adjusted net capital of at least \$300 million, evidence appropriate experience in the CDS market commensurate with their anticipated clearing activities, participate in CME Clearing's CDS default management, participate in CME's daily mark-to-market process, have requisite risk management and operational capabilities and infrastructure in place to support CDS clearing. This allows well-capitalized CDS market participants to maximize protection of their positions and IM by becoming clearing members, without registering with the CFTC as an FCM.

We have addressed each of the specific factors suggested by the Committee below.

- a. *Netting implications for CMs and their affiliates (from a credit, accounting and capital perspective);*

CME's approach recognizes the agency relationship that exists between a clearing firm and its customers. As such, clearing firms may not net exposures between proprietary positions and those of their customers, although the clearing firm may net exposures between its proprietary exposures and those of its affiliates. See part 5.b. below for a fuller discussion of the capital perspectives.

- b. *Regulatory capital implications for CMs and their affiliates;*

We anticipate that most active dealers in the CDS market already have FCM affiliates that are well-capitalized and meet CME's requirements. Others very likely have (or certainly may establish) relationships with existing CME clearing member firms.

FCMs are subject to capital requirements imposed by CME, the CFTC and/or, if they are also broker dealers, the SEC. CME has secured specific approval for its portfolio-based margining methodology from FINRA and the SEC under FINRA

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Rule 4240 (see: <http://www.sec.gov/rules/sro/finra.shtml>) and clarification that an FCM/broker dealer (FCM/BD) that meets the requirements of Rule 4240 is generally obliged to hold no incremental broker dealer regulatory capital in respect of CDS positions it clears on behalf of either customers or affiliates (beyond a possible concentration charge specified in paragraph (e) of FINRA Rule 4240, which may also be reduced by excess margin held in all customer and affiliate accounts). FCM capital requirements are continuously monitored and reviewed by CME Clearing.

Non-FCMs that clear directly with CME will be subject to its regulatory requirements. For Basel I counterparty credit risk purposes, we would expect that US banking entities would treat CME's cleared CDS products identically to exchange-traded derivative contracts and other cleared only OTC swaps. CME continues to work with all relevant regulators to ensure the appropriate capital treatment for all CDS participants.

There is a range of trade flows available to CMs to optimize the benefits of CME Clearing for CMs, their customers and their affiliates as discussed below.

**Indicative Trade Flow Options**

The diagram below is a representation of current OTC trades that a customer (Customer A) may have with a bank (Holding Company B). Under this depiction, the Holding Company B holds the CDS position in its bank (Bank B) with the following capital implications:

- Bank B incurs market risk associated with its position.
- Bank B incurs counterparty credit risk associated with Customer A as its counterparty.
- BD/FCM B does not hold a position nor does it act as agent of a transaction and thus, requires no SEC and or CFTC capital for this transaction

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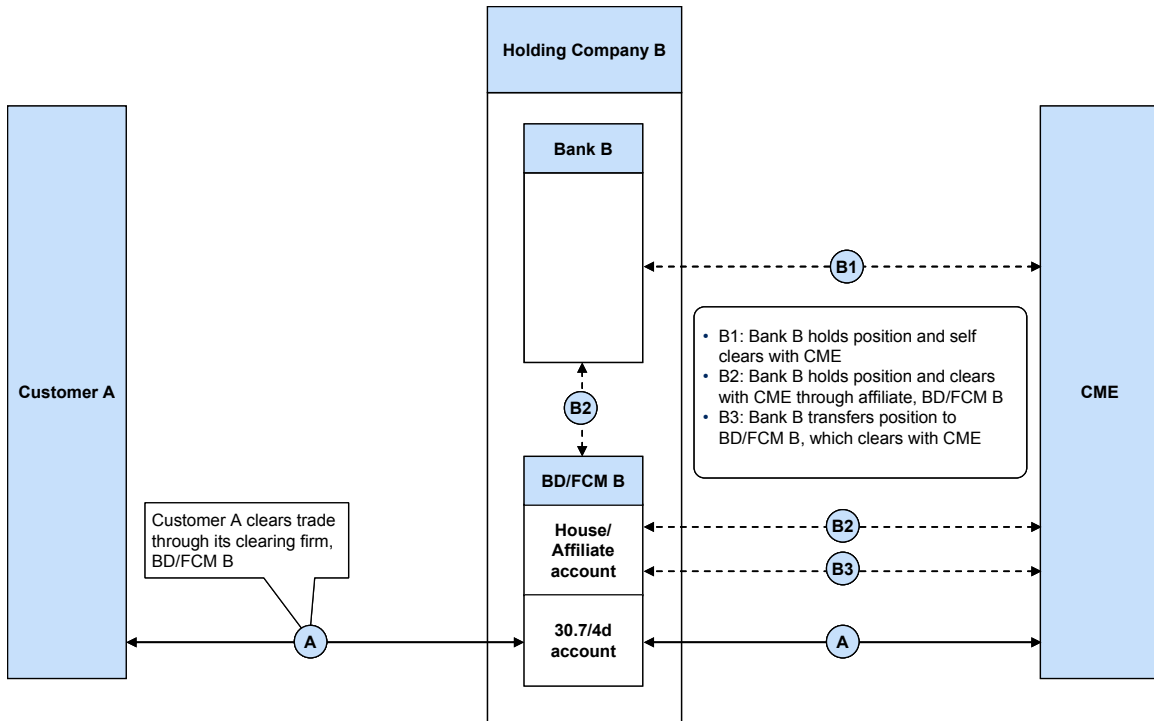


As the diagram below illustrates, if Customer A and Bank B agree to clear this trade with CME Clearing, Holding Company B will be involved in: (i) an agency transaction between Customer A, its BD/FCM, and CME Clearing (see flow A below); and (ii) a principal transaction that faces CME Clearing (see flows B1, B2 and B3 below). Note that we lay out three options for Holding Company B in arranging this principal transaction with CME Clearing:

- Flow B1: Holding Company B continues to hold the position in Bank B but then self clears this position with CME Clearing. Bank B must become a self-clearing member.
- Flow B2: Bank B holds the position but chooses to clear through its affiliate, BD/FCM B. In this instance, Bank B is the principal and BD/FCM B is acting as agent for Bank B.
- Flow B3: Bank B transfers the position to its affiliate, BD/FCM B, whereby BD/FCM B becomes the principal in this transaction. BD/FCM B clears this position with the CME.

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**Capital effects of clearing CDS with CME under these Indicative Trade Flows**

We understand certain key capital implications for Holding Company B in respect of each trade flow to be as follows:

Agency Transaction

- Agency Transaction A: BD/FCM B clears trade with CME for Customer A
  - BD/FCM B
    - FCM/BDs clearing for customers must meet the margin requirements set out in FINRA Rule 4240. Rule 4240 generally allows a broker dealer to meet its Rule 4240 margin obligations by collecting from customers an amount of margin equal to the margin collected by CME from the broker dealer. The SEC has clarified that a broker-dealer that holds a CME contract for a customer will not take any incremental broker-dealer regulatory capital charges (beyond a possible concentration charge specified in paragraph (e) of FINRA Rule 4240, which may also be reduced by excess margin held in all customer and affiliate accounts) provided (a) the broker-dealer collects from the customer the margin required under FINRA Rule 4240 and (b) the position is held in a segregated account.

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- Under CFTC regulations, FCMs must maintain regulatory capital equal to at least 8% of the required margin for customer positions.
- A joint BD/FCM such as BD/FCM B would apply the greater of the CFTC or SEC capital requirements on all of its positions. An FCM that is not an FCM/BD would be subject only to CFTC regulatory capital requirements.
- Holding Company B
  - Because BD/FCM B is acting as agent in this transaction, Holding Company B requires no Basel I or Basel II market risk charge in this transaction.
  - Holding Company B must maintain appropriate counterparty credit risk capital in facing Customer A and CME Clearing. Regarding Holding Company B's counterparty risk capital treatment for CME-cleared CDS, see paragraph regarding Basel I capital below.
- Legal and collateral offset between customer positions held at affiliated CM and derivatives dealer entities
  - With respect to cleared and bilateral CDS positions booked to disparate derivatives dealer and CM legal entities, in order to create legal close-out netting, and if desired, position flattening to effect net margin calculation and collateral calls in respect of such CDS positions, FCM and swap dealer affiliates could enter into a master netting and collateral agreement with a customer. Provided the required customer CME margin is posted for CME-cleared positions, there is no CME restriction on any such arrangements between CMs and their customers. Furthermore, there is no CME restriction on the affiliates of a CM entering into such arrangements with the CM and the CM's customers.

**Principal Transaction**

- Principal Transaction B1: Bank B holds position and self-clears with CME
  - Bank B/Holding Company B
    - Any Holding Company Basel I or Basel II market risk charge should be no different between (i) holding the position on a bank or unregulated vehicle directly facing a counterparty (as is likely the case today), and (ii) clearing the position and facing the CME Clearinghouse.
    - Holding Company B must maintain appropriate counterparty credit risk capital in facing CME. See the paragraph regarding Basel I counterparty credit risk capital charges below.
    - Bank B is not a broker-dealer nor FCM and therefore is not subject to SEC nor CFTC regulatory capital requirements.
- Principal Transaction B2: Bank B holds position and clears with CME through its affiliate FCM
  - BD/FCM B

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- FCM/BDs clearing for affiliates must meet the margin requirements set out in FINRA Rule 4240. Rule 4240 generally allows a broker dealer to meet its Rule 4240 margin obligations by collecting from affiliates an amount of margin equal to the margin collected by CME from the broker dealer. For the purposes of broker-dealer regulatory capital, a broker-dealer that holds a CME contract for its affiliate will not take any incremental broker-dealer regulatory capital charges (beyond a possible concentration charge specified paragraph (e) of FINRA Rule 4240, which may also be reduced by excess margin held in all customer and affiliate accounts) if (a) the broker-dealer collects from the affiliate the margin required under FINRA Rule 4240 and (b) the account is included in the SEC 15c3-3 (SEC customer protection) calculation.
- Under CFTC regulations, FCMs must maintain regulatory capital equal to at least 4% of the required margin for positions of their affiliates.
- A joint BD/FCM such as BD/FCM B would apply the greater of the CFTC or SEC capital requirements on all of its positions. An FCM that is not a joint BD/FCM would be subject only to CFTC regulatory capital requirements.
- Bank B/Holding Company B
  - Any Holding Company Basel I or Basel II market risk charge will be no different between (i) holding the position on a bank or unregulated vehicle directly facing a counterparty (as is likely the case today), and (ii) clearing the position through its affiliated CM and facing the CME Clearinghouse.
  - Bank B may be required to ascertain appropriate intra-company counterparty credit risk capital in facing its affiliate, BD/FCM B. We understand that at the holding company level, this capital charge is consolidated, and for holding company purposes only the CME's counterparty credit risk capital treatment would apply. See the paragraph regarding Basel I counterparty credit risk capital charges below.
  - Holding Company B must maintain appropriate counterparty credit risk capital in facing CME. See the paragraph regarding Basel I counterparty credit risk capital charges below.
- Principal Transaction B3: Bank B transfers positions to BD/FCM B, which clears with CME
  - BD/FCM B
    - For SEC regulatory capital purposes, the proprietary haircut for a CDS of a:
      - CSE broker-dealer is calculated using its VAR haircut formula
      - Non-CSE broker-dealer that is a CDS buyer is zero
      - Non-CSE broker-dealer that is a CDS seller is calculated per SEC Rules for Nonconvertible Debt Securities if the underlying debt

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obligation is rated in one of the four highest rating categories by at least two NRSROs. This haircut varies between 2% to 9%. If the underlying debt obligation is not so rated by a NRSRO, the haircut is 15%.

- For CFTC regulatory capital purposes, the CFTC will defer to the SEC where its product rules are not inconsistent.
- Holding Company B
  - Any Holding Company Basel I or Basel II market risk charge will be no different between (i) holding the position on a bank or unregulated vehicle directly facing a counterparty (as is likely the case today), and (ii) holding the position in its affiliated broker-dealer and facing the CME Clearinghouse.
  - Holding Company B must maintain appropriate counterparty credit risk capital in facing CME. See the paragraph regarding Basel I counterparty credit risk capital charges below.

Confirmation of exemption from Basel I counterparty credit risk capital charges, Basel II status

As noted in each type of transaction, Holding Company B would be subject to counterparty credit risk capital requirements in facing the CME. CME is in the process of confirming with the appropriate regulators that CDS cleared through CME, subject to twice-daily marking to market, a rigorous initial margin methodology and the full financial safeguards of the CME are excluded from Basel I counterparty credit risk capital charges. The key regulatory agencies have already acknowledged that they “consider a qualifying central counterparty to be the functional equivalent of an exchange, and have long exempted exchange-traded contracts from risk-based capital requirements.”<sup>4</sup> The CME meets the conditions of a qualifying central counterparty under Basel II and believes that participants should be accorded the same treatment for CDS cleared through CME as they would receive on exchange-traded products, currently exempt from counterparty credit risk capital charges.

*c. Operational efficiencies or inefficiencies, and other business implications of operating through the permitted entity types;*

CFTC regulation offers the industry a tested, flexible, and viable customer protection mechanism, while at the same time allowing CME to recognize the agency relationship that exists between a clearing firm and its customer. CME Clearing offers its clearing membership a wide variety of choices around how to administer its business functions from remote locations, or to opt to fully operate

<sup>4</sup> Federal Register, Vol. 72, No. 235, Friday, December 7, 2007, Rules and Regulations, p. 69356.  
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a clearing entity from approved foreign locations, such as the UK. CME clearing membership standards support a wide variety of corporate and regulatory organizational types, such as banks, so as to offer firms the widest degree of choice in determining how to best minimize operational issues in choosing how to internally structure CDS clearing.

For those firms desiring to clear CDS out of their FCM entities, bookkeeping systems have been built to support CDS requirements, and CME is working with interested parties to minimize adoption hurdles; CME is agnostic to clearing firms internal systems, so long as they meet operational and regulatory requirements. Moreover, we position clearing firms to achieve a variety of financial efficiencies and diversification benefits in using CME's existing pool of financial safeguards.

- d. *Adverse pass-through effects (e.g., unfavorable pricing) flowing from the CMs to customers as a result of the foregoing; and*

Centralized and independently determined daily mark to market prices actually reduce the potential for adverse marks and the attendant disputes between dealers and their customers. CME has a well established process for investigating concerns with our centralized and independently determined daily mark to market prices and with incorporating enhancements over time to adapt for changing market conditions.

- e. *The legal regime applicable to the proposed clearing framework upon an insolvency of a CM, customer or custodian.*

CME's clearing is backed by our existing financial safeguards package of nearly \$8 billion and provides customers the special protections afforded under the Bankruptcy Code (as described in detail in the legal section of this document) with respect to cleared commodity contracts.

Assets held in custody at banks or other custodians under the benefit of the customer segregation protections are remote from the bankruptcy of the bank or custodian and protected from inclusion in the bankruptcy estate of an insolvent FCM.

Consequently, the entity requirements for CMs and Custodians are governed by CME's existing rules, CFTC requirements, requirements imposed by the SEC<sup>5</sup>

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<sup>5</sup> SEC Order Granting Temporary Exemptions Under the Securities Exchange Act of 1934 in Connection With Request of Chicago Mercantile Exchange Inc. and Citadel Investment Group, L.L.C. Related to Central Clearing of Credit Default Swaps (Release No. 34-59578, March 13, 2009) (the "SEC Order").  
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(which are consistent with CFTC requirements), and specific requirements imposed by CME with respect to CDS clearing, as described above. We believe that the approach of clearing through our DCO and the related entity requirements strike the best possible balance among the goals of (i) greatly reducing counterparty credit risk and systemic risk in the CDS market, (ii) providing for fair and open access for fully qualified market participants, (iii) maximizing operational effectiveness and legal protections for both CMs and customers in a default situation, and (iv) enhancing operational efficiencies and reducing operational risks.

Our approach offers CM's the maximum possible netting of actual positions in our standardized contracts for themselves and their affiliates, as all such positions are carried together and offsets are automatic. Customers similarly enjoy full netting benefits for positions carried with a single clearing member. Certain qualified market participants that are not FCMs conducting customer business may also become CMs themselves in order to face the CCP directly for self-clearing CDS positions, provided that they meet CME's requirements for clearing membership, including specific requirements with respect to CDS clearing.

CME's approach also avoids adverse pass-through effects with respect to the relationship between CMs and customers. CMs are permitted to require customers to post higher amounts of IM than required to be collected by CME. This provides CMs flexibility to risk manage their customer relationships, but the availability of information about CME's margin requirements and the publication of daily settlement prices enhances margining and mark to market pricing transparency for customers.

CME's approach also enhances operational efficiencies and reduces operational risks. Most major institutions that are active as dealers in the CDS markets have affiliates that are already CMs of CME and registered with the CFTC as FCMs. These CMs are well-capitalized institutions with substantial experience managing customer relationships. They are connected to CME's clearing systems and are familiar with CME's policies, procedures and operational requirements; this familiarity will reduce operational risks, particularly in emergency situations. Our approach provides sufficient operational flexibility to adapt for the fact that the CDS dealing business is generally conducted not by our CMs but by their affiliated entities, and that these affiliates may employ different systems to connect to their CDS customers. However, such operational hurdles can be overcome and separate systems can be readily integrated or interconnected into our standardized, automated interfaces, and we believe that the overall operational benefits of our approach outweigh these concerns.

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Finally, we chose to offer CDS clearing in our DCO capacity precisely because it provides superior protections to all participants (and reduces systemic risk effects) in an insolvency of a CM, a customer or a custodian, as described in detail in our answers in section B below. CMs and customers are protected by CME's risk management approach and the resources of CME's full financial safeguards package. Customers' net equity held by an insolvent CM is also protected under the special provisions of the Bankruptcy Code and Part 190 of the CFTC's regulations promulgated under the CEA.

*13. What is the process for approval and consideration of risks presented by additional CM or custodian entity types (by way of inclusion of new CMs or custodians or mergers of existing CMs or custodians in a manner that changes the applicable legal structure)?*

CME employs the same considerations and analyses as that included in Question 12 in accepting new types of CMs as well as any new custodians used by CME. Specifically, we assess their operational capacity and financial wherewithal. In the case of mergers, CME considers the concentration of business for specific entities to ensure we continue to be comfortable with the entity's ability to meet its operational, risk management and financial requirements and responsibilities.

**B. Segregation and Safekeeping of IM****IM Held at or for the CCP ("CCP Margin")<sup>6</sup>****Composition of CCP Margin**

- 1. Please describe the types of assets (e.g., Treasury securities, US dollars, non-US currencies, etc.) that may be deposited as CCP Margin to satisfy IM requirements imposed by the CCP ("Required Margin"). To what extent did customer protection considerations affect the CCP's determination in this regard?*

CME Clearing has structured its collateral programs to support acceptance of a wide variety of collateral. Generally, CME Clearing structures its collateral programs so as to achieve a state of simultaneous possession and control over the collateral, with custodial omnibus account structures employed at applicable custodians. In some instances (e.g.,

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<sup>6</sup> Please also answer the questions below with respect to excess variation margin (i.e., mark-to-market margin posted by customers in excess of the CCP's requirements), to the extent excess variation margin is treated differently from CCP Excess Margin.

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equity shares), CME Clearing accepts collateral on the basis of achieving control over the collateral. In any case, CME Clearing's incentive is to ensure that the quality of its first priority security interest in the collateral is as strong as possible. Customers enjoy a high degree of clearing-level protection and benefit through these arrangements.

The assets acceptable for meeting margin requirements are those deemed by CME Clearing to present the least exposure to credit, liquidity and market risks. CME Clearing seeks to accept only those assets that are readily available to market participants and can be readily converted to cash at a predictable value, in a predictable timeframe in order to minimize systemic risk during times of market stress.

CME Clearing collateral programs are subject to the approval of the Clearing House Risk Committee. See the appendix attached to this document for a full description of CME collateral management services, or utilize the following link:  
<http://www.cmegroup.com/clearing/financial-and-collateral-management/>.

CDS exposures will be subject to a twice daily cash mark-to-market process, with variation margin denominated in U.S. dollars for U.S. dollar-denominated CDS, and in euro currency for euro-denominated CDS. Losses are fully collected by CME Clearing from CMs; profits are fully paid by CME Clearing to its CMs both to the extent required to maintain necessary margin requirements.

Clearing firms are generally free to accept a wider array of collateral from their customers, so long as such collateral meets SEC readily marketable standards. See CME Rule 930.C.

As many CM's determine their acceptable collateral policy for customers based on CME Clearing's collateral policy, ensuring that the assets are readily available to all market participants and can be readily converted to cash as noted above is of consideration at both the CCP level and the CM level.

### *Nature of Relationship Between CCP, CMs, Custodians and Customers*

- Please describe the nature of the legal and contractual relationship between the CCP, the CMs, custodians, the customers and any other relevant parties, specifically addressing the following:*

The CCP's relationship with its CMs is controlled primarily by the rules of the CCP. (See Chapters 8 and 9 of the Rulebook in Appendix) The rules form a contractual relationship between the CCP and the CMs and outline the rights and responsibilities of the CMs. In

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addition to the rules, each CM executes a CM Agreement that requires the CM to abide by the rules of the CCP.

The CCP also has a contractual relationship with its Custodians. The CCP and the Custodians execute a Custody Agreement that explains the rights and responsibilities of each party. Finally, each CM enters into a agreement with its Customers that set forth the legal rights and responsibilities of the CM and the Customer.

- a. *Are CMs acting as agents or principals (or operating with aspects of both) vis-à-vis (i) the CCP and (ii) customers? Please elaborate.*

CMs clearing customer business act as agents for undisclosed principals, (the customers), vis a vis CME Clearing and guarantee their customers' performance to CME Clearing, and thus from the CME's perspective, the CM is facing the CME as principal on its customer transactions. The CM-customer agency relationship facilitates customer segregation protection, bankruptcy portability of customer positions and favorable capital treatment for the CM. It also facilitates operational simplicity and efficiency by avoiding the necessity of the CMs booking a string of back to back transactions between the CM and CCP, CM and customer. This structure also facilitates improved systemic risk protection by providing bankruptcy protections and certainty to the CCP in the event of a CM default. The CM will face CME Clearing as a principal for its proprietary business.

- b. *If customers are permitted to clear transactions through non-CM affiliates of the CM, who in turn clear through the affiliated CM, please describe in detail the mechanics of such an arrangement.*

This process would be accomplished through the use of omnibus accounts. In these situations, the individual customers are fully disclosed on the books of the non-CM. The non-CM would then open an account on the books of its affiliated CM in the name of the non-CM "for the benefit of customers". The customer positions would flow through to this account. The CM would need to be registered with the CFTC as an FCM.

If neither the non-CM nor its customers were domiciled in the US, the non-CM would not need to register as an FCM. However, if either the non-CM or its customers were domiciled in the US, the non-CM would also have to register with the CFTC as an FCM in order to hold customer funds and positions.

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*Description of Proposed Clearing Structure<sup>7</sup>**3. Please detail the manner in which customers will post CCP Margin.*

Generally once transactions are submitted for clearing (via direct submission by the clearing member or via the submission of an allocation or “give-up” by another clearing member and acceptance of the allocation by the primary clearing member), those transactions are treated the same for clearing purposes. The only difference between direct transactions with the primary clearing member and transactions entered for clearing as allocations is that the submitting clearing member is financially responsible for the allocations temporarily until the primary clearing member accepts responsibility –

CME Clearing's process is geared to marking current day trades and open positions to market, and to also margin all open position exposures, on a twice daily basis. CME Clearing performs these functions for each CM account with current activity and/or open exposures. Each CM generally will have two clearing level accounts for CDS; proprietary non-segregated, customer segregated, or, until CFTC issues a 4d order, a third customer secured account. Any margin deficiency for any CM clearing account must be met by a payment of margin cash, sufficient to meet the margin call amount. Once margin cash is on deposit with CME Clearing, the CM may replace the margin cash with other forms of collateral, acceptable to CME Clearing. CME Clearing performs the banking of the requisite margin cash and margin collateral transactions by and between each CM's customer segregated, proprietary non-segregated, or customer secured account maintained with CME Clearing, and the clearing firm's corresponding account, all of which are performed at banks and custodians acceptable to CME Clearing as specified above.

Please note: CME's use of the term “segregated” throughout this document refers to the CFTC customer segregated funds mechanism. Use of the term “segregation” or “segregated account” is not always reflective of segregation as a term of art – common usage of the word “segregation” is as a synonym for “separate”.

*a. Will the CCP Margin be posted pursuant to pledge or title transfer arrangements?*

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<sup>7</sup> Please address the relevant questions with respect to each proposed clearing structure. For instance, if the CCP has one clearing structure for transactions entered into directly between a customer and its CM / prime broker, and another for transactions originally entered into between a customer and an executing broker that are subsequently given up to the customer's CM / prime broker, please respond to the questions with respect to each proposed clearing structure.

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As described in 1 above, collateral is generally held on a pledge basis, where a position of simultaneous possession and control is achieved by CME Clearing over the collateral. In certain limited circumstances, some assets are held through achieving control over the collateral. We do not transfer title.

- b. *May the CCP Margin consist of property posted by customers and pledged or transferred to the CCP, or must it consist of the proprietary assets of the CM?*

Yes, CCP Margin can consist of collateral posted by customers of CM and transferred to the CCP.

4. *Please detail the manner in which CCP Margin will be held (noting any circumstances in which the default clearing structure may be modified by elections available to CMs or customers), distinguishing between various categories of margin to the extent appropriate – e.g., (i) Required Margin, (ii) margin in excess of that required by the CCP to secure performance obligations in connection with cleared transactions (“CCP Excess Margin”), (iii) margin posted in respect of requirements imposed by CMs on their customers in excess of the CCP’s margin requirements (“Dealer Excess Margin”), etc. – and specifically addressing the following:*

Answers apply in principal to all three types of margin (CCP requirements, excess at CCP, and excess at CM) Per CFTC Rule 1.20, all customer assets are required to be held only in accounts maintained at large custodial banks and other permitted financial institutions, including clearing houses that are registered with the CFTC as DCOs. All customer segregated accounts are required to be clearly identified as segregated pursuant to CFTC Rule 1.20. CFTC Rule 30.7, known as customer secured amount, governs 30.7 assets. These funds are required to be held in accounts at banks and other permitted financial institutions, including non-US clearing houses and members of non US exchanges provided such non US clearing houses are deemed to be a “good control” location.

All 1.20 and 30.7 cash and custody omnibus accounts are named CME Inc, along with appropriate seg and secured designation.

- a. *CCP Margin Held Directly at a CCP (or at a Custodian Holding Solely for the Benefit of the CCP) – If the CCP will hold CCP Margin directly (without a custodian), or the custodian will hold CCP Margin only for the CCP (rather than for individual CMs or customers (individually or as a group)), please detail all aspects of the arrangement that are relevant from a customer protection standpoint, specifically addressing the following:*

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Generally, CME uses custodians and banks to hold most forms of collateral, within prescribed regulations. CME's collateral model is, where possible, to assume a position of simultaneous possession and control over the collateral, and to employ the use of omnibus accounts held in CME's name to facilitate certainty of access to collateral in a clearing member insolvency at each custodian for this purpose.

Clearing firms are generally free to utilize the same custodians as CME Clearing. CME Clearing margins clearing firm customer segregated and customer secured CDS exposures on a gross basis, and margins clearing firm proprietary, non-segregated exposures on a net basis.

To facilitate clearing member reconciliation, CM collateral holdings are booked at a sub-account level on CME Clearing's books and records to properly record the collateral holdings on behalf of each CM.

In limited cases, CME Clearing accepts collateral via a pledge transaction, thereby establishing "control" but only establishing "possession" in the case of a clearing member default. Pledge programs are thoroughly evaluated to determine the breadth of the control mechanism and the certainty of establishing possession if warranted. Equity shares are a good example of this particular practice.

Please note that while a CM must post minimum margin to CME for its customer positions, the CM, if it also acts as a prime broker for that same customer, may agree to margin netting arrangements for non-cleared customer positions.

In the event of a CM bankruptcy, a customer's claim against the bankrupt's estate is calculated in accordance with Regulation § 190.7(b) by netting the customer's claim in respect of commodity contracts against any obligations of the customer to the insolvent clearing member:

"Net equity means the total claim of a customer against the estate of the debtor based on the commodity contracts held by the debtor for or on behalf of such customer less any indebtedness of the customer to the debtor."

- i. *The manner in which the CCP holds the CCP Margin, distinguishing to the extent relevant between various categories and types of CCP Margin (e.g., securities or cash), and identifying in particular:*

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1. *On behalf of whom the CCP is holding the property – itself, the CMs or the customers (as a group or individually);*

Generally, CME employs two types of collateral accounts for cash and securities, all within prescribed CFTC regulations. At all times, collateral is held to secure the obligations of the depositing CM to the CCP. Customer segregated funds are held solely to secure the obligations of the customers of the depositing CM. Customer property is held on behalf of the customers as a group.

2. *Whether CCP Margin securing the positions of a particular CDS customer will be segregated from (i) the CCP Margin posted by other CDS customers and (ii) the property of other custodial claimants of the CCP or instead, commingled in a single omnibus account (either for CDS customers or custodial claimants of the CCP generally);*

Individual customer portfolios are margined on a net basis and all customer account margin at each clearing member will be held gross in the CM's customer segregated account at CME Clearing. Collateral lodged by a clearing firm for the benefit of a particular customer will be comingled with collateral held for the benefit of other customers. The pooled customer collateral and CME Clearing's right to liquidate that collateral if necessary in the event of a default is an important part of the systemic risk protections provided by a CCP. It keeps the impact of a default from impacting other clearing participants and provides customers with an important incentive to perform the proper due diligence and credit evaluation of their clearing members.

- a. *In whose name(s) has/have the account(s) been established?*

All 1.20 and 30.7 cash and custody omnibus accounts are named CME Inc, along with appropriate seg and secured designation.

3. *Whether CCP Margin securing customer positions will be segregated from the CCP Margin securing proprietary positions of CMs;*

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Yes; per CFTC segregation and secured requirements, CM's must appropriately separately account for customer segregated and customer secured positions and property from proprietary positions and property on their own books and records, and at their custodians as well. The rights of the FCM, a clearing house or a custodian or bank holding CFTC segregated customer property are limited and such limitation is affirmatively acknowledged by the custodial entity – no one holding CFTC segregated customer property is entitled to offset the unpaid obligations of the clearing member against the property of its customers, including a close-out netting or insolvency situation.

In fact, the Bankruptcy Code affords claims of customers the highest priority, subject only to the payment of claims relating to the administration of customer property. First, the customer segregated property of the bankrupt clearing member is to be distributed pro rata among the clearing member's customers. In determining the pro rata distribution, all property segregated on behalf of, or otherwise traceable to, a particular account class is allocated to that class. Property is distributed pro rata notwithstanding that it can be specifically identifiable to particular customers.

Second, if the segregated assets are insufficient to satisfy all customer claims in full, the clearing member's remaining assets are to be used to satisfy such claims before they are available for distribution to the clearing member's general creditors. After the claims of customers are paid in full, the same allocation formula is applied to distribute any remaining property to non-customers. The applicability of these and other bankruptcy-related provisions will depend on the circumstances of each situation.

See Section II, Legal Considerations, for a comparison of 4d and 30.7 customer protection requirements.

“Additionally, paragraphs (c) and (d) of the SEC Order provide that, in order to participate in CME's CDS clearing solution, CME CMs “shall segregate such funds and securities of U.S. customers from the CME clearing member's own assets” and comply with the rules of CME and applicable laws and regulations, including the obligation to maintain sufficient books and records to establish

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separate ownership of the customer funds, securities, and positions.”

4. *Any operational practices (whether voluntary or mandated by regulators) relevant to the analysis of customer protection and the sharing of any shortfalls in custodial property;*<sup>8</sup>

CFTC Part 190 rules have a detailed system regarding what will occur if there is a shortfall in customer property in the event of an FCM bankruptcy. CME's voluntary operational practice will be to mandate the use of 30.7 accounts for the segregation of customer funds until our 4d order is granted (see Rule 8F03 of the CME Rulebook).

As a self-regulatory organization, the CME's Audit Department operates a sophisticated financial surveillance program that monitors all of its CMs. The Audit Department routinely inspects the books and records of its CMs to ensure, among other things, their compliance with segregation requirements. These inspections are risk-based, focusing on those areas of greatest concern to the Clearing House. Violations of segregation requirements are considered serious infractions and can result in major penalties. In addition, for those CMs who are members of other exchanges, CME shares the results of its examinations.

5. *Under what circumstances CCP Excess Margin held at the CCP may be (i) withdrawn by the CM or customers or (ii) applied by CMs or the CCP.*

CM's may withdraw excess collateral at any time, consistent with CME Clearing rules and practice. CME Clearing does not set the policies by which clearing members govern collateral withdrawals by their customers. Customers are not allowed direct access to make collateral withdrawals from the collateral held by the CCP, but must effect their collateral transactions via their FCM.

All property held in the customer origin account in the name of CME may be used to fulfill the obligations of the clearing member with respect to its customer business in the case of an FCM's

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<sup>8</sup> See clause (ii) of note 6.  
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failure to pay its obligations to the CCP on behalf of its customer business.

- ii. *Whether the CCP has the right to rehypothecate or cause liens to be placed on the CCP Margin – e.g., to potential lenders or liquidity providers to the CCP – and if so, whether any such liens have been subordinated or waived; and*

CME Clearing has broad rights with respect to the use of the collateral posted by a clearing member in case of that clearing member's default on its obligations to the CCP.

CME Clearing may use assets deposited by a clearing member, other than customer segregated or secured assets, to secure its obligations to lenders under the liquidity facility, in accordance with CME Rule 817. Assets held in customer segregation, or via 30.7 protection or secured, may not be used for this purpose. CME Rule 827 permits CME Clearing to use certain financial instruments: "that are deposited with the Clearing House by clearing members in satisfaction of Security Deposit requirements or as performance bond for their own (i.e., "house") trades" to be rehypothecated in connection with a securities lending program. Customer segregated property is not subject to rehypothecation.

- iii. *Whether investment of CCP Margin in interest-bearing instruments or vehicles (e.g., overnight sweeps into repos) is permitted or required, and if so, in what types of instruments or vehicles.*

CME Clearing can invest "free" (cash posted to CME Clearing by the clearing firm and left un-invested by the clearing firm) clearing firm cash balances in overnight investments, typically collateralized by Treasuries in the form of overnight sale/buy back agreements. Investments on proprietary, non-segregated, customer segregated, or customer secured cash are performed separately and not comingled.

1. *Who obtains the economic benefit of investment of CCP Margin in permitted instruments? Who bears the risk of loss?*

In the vast majority of cases, CMs either place with the clearing house collateral instruments, such as securities, that bear a return or CMs direct the clearing house to invest their deposited cash in one or more of the CCP provided investment programs. In all of

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those cases, the risk and return of the investment accrues to the CM.

On occasion, clearing members may leave un-invested cash deposits with the clearing house. In those cases, CME policies allow for the clearing house to invest those deposits in overnight sale/buy backs. In such cases, the risk and return of those investments accrues to the CME.

CME has the ability to engage in securities lending with clearing firm proprietary collateral, through Rule 827. The risk and return of these investments accrues to CME Clearing.

2. *How does the above response differ as between Required Margin and CCP Excess Margin posted to the CCP?*

There is no difference in the treatment of required margin versus excess.

- b. *CCP Margin Held at a Custodian (Whether the Custodian is Holding for the CCP, Individual CMs or Customers)* – *If the CCP will hold CCP Margin at a custodian, please detail all aspects of the custodial arrangement that are relevant from a customer protection standpoint, specifically addressing the following:*

The answers to the questions in this section 4.b will in general mirror the answers to questions 4.a above. Generally, CME establishes a position of simultaneous possession and control over the collateral, and the custodian holds the collateral for the exclusive benefit of CME. However, clearing firms are generally free to utilize the same custodians as CME Clearing, subject to their own arrangements with the custodian.

- i. *The manner in which the custodian holds the CCP Margin, distinguishing to the extent applicable between various types of CCP Margin (e.g., securities or cash), and identifying in particular:*
  1. *On whose behalf the custodian is holding the property – the CCP, the CMs or the customers (as a group or individually);*

The custodian holds customer funds in an account specifically identified as one holding customer funds with an account title as specified per CFTC rules. Accordingly, funds deposited in the

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Account shall be separately accounted for and segregated as belonging to the commodity customers of Clearing Members; no portion of the funds in the Account may be obligated to any person (including the custodian), except to purchase, margin, guarantee, secure, transfer, adjust or settle trades, or contracts of commodity customers; and no person (including the custodian) may hold, dispose of, or use any funds in the Account as belonging to any person other than commodity customers. Without limiting the generality of the foregoing, the funds in the Account will not be subject to any lien or offset or liability which may now or hereafter be owing to the custodian by the Exchange or any other person other than customers and such funds shall not be applied by the custodian upon any such indebtedness or liability.

2. *Whether CCP Margin securing the positions of a particular CDS customer will be segregated from (i) the CCP Margin posted by other CDS customers and (ii) the property of other custodial claimants of the custodian, or instead, commingled in a single omnibus account (either for CDS customers or custodial claimants of the custodian generally);*

Accounts at a custodian are not held at the individual customer level.

- a. *In whose name(s) has/have the account(s) been established?*

All 1.20 and 30.7 cash and custody omnibus accounts are named CME Inc, along with appropriate seg and secured designation.

3. *Whether CCP Margin securing customer positions will be segregated from the CCP Margin securing proprietary positions of CMs;*

Customer funds must be segregated from funds securing proprietary positions.

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4. *Any operational practices (whether voluntary or mandated by regulators) relevant to the analysis of customer protection and the sharing of any shortfalls in custodial property;<sup>9</sup> and*

CFTC Part 190 rules have a detailed system regarding what will occur if there is a shortfall in customer property in the event of an FCM bankruptcy. CME's voluntary operational practice will be to mandate the use of 30.7 accounts for the segregation of customer funds until our 4d order is granted (see Rule 8F03 of the CME Rulebook).

5. *Under what circumstances CCP Excess Margin held at the custodian may be (i) withdrawn by the CM or customers or (ii) applied by CMs or the CCP.*

Please see answer to 4a) above

- ii. *Whether the custodian has the right to rehypothecate or cause liens to be placed on the CCP Margin, and if so, whether any such liens have been subordinated or waived;*

Please see answer to 4a) above

- iii. *Whether investment of CCP Margin in interest-bearing instruments or vehicles (e.g., overnight sweeps into repos) is permitted or required, and if so, in what types of instruments or vehicles; and*

Please see answer to 4a) above

1. *Who obtains the economic benefit of investment of CCP Margin in permitted instruments? Who bears the risk of loss?*

Please see answer to 4a) above

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<sup>9</sup> For example, please consider, to the extent relevant, (i) whether the intermediary is a UCC securities intermediary that credits securities to a securities account in the name of a particular customer or customers generally, and whether the securities intermediary debits securities from the securities accounts of its customers upon any rehypothecation of such securities, and (ii) whether any cash held by the intermediary is maintained as a segregated "special deposit" that remains property of a particular customer or customers generally under applicable law (as distinguished from a "general deposit" in which legal title to the cash passes to the intermediary).

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*2. How does the above response differ as between Required Margin and CCP Excess Margin posted to the CCP?*

Please see answer to 4a) above

*iv. How the risk of the custodian's insolvency is allocated among the CCP, the CMs and the customers (as a group and individually).*

CFTC segregation and custody agreements operate to insulate the CCP from the insolvency of the custodian. Margin assets are held in custodial safekeeping accounts, and are remote from the assets and liabilities of the custodian. Please also see our responses to Questions 1a and 2a in the Legal Considerations section.

*Transfer of CCP Margin from CMs to the CCP*

*5. If CCP Margin will be deposited by customers at their respective CMs, and subsequently transferred to the CCP, please address the following (distinguishing between various categories of CCP Margin (e.g., Required Margin, CCP Excess Margin, Dealer Excess Margin, etc.) and types of CCP Margin (e.g., securities or cash) to the extent relevant):*

*a. How long will it typically take for a CM to transfer CCP Margin posted by customers to the CCP?*

CME Clearing will calculate a clearing member's total customer margin requirement as the sum of the requirements across its individual customer accounts; this approach maximizes, rather than minimizing, the pass through of customer margin deposits from the CM to the CCP. CM's will be subject to twice daily margin calls, which should result in the prompt pass through of customer collateral deposits. CME Clearing's established settlement system and account infrastructure help facilitate the posting of collateral by its CMs. At its accounts with global custodians CME Clearing utilizes various automated collateral transfer systems and processes (ex: DTCC, FedWire, and Euroclear). CME Clearing has real time capabilities to deposit and withdraw collateral on behalf of Clearing Member Firms. CME Clearing is dependent upon the infrastructure of each CM for the timely pass-thru of customer collateral.

However, Clearing members are allowed to accept from customers a wider variety of collateral than they can pass through to CME Clearing; see Rule 930.C. If CMs choose to accept collateral that they cannot pass through to CME Clearing, they

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will have to hold the customer's collateral in a segregated account with their custodian and fund their clearing level requirements from their own financial resources. Any firm assets used to meet customer requirements become defacto assets of the customers.

*b. In the intervening period, where at a CM will the CCP Margin be held?*

Customer collateral held at a CM will be transferred and held at those banks and custodians where the CM has a corresponding business relationship, or held at another FCM, and are always subject to a customer segregation letter strictly restricting the custodian's right of offset against those funds.

*c. At what point is the CM deemed to be in default for failing to transfer CCP Margin to the CCP?*

As noted in Rule 802.A., a CM is deemed to be in default when it fails to promptly discharge any obligation to the Clearing House. As such, if at the time a call is made for initial margin, a CM fails to meet the call , the CM will be considered in default.

*d. What considerations militate in favor of, or against, allowing customers to deposit CCP Margin directly with the CCP?*

As a general matter, clearing members will provide additional flexibility for their customers beyond the flexibility that CME Clearing provides to its CMs. This can include additional collateral types, more liberal deadlines, and a wider variety of banks and custodians where customers can deposit their funds. Customers tend to appreciate this additional flexibility, especially with respect to the more liberal deadlines. In addition, since a CCP only has a legal relationship directly with the CM, it is difficult to facilitate direct deposit and withdrawal of collateral with other parties. One of the key benefits of the CFTC customer segregation regime is that the customer should be indifferent as to whether his collateral is being held at the CCP or at the CM – because the same segregation requirements and protections exist at both levels. In addition, CME routinely audits the CM for compliance with various regulatory and financial requirements including the proper account structure and processes and procedures to ensure appropriate segregation of customer funds.

*Economic Effects of Proposed Clearing Structure for CCP Margin*

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6. *Please describe the economic benefits or disadvantages (from the perspective of CMs and their customers) of the proposed clearing structure for holding IM at the CCP or its custodian (as opposed to at CMs or their custodians).*
- a. *Do CMs have the ability to generate returns on customer property under the proposed structure?*

To the extent customer posts cash with the CM, CMs are allowed to invest customer funds in a number of instruments governed by CFTC Regulation 1.25. (CM investment of customer funds is also something CME audits for.) The customer segregation regulations allow CMs to retain the return on these investments. However, CMs may choose to pass the benefits to their customers, depending upon the specific agreements negotiated with each customer. To the extent the customer posts securities, the customer retains the return

- b. *To what extent do the benefits or disadvantages of the proposed structure flow through from CMs to their customers?*

Please refer to our answer to Section B, Question 6, sub a.

*Determination of Required Margin and Related Considerations*

7. *Is Required Margin determined on the basis of net exposures (i.e., by netting offsetting positions across different customers) or gross exposures? Are offsetting positions within a particular customer-CM relationship netted for this purpose?*

CDS margins are calculated on a gross basis at the CM level for customer positions. Each customer account holding CDS positions is margined independently and results are summed so that clearing members obtain no clearing level benefit for offsets between different customers at the CM level. Still, each individual customer receives the full benefit of any risk offsets in their account as recognized by the portfolio-based, multi-factor, risk-based margin calculation, as described below. Proprietary or house positions are margined on a net basis.

8. *Please describe whether margin requirements will be reported and published, and whether calculations are replicable by the CCP upon demand from a CM or customer.*

Initial margin requirements will be reported at an aggregate level to the CM and at a customer level to the CM. This information will be available through CCP reports to the CM. CME Clearing will also make available a PC-version of the margin program so that any customer can replicate their margins or do hypothetical margining based on changing

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positions to the portfolio. This user-friendly utility will allow customers and CM's to independently replicate the margin methodology to ensure transparency in the overall portfolio margin approach and allow for more complete risk management. This program can also be integrated into CM's front end solutions to allow for a quick assessment of initial margins on current and revised positions.

9. *Are there any restrictions on the ability of the CCP to demand additional margin from a CM or customer?*

Typical margin changes are made periodically based on market conditions reflecting changes to volatility and other factors. These changes are announced through publicly available margin notices and implemented shortly after those notices are distributed. CME Rule 824 describes that the Clearing House may call for additional initial margin for any specific CM or all CM's at the CCP's discretion with the amounts also being at the CCP's discretion. CME Rule 930.L. also states that the Clearing House may require CM's to collect additional margin from specific customer accounts as deemed necessary.

10. *Are there any restrictions on the ability of a CM to demand additional margin from its customer?*

CME rules establish the minimums that must be collected by a CM from a customer, but do not prescribe any other restrictions between the amounts that can be collected unless there is a margin call, where Rule 930.E. states that CM's must issue calls for margin to bring an account up to the initial margin level.

11. *Is the required amount of CM guarantee fund contributions relating to customer positions at the CCP determined on the basis of net or gross clearing exposures? Are offsetting positions of a single customer netted for this purpose?*

Guarantee fund calculations are based on the margin calculations, which are done on a gross basis at the CM level. In other words, positions across different customers do not net. However, within a portfolio, the CME CDS initial margin methodology will take into account offsetting risk. The total guarantee fund is based on 2.25% of the total aggregate margin requirement across the Clearing House. Expressly for CDS products, for the purposes of a CM's security deposit calculation only, the margin will be scaled by a factor of three. The aggregate security deposit for CDS, as determined above, will be allocated to each CME CM based on each CM's relative contribution of initial margin, volume and settlements for CDS products. Initial margin, volume, and settlements are accorded the following weights: 84%, 15%, and 1%.

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Furthermore, CME Clearing retains its right to assess CMs for any unsatisfied obligations, in the event of a CM default, in excess of their security deposits. The balance of any unsatisfied default after the CM aggregated security deposits are applied would then be allocated among the clearing membership up to an amount equal to 275 percent of the aggregate default fund across all CMs. The allocation would be based on each clearing member's share of the Security Deposit Pool.

The guarantee fund is sized to cover at least the largest net debtor in an extreme market move situations along with collateral damage of smaller clearing members also defaulting. These stress tests are based on the largest market moves (such as the 1987 Stock Market Crash) for each asset class. The results from each asset class stress test are then aggregated without regard to correlation to arrive at a combined worst loss stress test. As the same clearing firm tends not to have the largest positions in each asset class, there is a diversification benefit by combining more products in one guarantee fund so that the total guarantee fund can be less than the aggregate guarantee funds that would be required for each asset classes individually.

Customer funds are not part of the guarantee fund. The clearing members contribute their own monies to the guarantee fund based on the above calculations on the overall business. So portability is not an issue.

*12. Please discuss the approximate timeline for trade execution, submission to the CCP and novation, and how the CCP's structure in this regard (together with any other operational efficiencies) affects the customer protection analysis.*

CMDX and CME Clearing promote open CDS clearing solutions. There are multiple methods in which bi-laterally negotiated contracts may be submitted to CME Clearing: CMDX Trade Booking Facility, Migration Utility, and CME ClearPort. The timeline for trade submission to the CCP and novation will vary based on the trade submission method adopted.

- The CMDX Trade Booking Facility is a state-of-the-art trade booking and confirmation platform. The Trade Booking Facility enables trades to be booked at execution and on trade date, confirmed, and sent straight through to CME Clearing for nearly instantaneous clearing acceptance and confirmation. Trades are vetted against a credit limit which eliminates the need for a CM to explicitly accept their customer's transactions, and further expedites the clearing acceptance and confirmation. The clearing guarantee is in effect once CME Clearing has accepted the trade.

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- The Migration Utility serves two functions: (i) it allows participants to migrate (or backload) existing trades to CME Clearing, and (ii) it allows participants to execute and confirm new trades through their current technology (e.g. DTCC Deriv/SERV, DTCC TIW, T:Zero, etc), then migrate these trades to CME Clearing after the trade is confirmed in the Trade Information Warehouse (TIW) and the upfront fee is bi-laterally settled. Migrated trades are accepted for clearing upon payment of either (i) initial or variation margin, (ii) up-front settlement amount, or (iii) periodic coupon amount by the relevant Participant (or its designee) in accordance with CME Rules. This is the point at which the clearing guarantee is in effect.
- Participants may also submit trades directly to CME Clearing using the C360 Interface. Trades submitted through this Interface post to the CME Clearing system in a pending state, and requires CMs guaranteeing the trade explicitly accept it. Once the CM has accepted the trade, it is immediately confirmed and accepted for clearing.

*Allocation of Risk upon CM Default*

*13. In the event of a CM default to the CCP, please detail the risk waterfall among guarantee fund contributions, Required Margin securing CM proprietary positions, Required Margin securing customer positions, and any other applicable source of funds (e.g., CCP Excess Margin, to the extent accessible by the clearinghouse), drawing distinctions between defaulting and non-defaulting parties where relevant.*

The definition of default is captured in CME Rule 802.A.1 which states “If a clearing member of CME, CBOT, NYMEX, or COMEX fails to promptly discharge any obligation to CME Clearing House, it shall be in default.” The risk waterfall will be very similar in Customer Segregation, Customer Secured, or a House default, with the exception being that house gains in the positions and house collateral can be used to cure the defaults of either Customer Segregated or Customer Secured positions.

Therefore, customers are potentially protected by an even greater amount through the use of a CCP given the power that a Clearing House can use house gains and proprietary account collateral to cure a customer default thereby possible reducing the overall default amount and providing greater amounts of monies to defaulting pool.

The waterfall of the financial safeguards package consists of:

- The defaulting firm's performance bond collateral
- If Customer Segregated or Customer Secured default, apply any proprietary account gains and proprietary account collateral

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- The defaulting firm's membership requirement
- The defaulting firm's contribution to the default fund
- CME surplus funds of approximately \$100 million
- CME default fund of \$2 billion
- CME assessment powers of \$5.5 billion

In addition, for a default occurring in a customer origin, the defaulting firm's customer performance bond collateral may also be included. However, per CFTC regulations, no customer funds can be used in a proprietary account default – the customers' positions and funds would be transferred to a solvent CM. Likewise, if a default were to occur in the 4d account, no 30.7 funds can be utilized – those positions and funds would be transferred to another CM. The reverse is also true.

- a. *How does the applicable risk waterfall vary (if at all) depending upon whether the default arises from an insolvency event, as opposed to a non-insolvency event?*

The risk waterfall does not vary based on whether or not the default arises from an insolvency versus non-insolvency event. A default arises from the failure of a CM to discharge its obligations to the Clearing House.

- b. *How does the applicable risk waterfall vary (if at all) depending upon the nature of the IM being applied – i.e., is IM securing customer positions applied in a different manner from IM securing proprietary CM positions?*

As mentioned above, the customer and proprietary positions are kept separate so that the waterfall will be utilized for those positions that are in default. The only difference is that proprietary collateral and gains can be used to offset customer losses, but not vice-versa.

- c. *In the event of a CM default arising from a failure to post sufficient margin, how does the applicable risk waterfall vary (if at all) depending upon whether the failure to post sufficient margin arose in respect of customer positions, rather than proprietary positions?*

The risk waterfall would be the same, with the exception noted that proprietary collateral and gains can be used to offset customer losses, but not vice versa.

- i. *Please explain (to the extent applicable) how the CCP's methodology for isolating the origins of the CM default permits the CCP to identify, in a sufficiently precise manner, which risk waterfall applies in any particular*

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*instance (especially in circumstances under which the CM default may have arisen from multiple complex and interlocking factors).*

The CCP will have the proprietary positions and collateral segregated from the customer positions and collateral so that the origin of the default can be easily determined.

The appropriate risk waterfall could then be applied based on whether it's a customer or proprietary default. As CME Clearing is using one guarantee fund to back all CME cleared positions, gains and losses across all products would be evaluated to determine the waterfall amounts.

*14. If a CM has defaulted on an obligation to its customer in respect of a cleared transaction (or a transaction related to a cleared transaction), but is not otherwise in default to the CCP, what are the customer's remedies against the CCP?*

Generally, customer interests are protected via CFTC regulations, and as a result of these protections, do not have direct remedies against CME Clearing. In a CM default situation, CME Clearing will execute its default management procedures, coordinate its activities with responsible regulators, and comply with legal processes as applicable or warranted.

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**IM Held at or for the CM (“Dealer Margin”)****Permitted Asset Types for Customer Margin**

15. *Do the types of assets that may be deposited as margin with the CM differ from the types of assets that qualify as Required Margin?*

Clearing members are allowed to accept from customers a wider variety of collateral than they can pass through to CME Clearing; see Rule 930.C. If CMs choose to accept collateral that they cannot pass through to CME Clearing, they will have to hold the customer's collateral in a segregated account with their custodian and fund their clearing level requirements from their own financial resources. Any firm assets used to meet customer requirements become de facto assets of the customer segregated account.

**Description of Proposed Clearing Structure for Dealer Margin<sup>10</sup>**

16. *Please detail the manner in which customers will post Dealer Margin.*

- a. *Will Dealer Margin be posted pursuant to pledge or title transfer arrangements?*

Customers post margin exactly in the same capacity as is the case with futures positions. The margin is owned by the customer, but held by the FCM to secure obligations of the customer to the dealer in respect of obligations relating to cleared CDS positions.

17. *Please detail the manner in which Dealer Margin will be held (noting any circumstances in which the default clearing structure may be modified by elections available to customers), specifically addressing the following and distinguishing between different types of margin (e.g., cash versus securities) and categories of margin (e.g., Required Margin, CCP Excess Margin, Dealer Excess Margin and any other applicable categories of margin) where appropriate:*

Generally, CME Clearing will face its clearing membership with each CM facing its customers. Each CM will have at most three clearing level accounts, maintained with CME Clearing: a customer segregated account, a customer secured account, and a proprietary, non-segregated account. (Note that a broker-dealer FCM's affiliate positions will be held in this proprietary, non-segregated account with the CME, but for broker-dealer administration purposes, these affiliate positions will be maintained in a separate account at the broker dealer under SEC Rule 15C3-3.) Each CM will have

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<sup>10</sup> See note 4.  
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corresponding customer segregated, customer secured, and proprietary, non-segregated accounts established at qualified banks and custodians in its own name, to support operations with its customers and internal accounts. All such accounts must be maintained in accordance with applicable CFTC regulations, including section 4d of the Commodity Exchange Act, Regulations 1.20 through 1.30 and Regulation 30.7. CME Clearing will assess margin requirements to clearing level portfolios, following published clearing firm minimum margin required (although CME Clearing has the ability, through Rule 824, to require additional clearing level margin, or, through CME Rule 930.L, to require a clearing firm to assess additional margin related to a particular customer level exposure). CM's are free to assess customer margin greater than minimum levels prescribed by CME Clearing.

- a. Dealer Margin Held Directly at a CM (or at a Custodian Holding Solely for the Benefit of the CM) – *If the CM will hold Dealer Margin directly (without a custodian), or the custodian will hold Dealer Margin only for the CM (rather than for customers (individually or as a group)), please detail all aspects of the arrangement that are relevant from a customer protection standpoint, specifically addressing the following:*

Cash deposited by customers and held at a custodian must be held in a demand deposit account in the name of the CM “for the benefit of customers”. Likewise, collateral deposited by customers and held at a custodian must be held in a safekeeping account in the name of the CM “for the benefit of customers.” We do not anticipate any Dealer Margin would be held directly with the CM. The same is true for all types of customer owned assets – required margin, excess CCP margin, excess Dealer margin.

For cash and collateral deposited by affiliated entities of the CM for proprietary positions, the CM will hold those funds in either a demand deposit account (cash) or safekeeping account (collateral) in the name of the CM. There are no customer protections given to these funds.

- i. *The manner in which the CM holds the Dealer Margin, distinguishing to the extent applicable between various types of Dealer Margin (e.g., securities or cash), and identifying in particular:*
1. *Whether Dealer Margin securing the positions of a particular CDS customer will be segregated from (i) the Dealer Margin posted by other CDS customers and (ii) the property of other custodial claimants of the CM, or instead, commingled in a single omnibus*

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*account (either for CDS customers or custodial claimants of the CM generally);*

CFTC regulations require that customer segregated and customer secured accounts be treated as pooled funds in one account at the custodian in the name of the CM "for the benefit of customers." However, on the books of the CM, CFTC regulations and CME rules require that CMs must account for cash and collateral deposited by each specific customer, and that one customer's collateral may not be used for another customer's benefit.

- a. In whose name(s) has/have the account(s) been established?  
See above.

2. *Whether Dealer Margin securing customer positions will be segregated from the margin securing proprietary positions of CMs;*

Yes, Dealer Margin securing customer positions is segregated from Dealer Margin securing proprietary positions.

3. *Any operational practices (whether voluntary or mandated by regulators) relevant to the analysis of customer protection and the sharing of any shortfalls in custodial property;<sup>11</sup> and*

CFTC regulations require that all customer funds must be held in "segregated" locations in the name of the CM "for the benefit of customers". The custodian is required to acknowledge that they understand the funds are held for the CM's customers and cannot be used to offset any obligations of the CM to the custodian.

CMs are required by CFTC regulations to maintain enough funds in segregated locations to cover all of their obligations to their customers. In the event of a shortfall, the CM must notify the CFTC and CME of such event and immediately replenish the shortfall with its own funds. In the event of a shortfall where the firm's own funds are insufficient to cover the shortfall, each

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<sup>11</sup> See note 6  
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customer will receive a pro rata share of all assets held in segregation based on their share of all funds owed to customers.

4. *Under what circumstances Dealer Margin may be (i) withdrawn by customers or (ii) applied by CMs or the CCP.*

Customers may withdraw any excess funds ( in their account provided that they maintain initial performance bonds. If the withdrawal puts them below that level, the CM is considered in violation of CM margin rules.

CMs can apply customer collateral to any unsatisfied obligations the customer has to the FCM. The CCP has no claim or access to customer collateral held at the FCM. The CCP can only apply customer collateral to any unsatisfied obligations the clearing member has to CME Clearing on behalf of its customer business.

ii. *Whether the CM has the right to rehypothecate or cause liens to be placed on Dealer Margin, and if so, whether any such liens have been subordinated or waived; and*

CMs do not have the right to rehypothecate customer margin. In a CM insolvency or bankruptcy, the rights of the custodian with respect to customer account margin are subject to CFTC Part 190 bankruptcy regulations, and to the US Bankruptcy Code which precludes their use as an offset to CM obligations and facilitates their prompt release to customers.

iii. *Whether investment of Dealer Margin in interest-bearing instruments or vehicles (e.g., overnight sweeps into repos) is permitted or required, and if so, in what types of instruments or vehicles.*

1. *Who obtains the economic benefit of investment of Dealer Margin in permitted instruments? Who bears the risk of loss?*

CFTC regulations permit CMs to invest customer funds for its own benefit – these investments are limited to and governed by Regulation 1.25. In these circumstance, the CM may retain the economic benefits of such investments, while also bearing the risk of loss of those investments. However, the CM may elect to share

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the returns with its customers depending upon specific negotiations/agreements with each customer.

- b. *Dealer Margin Held at a Custodian (Whether the Custodian is Holding for the CM or the Customers)* – *If the CM will hold Dealer Margin at a custodian, please detail all aspects of the custodial arrangement that are relevant from a customer protection standpoint, specifically addressing the following:*

Please reference our answers to Section I, Section B, question 4, sub a

- i. *The manner in which the custodian holds the Dealer Margin, distinguishing to the extent applicable between various types of Dealer Margin (e.g., securities or cash), and identifying in particular:*
1. *On whose behalf the custodian is holding the property – the CM or the customers;*
  2. *Whether Dealer Margin securing the positions of a particular CDS customer will be segregated from (i) the Dealer Margin posted by other CDS customers and (ii) the property of other custodial claimants of the custodian or instead, commingled in a single omnibus account (either for CDS customers or custodial claimants of the custodian generally);*
    - a. *In whose name(s) has/have the account(s) been established?*
  3. *Whether Dealer Margin securing customer positions will be segregated from Dealer Margin securing the proprietary positions of CMs; and*
  4. *Any operational practices (whether voluntary or mandated by regulators) relevant to the analysis of customer protection and the sharing of any shortfalls in custodial property.<sup>12</sup>*
- ii. *Whether the custodian has the right to rehypothecate or cause liens to be placed on the Dealer Margin that is not posted to the CCP, and if so, whether any such liens have been subordinated or waived;*

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<sup>12</sup> See note 6  
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Custodians do not have the right to rehypothecate customer margin. In a CM insolvency or bankruptcy, the rights of the custodian with respect to proprietary customer account margin are subject to CFTC Part 190 bankruptcy regulations, and to the US Bankruptcy Code which precludes their use as an offset to CM obligations and facilitates their prompt release to customer.

- iv. *Whether investment of Dealer Margin that is not posted to the CCP in interest-bearing instruments or vehicles (e.g., overnight sweeps into repos) is permitted or required, and if so, in what types of instruments or vehicles;*

Investment of customer segregated margin funds that are on deposit with the CM and not posted to the CCP are covered under CFTC regulation 1.25. The CM must execute its fiduciary responsibility in performing investments for customer secured monies.

5. *Who obtains the economic benefit of investment of Dealer Margin in permitted instruments? Who bears the risk of loss?*

CFTC regulations permit a CM to retain the economic benefits of investments of customer funds. Those investments are limited to and governed by Regulation 1.25. In addition, the CM bears the risk of loss in value of those investments. However, the CM may elect to share the returns with its customers depending upon specific agreements reached with each customer.

- v. *Under what circumstances Dealer Margin may be (i) withdrawn by customers or (ii) applied by CMs or the CCP; and*

Customers who have excess margin on deposit with their CM are free to withdraw the excess at any time, subject to agreements with the CM, and in compliance with applicable CME rules and CFTC regulations. CM's may "apply", or liquidate, customer margin funds in the general circumstance of a customer failing to meet an obligation to the CM on a timely basis. CME Clearing will generally only "apply", or liquidate, collateral in the event of a CM default. However, CME's rights to apply collateral extend only to collateral on deposit with the CCP. By the definition used in this questionnaire, CME has no access to and no rights against "Dealer Margin" as it is held by the dealer.



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- vi. *How the risk of the custodian's insolvency is allocated among the CMs and the customers (as a group and individually).*

CFTC segregation and custody agreements operate to insulate the CM from the insolvency of the custodian. Margin assets are held in custodial safekeeping accounts, and are remote from the assets and liabilities of the custodian. Please also see our responses to Questions 1a and 2a in the Legal Considerations section.

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**C. Portability**

1. *Please consider whether a customer's positions and initial and variation margin (and any associated contractual relationships) can be ported to another CM, under each of the following scenarios.*

a. *Can a customer effect a voluntary, pre-CM default transfer of its positions and margin (and any associated contractual relationships)? From which entities must the customer obtain consent before effecting such a transfer?*

Yes. Transfer of positions and property between CM's at the request of a customer is standard practice in the futures industry. CME will ensure that this practice applies to CDS as well. Generally, it is incumbent on the customer to establish an account at a new CM, subject to the CM's account papers. Once the customer submits a transfer request to the carrying CM, the carrying CM must execute the transfer "promptly".

b. *Does the CCP have the authority to mandate that a CM transfer any or all of its customer positions and initial and variation margin (and any associated contractual relationships) to another clearing member, if such CM is not in "default" (as defined in the CCP's rules)?*

Yes. In non-emergency situations, CME Clearing is available to intervene with CM's who report issues with the prompt execution of a transfer and facilitate the customer's request being honored according to NFA rules.

i. *Does the answer change if the CM, although not in default, is perceived by the CCP to be in a state of impending financial distress?*

*Power of CH to require CM to transfer customer accounts in a non-default situation*

Absent a default by the clearing member, the Clearing House has broad powers to require a clearing member to post additional margin, liquidate or transfer customer positions due to risk management or market concentration concerns. The clearing house powers with respect to emergency financial conditions are specified in CME Rule 975, Emergency Financial Considerations.

ii. *To what extent is a default under the CCP's rules the product of the CCP's subjective determination, rather than being determined by reference to objectively verifiable events?*

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CME Rule 802.A. says, in relevant part:

**PROTECTION OF CLEARING HOUSE****802.A. Default by Clearing Member and Other Participating Exchanges****1. Default by Clearing Member**

If a clearing member of CME, CBOT, NYMEX or COMEX fails promptly to discharge any obligation to the CME Clearing House, it shall be in default.

The situations under which a clearing firm can conceivably default to CME Clearing are varied by nature and circumstance. CME's default rules and standards recognize this state of affairs, and employs a broad standard to define a clearing firm default. In most foreseeable circumstances, a clearing firm default will likely be determined through a failure of the clearing firm's settlement bank to honor a clearing firm settlement obligation (i.e., a margin payment and/or settlement variation due to CME Clearing) due to CME Clearing.

*c. How does the CCP intend to transfer customer positions and initial and variation margin (and any associated contractual relationships) from a defaulting CM to a non-defaulting CM? Please elaborate on the following details (distinguishing between Required Margin, CCP Excess Margin, Dealer Excess Margin and any other categories of margin where relevant):*

- Subsequent to a CM proprietary default, CME Clearing will provide that customer segregated and/or customer secured variation margin and cash margin payments due to/from CME Clearing will be collected from or paid to a successor CM, who has agreed to accept the defaulting clearing firm's customer portfolio, as in the regular course of business. Customer segregated and customer secured collateral on deposit with CME Clearing for the benefit of the defaulting firm, will be deposited in clearing level collateral accounts for the benefit of the receiving CM and its customers.
- Since CME Clearing holds most forms of collateral in custodial omnibus accounts, the exercise of moving collateral from the account of the defaulting firm to the account of the receiving firm is an operational exercise accomplished on CME Clearing's books and records. Specific actions taken will be coordinated with the CFTC, with each firm, and with the trustee, if one has been appointed. Please note that CME Clearing has the ability to administer this solution only to the extent that collateral is on deposit in CME controlled bank or custodial accounts. Collateral that remains on deposit at the CM level will require coordination between the defaulting and receiving clearing firms.

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- In either an emergency or a default event, non-defaulting CM's accept the accounts of non-defaulting customers in two broad cases. Either the non-defaulting CM will have already have an account established for a particular customer due to an existing relationship, in which case the non-defaulting CM and the customer have a degree of freedom to arrange the transfer to their own timings. For the broad majority of customer accounts at the defaulting CM, accounts will generally be transferred to the non-defaulting CM under a bulk transfer, using the customer's existing account papers. Prior to the transfer, the defaulting CM will send a "negative consent" letter to its clients, after having first coordinated this with CME and the CFTC. CME Clearing will then arrange the bulk transfer of clients from the defaulting CM to the non-defaulting CM. Customers who have transferred to the non-defaulting CM have the right to transfer their accounts to a new CM, subject to the execution of the requisite account documents for the new CM. If the customer elects to stay at the non-defaulting CM, it is likely that the CM will require execution of the CM's account papers for customers received via the bulk transfer process.
- Customer segregated and customer secured collateral, on deposit with CME Clearing for the benefit of the defaulting firm, will be deposited in clearing level collateral accounts for the benefit of the receiving CM and its customers.
- Positions will generally be transferred at prior day settlement price. Subject to ensuring that there is no segregation or secured deficiency at the defaulting CM, the open trade equity, or unrealized P&L associated with the CDS, will be paid directly between the defaulting CM and the receiving CM. The timings of those can vary, with merger events tending to happen on the same day and regular customer transfer activity happening in a day. Even with unexpected events, the transfer activity has been able to take place quickly either with the accounts moving to other non-defaulting clearing members on their own or using the assistance of the Clearing House to move to non-defaulting firms.
- History has shown a good record for finding a buyer for the customer business of an insolvent/impaired CM in a packaged bankruptcy transaction. (i.e. Refco, Lehman (U.S.)
  - i. The expected timeline from CM default to re-establishment of customer positions and initial and variation margin (and any associated contractual relationships) at a non-defaulting CM;*

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If the default was caused by a clearing member's proprietary business, the CH works on an ongoing basis to establish relationships with CM's of varying business profiles to determine their interest in accepting a bulk transfer of customer business from a troubled or defaulting clearing member. History has shown good success in identifying appropriate CM's to accept a pool of customer business in such situations, given that firms generally assess the circumstances to be both optimal in terms of systemic risk protection, customer protection, and business opportunity. Also, see (ii) below.

- ii. *The mechanism for transferring customer positions and initial and variation margin (and any associated contractual relationships) to a non-defaulting CM, including a description of:*

Please see general process description above. In the case of a clearing firm proprietary account non-segregated default, one of the first actions CME Clearing will take is to transfer customers to a non-defaulting clearing firm or firms. Please note that while it is likely that customers' futures and options on futures will be transferred to the non-defaulting CM in addition to CDS, CME Clearing reserves the right to transfer CDS, futures, and options on futures to different non-defaulting CM's, consistent with prevailing circumstance. CME Clearing's experience has been that, generally, for so long as customer collateral is transferred along with customer positions so as to ensure margin coverage, clearing firms take the view that account acceptance in such circumstances is consistent with prudent systemic risk management, and is a good business opportunity. Post-transfer, nothing prevents the receiving, non-defaulting CM from requiring select accounts to transfer their business to another CM, post additional margin, or limit their trading activities.

1. *How customer positions and initial and variation margin (and any associated contractual relationships) are allocated and how transferee CMs are selected (including whether a non-defaulting CM and its customers can be forced by the CCP to accept a transfer of positions through auction, assignment or other allocation procedures);*

The CCP will seek CMs qualified to accept the positions and initial and variation margin on a case-by-case basis using its best judgment. The CCP will take into consideration the size of the

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defaulting CM, the types of customers and positions held by the defaulting CM as well as the size of the non-defaulting CMs that are interested in receiving the positions of the defaulting CM and the risk management capabilities of such non-defaulting CMs to take on such positions.

2. *Whether customer positions and initial and variation margin (and any associated contractual relationships) in respect of cleared transactions can be effectively transferred separately from non-cleared transactions between the defaulting CM and its customers;*

The Clearing House does not have authority to direct or control the transfer of non-cleared positions between the defaulting CM and its customers.

3. *Whether the treatment of CCP Margin differs from the treatment of Dealer Margin, from a portability perspective; and*

We expect that both classes of margin (CCP and Dealer) will be segregated, either in CEA section 4d or Regulation 30.7 accounts. The Clearing House has sufficient control to transfer the CCP Margin without the consent of the court or trustee. The cooperation of the trustee will be needed to transfer Dealer Margin.

4. *Any pledge or other arrangements designed to facilitate transfer of customer positions and initial and variation margin (and any associated contractual relationships).*

All rights with respect to customer collateral are governed by CEA section 4d and Regulation 30.7 to the exclusion of any private arrangements. This question appears to be directed to an institution that is not governed by the CEA.

- iii. *Any procedures designed to control the effect of market movements on the value of customer positions during the pendency of the transfer – e.g., institution of hedge positions subsequent to the CM default, or assigned allocation of customer margin deficits to non-defaulting CMs – and the allocation of losses if the customer positions cannot be assigned to a non-defaulting CM.*

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Let us assume the following: a CM carries two accounts with CME Clearing, a proprietary, non-segregated account, and a customer segregated account. The CM defaults to CME Clearing opposite its proprietary, non-segregated obligations. CME's default management procedures are geared to seizing the defaulting CM's proprietary, non-segregated futures, options on futures, and CDS positions and property, and conducting liquidation procedures designed to produce an orderly unwind of the defaulting CM's obligations. CME Clearing may execute hedge transactions against the defaulting CM's proprietary, non-segregated exposures as a means to limit risk in the execution of the liquidation process. The defaulting CM's customer segregated account is left unaffected by the CM's proprietary, non-segregated account default. CME Clearing will act to transfer the customer protected positions and property of the defaulting CM to a non-defaulting CM or CM's.

If the CM defaults to CME Clearing opposite its customer segregated account, then by definition, the firm has also experienced a proprietary account default. If, in executing its default procedures, CME Clearing verifies that there is a deficiency in segregation, CME Clearing will seize customer futures, options on futures, and CDS positions and property, and conduct liquidation procedures designed to produce an orderly unwind of the CM's obligations. All proceeds net of the CM's required obligations will be paid to the trustee in bankruptcy, with customers receiving a pro rata distribution, as per CFTC Part 190 regulations and the US Bankruptcy Code.

The primary means that CME Clearing intends to employ to liquidate a CM CDS default portfolio is through a competitive auction process, involving non-defaulting firm entities. Should the auction fail to meet pre-defined success criteria, CME Clearing, through its rules and procedures, will have the right to allocate default portfolio positions and associated collateral, as applicable, to non-defaulting firms. Default procedures related to CDS will be scaled to the exposures cleared; CME Clearing anticipates that procedures will evolve over time, and in any case we intend to periodically discuss and reach a consensus with our founding members respecting the proper allocation of loss in the event of an allocation of positions.

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1. *Who determines the close-out price applicable to terminated positions? If the CCP, does the CCP's close-out price flow through to the customer? How is the close-out price determined? Does the same close-out price apply to CM-customer positions and offsetting CM-CCP proprietary positions?*

Close out prices will be determined either through market based liquidations of individual positions, or through competitive auction of the defaulting firm's portfolio.

2. *How does the CCP account for any unpaid variation margin obligations that may have accrued subsequent to the default of the CM?*

Unpaid variation subsequent to the CM default are an obligation of the defaulting CM. CME Clearing will seek to pay for the this variation through set-off of the defaulting CM's retained property; else, the loss would be mutualized amongst the surviving CM's, and would be a claim on the estate of the bankrupt CM.

- iv. *Any limitations on the rights of customers to (a) terminate non-cleared transactions with CMs upon a CM default, or (b) set off their obligations under non-cleared transactions against obligations to CMs under cleared transactions;*

CME rules and applicable CFTC regulations apply to the clearing member's cleared positions and associated property. CME rules and procedures, and CFTC regulation will determine how the unwind process is accomplished relative to cleared transactions in a CM default, while any non-cleared transactions will be covered by contract between the customer and its dealer. Clearing certain transactions does not affect the termination or unwind provisions of non cleared transactions.

- v. *Whether affiliate and third-party liens or cross-margining and netting arrangements in respect of non-cleared transactions affect the portability analysis;*

No liens, cross-margining or netting arrangements will reach the collateral or positions controlled by the Clearing House or any Dealer Margin.

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- vi. *Whether the defaulting CM's contractual agreements with the customer are binding upon the transferee CM and such customer upon any transfer of the customer's positions and initial and variation margin, or whether the transferee CM and such customer can (or must) execute a new set of documentation;*

In the event of a default, the receiving CM is allowed to accept the customer documents and agreements originally opened with the defaulting CM in order to ensure the timely transfer of customer funds and positions. Over time, the new CM would need to document the customers using its own documents and agreements. While there is no specific time deadline for such new documentation, in order to ensure legal certainty, the new CM should do this as soon as possible. CFTC Regulation 1.65 (a)(3) requires the new CM provide required risk disclosures to the customers and receive new risk disclosure acknowledgements within 60 days of transfer unless the CM has clear written evidence that the customer has previously received and acknowledged the required risk disclosures

- vii. *In connection with a transfer of customer positions and initial and variation margin (and any associated contractual relationships) to a non-defaulting CM, any rights of customers to elect not to transfer the associated margin, and instead, to apply such margin as a setoff against other amounts that may be payable to the defaulting CM (while separately posting new IM to the transferee CM); and*

Generally, in a bulk transfer process, "all" non-defaulting customer accounts, and their associated positions and property are transferred to the non-defaulting CM, as per 1.c above. In the days leading up to the default, individual customer accounts can negotiate transfer of their positions and property, consistent with customary arrangements.

Once the CM is in default, the Clearing House and any trustee will not permit a customer to take an action that will give it a greater return than would have been the case if there had been an appropriate pro rata distribution of customer segregated funds. In order to effectuate a set off, the customer may liquidate her positions at the defaulting CM, remove the resulting free credit balance from segregation and allow the CM to attempt to effectuate an offset. However, since the clearing member had no access to those funds prior to its default, it is likely that the process would be challenged.

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- viii. *The effects on the portability analysis of (a) IM at the CCP for customer positions being posted on a gross or net basis (as applicable), (b) the existence of Dealer Margin held at the defaulting CM, and (c) non-cleared trades between the defaulting CM and its customers being “in-the-money” or “out-of-the-money” (as applicable) to the CM.*

Customer CDS positions, whether subject to customer segregation or customer secured treatment, will be margined by CME Clearing on a ‘gross’ basis, thus positioning CME Clearing to achieve a high standard of care with respect to customer protection in a CM default scenario. IM held at the CM, if for the benefit of customers, will be subject to customer segregated or customer secured treatment, and will complement actions CME Clearing pursues to administer the default event. Administration of non-cleared trades is a contractual matter between the customer and its dealer and/or trustee. CME has every expectation that the obligations associated with non-cleared transactions will not affect the integrity of positions and property held per customer segregated or customer secured standards.

Posting IM at the CCP on a gross basis facilitates portability, since the CCP holds sufficient IM to properly margin the positions at a new CM. If Dealer Margin is held at the defaulting CM and the customer segregated pool of such Dealer Margin is intact, it should be readily transferred to the new CM and be accessible to the customers and available to the new CM to satisfy appropriate margin calls from the CCP.

Non cleared trades will not be readily transferable from an insolvent firm. If there is an ISDA in place, the open positions will be closed and parties will look to the secured collateral.

**D. Documentation****Required Documentation**

1. *What trading documentation will CMs (and their custodians, if applicable) and customers need to execute with the CCP (and its custodian, if applicable) in order to have customer transactions cleared?*

A CME Clearing Member:

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- Enters into (or likely already has in place) a clearing application and agreement with the CME that governs the relationship between the Clearing Member and the CME
- Enters into (or likely already has in place) a Clearing 360 connectivity agreement with the CME that governs submission of OTC transactions on behalf of or from a customer of the CM, an affiliate of the CM or the customer of an affiliate of the CM for clearing through the Clearing 360 Interface
- Enters into a CMDX Participant Access Agreement, which incorporates by reference the CMDX Terms of Use that govern use of the CMDX platform, including the CMDX Trade Booking, RFQ and Migration utilities

A customer of a CME Clearing Member:

- Enters into (or likely already has in place) a Futures and Options Clearing Agreement with its Clearing Member that governs the relationship between the customer and its Clearing Member with respect to CME-cleared CDS Contracts and incorporates CME Rules by reference (including the CME-cleared CDS Contract terms and conditions, which in turn set out the ISDA definitions, the CME and ISDA Determinations Committees procedures, auction settlement procedures, and all other aspects of the Cleared Contract that make it the functional economic equivalent of the bi-lateral ISDA transactions traded in the OTC market today)
  - Enters into the CMDX Participant Access Agreement, which incorporates by reference the CMDX Terms of Use that govern use of the CMDX platform including RFQ, Trade Booking and Migration utilities
- a. *Please discuss the extent to which the CCP “knows” the customers under the required documentation, and how this affects the customer protection analysis.*

Consistent with the rules and practices applicable in the futures and other centrally cleared derivatives markets, the CM functions as an “agent for undisclosed principals.” Contractually, again consistent with the established futures model, CCPs have a direct relationship with each CM and not with Customers of the CMs. Accordingly, CME as CCP does not have direct privity with the customers of the CM and is not required to “know” those customers in the securities law sense. However, CME Rules state that each CM shall adopt and enforce written procedures pursuant to which it will supervise in accordance with the requirements of the CME Rules and the CEA and CFTC Regulations thereunder, each customer's account(s).

This structure, again following the established approach in the futures markets and other cleared derivatives markets, is integral with the customer protections – including account segregation and portability – of our clearing solution as described in this survey. From the perspective of a customer with positions and

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margin held in segregated accounts, its CM is an “agent” in that the customer is not exposed to the default of the CM. From the perspective of the CCP, because the CM guarantees the obligations of its customers, and in doing so plays a vital role in protecting the integrity and efficiency of the CCP, the CCP does not “know” the customer. That said, for CDS, CME will margin at the customer account level, and actively monitor exposures and concentrations at the customer account level, as well as at the CM level. In likely exceptional circumstances, if such account level monitor raises exposure or concentration concerns, CME may work with its CMs to impose limits at the customer account level, or take other risk reducing measures to safeguard the mutualization fund.

2. *What trading documentation will customers need to execute with CMs (and their custodians, if applicable) in order to have their transactions cleared?*

A customer of a CME Clearing Member:

- Enters into (or likely already has in place) a Futures and Options Clearing Agreement with its Clearing Member that governs the relationship between the customer and its Clearing Member with respect to CME-cleared CDS Contracts and incorporates CME Rules by reference (including the CME-cleared CDS Contract terms and conditions, which in turn set out the ISDA definitions, the CME and ISDA Determinations Committees procedures, auction settlement procedures, and all other aspects of the Cleared Contract that make it the functional economic equivalent of the bi-lateral ISDA transactions traded in the OTC market today)

3. *Please describe any legal, operational or other issues arising from the adoption by CMs and customers of a pledge arrangement (from an existing title transfer structure), or of a title transfer arrangement (from an existing pledge structure), for the provision of collateral security.*

If the collateral supporting the open positions is held by the Dealer CM under a title transfer structure, the Dealer CM needs to transfer title back to the customer in the form of a transfer into the customer segregated account.

### Key Terms of Standardized Documentation

4. *Please describe the material terms of any documentation standardized by the CCP, including (but not limited to) terms relating to:*

CME-cleared CDS transactions will have standardized economic terms and conditions pursuant to the CME Rules. The CDS product chapters of the CME Rules include standardized terms and conditions that specifically incorporate directly or by reference

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the ISDA credit derivative definitions as supplemented by the ISDA CDS matrix, the hardwiring of the ISDA determination committee and the auction settlement processes, as well as the standard terms and conditions published by Markit for Markit index contracts. In addition, the CME rules provide for flexibility to apply to CME-cleared CDS contracts ongoing standardized upgrades in OTC documentation such as the upcoming “small bang” protocol to allow the auction settlement of restructuring credit events.

CMDX and CME Clearing promote open CDS clearing solutions. There are multiple methods by which participants may submit trades to CME Clearing: (i) for outstanding bilateral OTC trades, participants can utilize the CMDX Migration Utility; and (ii) for newly executed bi-lateral OTC trades intended for clearing, participants can access the CMDX Trade Booking Facility, CMDX RFQ Facility, or CME ClearPort. Each enables market participants to negotiate bi-lateral contracts as they do in the OTC market (verbally, electronically, or brokered) and submit trades to CME Clearing. The method of trade submission will determine the type of trading documentation required.

Outstanding bilateral OTC trades migrated to clearing:

- Trade counterparties mutually agree to migrate outstanding trades for clearing at CME
- Upon mutual consent to migrate and submit eligible outstanding trades through the CMDX Migration Utility, trade counterparties make a binding commitment to undertake no action that would be inconsistent with their commitment to migrate such trades during course of the migration exercise
- If an outstanding trade is not accepted for Clearing at CME for any reason, such trade simply remains unchanged as a bi-lateral trade between the two original counterparties in the form it took and under the documentation governing that trade
- If the outstanding trade is accepted for clearing at CME, the CME will substitute itself as the counterparty to each original OTC counterparty such that after substitution there are two equal and off-setting trades: one between the buyer (or the Clearing Member as agent of the buyer if buyer is not a Clearing Member) and the CME as seller; and one between the seller (or the Clearing Member as agent of the seller if the seller is not a Clearing Member) and the CME as buyer. If the trade was previously housed in the DTCC TIW, CME will contemporaneously with confirmation of the cleared trade send a message on behalf of the parties to the DTCC TIW instructing that the prior bi-lateral non-cleared trade is cancelled

Newly executed bilateral OTC trades intended for clearing:

- OTC counterparties enter into a trade on CME CDS Contract terms with intention to have such trade cleared to CME

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- Initial trade represents a binding bi-lateral OTC transaction between the counterparties governed by (i) the CME CDS Contract specifications, and (ii) the CMDX Global ISDA Master Agreement<sup>13</sup>, subject to the condition subsequent that the trade is accepted for clearing at CME
- Upon registration of the initial trade by the parties in one of CMDX's or CME's facilities, the trade will be immediately reviewed for acceptance for clearing.
- If the initial trade is accepted for clearing at CME, the CME will substitute itself as the counterparty to each original OTC counterparty, such that after substitution there are two equal and off-setting trades: one between the buyer (or the Clearing Member as agent of the buyer if buyer is not a Clearing Member) and the CME as seller; and one between the seller (or the Clearing Member as agent of the seller if the seller is not a Clearing Member) and the CME as buyer
- If the initial trade is not accepted for Clearing at CME for any reason (thus failing the condition subsequent to such initial trade), such trade is automatically immediately terminated and deemed null and void. In such circumstance, initial trade counterparties may bilaterally agree to enter into a replacement bi-lateral OTC trade on the same material economic terms as the terminated trade governed by their bi-lateral ISDA agreement<sup>14</sup>

*a. Circumstances under which posted margin may be returned to customers, and all related conditions and requirements;*

Margin is posted in support of open CDS positions against CME Clearing. Since the level of standardization makes contracts in the same CDS products fungible, positions are adjusted (offset and accumulated) with each new transaction. The amount of margin in support of that position is adjusted accordingly. Excess margining (over and above that required to support open positions with CME Clearing) may be held daily on deposit at the CME or returned to clearing firms. Margin may be returned on any business day, upon timely request by the firm according to published deadlines.

*b. Specification of events of default and termination events with respect to the CM (noting any distinctions drawn between insolvency and non-insolvency events) or customer;*

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<sup>13</sup> In connection with the CMDX license agreement with ISDA, trades executed on CMDX and intended for clearing at CME will, prior to acceptance for clearing only, be governed by the CMDX Global ISDA Master Agreement, as referenced in the CMDX Terms of Use.

<sup>14</sup> The parties could also elect to have the replacement bi-lateral OTC trade governed by the CMDX ISDA Master Agreement, but we would expect that in all cases where the parties have a pre-existing negotiated ISDA Master Agreement between them, they will select its terms to apply.

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CME is only directly concerned with defaults of clearing firms (as firms are responsible for customer obligations)

CME Clearing may take action to close out a clearing member's CDS portfolio as a result of insolvency of the CM, the default by the CM on an obligation to CME Clearing, or other circumstances that warrant emergency action under CME Rules.

A clearing member is insolvent if it seeks an order of protection under the United States Bankruptcy Code, for relief from claims of its creditors. Note that such a filing is public. Moreover, clearing members are required by CME Rules to report such a filing to the CME.

A clearing member default is triggered by the failure on any obligation to CME Clearing, including, without limitation, failure to pay mark-to-market collateral, initial margin, or any required settlement amounts. CME Clearing's settlement times (7:30 a.m. CST and 1:30 p.m. CST) are the most likely times for such failure to occur, leading to a default declaration.

Emergency action must be authorized by the Clearing House Risk Committee pursuant to CME Rule 403E and implemented by CME Clearing staff under the direction of the President of the CME Clearing House. The President of CME Clearing House must inform CME Group Senior Management and the Clearing House Risk Committee of the nature of the action. The Emergency Financial Conditions Panel is also convened, pursuant to CME Rule 975.

In the event of a clearing member's insolvency, a clearing member's default, or a CME Clearing House emergency action (collectively referred to as Suspension of Clearing Member Status), CME Clearing will disseminate a general notice to the CME membership.

*c. Standstill upon the occurrence of a CM default;*

The Clearing House is not subject to standstill provisions. We are excluded and thus free to act to enforce contracts and assert rights against the bankrupt estate. Thus, CME Clearing is able to close out the positions in the portfolio of the defaulting (bankrupt) firm.

*d. Advance elections to liquidate or transfer cleared contracts;*

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Advance consents that assist with the portability of the cleared contracts are contained in the membership agreement, the Clearing Rules and sign-on to the CDS Default Management Process. Firms agree to assist with an evaluation of the risk in the portfolio, execute a hedge, liquidate, and assume assignment of portions of the portfolio.

- e. *Advance consents (particularly those obtained to enhance portability of cleared contracts);*

If the customer has consented to transfer of the collateral for its benefit, that should be sufficient to permit transfer into the customer segregated account.

- f. *Limitations on rehypothecation;*

CME Clearing has possession and control of the collateral through a perfected security interest.

- g. *Limitations on setoff against non-cleared bilateral transactions between customers and their CMs; and*

There is no opportunity for set-off against non-cleared bi-lateral transactions at the clearing level.

- h. *Close-out calculations.*

In the unlikely event that customer positions cannot be transferred, CME will close out positions pursuant to closing prices at the next settlement cycle. Those settlement prices will be determined in the normal fashion.

### Modification of Proposed Clearing Structure

5. *Please state the circumstances in which the CCP has the ability to amend by rule or order any aspect of its proposed clearing structure.*

In the normal course of its business, the CCP has the ability to amend by rule or order certain aspects of its clearing structure. Generally, rule changes will be made if a better or more efficient way to operate is determined to exist based on feedback from market participants or based on the practical experience of the CCP. In addition, in the event that a regulatory authority requests that a rule or procedure be modified, the CCP will also comply with such a request.

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From a procedural perspective, proposed rule changes that are material in nature are discussed with senior staff. Rule proposals are then generally vetted with the Approving Officers of the CCP (the Chairman, Vice-Chairman and CEO) or potentially with the full Board of Directors. After receiving all internal approvals, depending on the rule in question, such changes are either self-certified with the CFTC or specific CFTC approval is requested by the CCP. A notification is then published by the CCP identifying and explaining the operational or procedural change.

**II. Legal Considerations**

*As stated in the introductory note to this questionnaire, the following questions should be considered under the laws of all jurisdictions relevant to the CCP (and its custodian, if applicable), the CMs (and their custodians, if applicable) and the customers. In the responses below, please highlight any areas of legal uncertainty. For matters requiring reasoned legal judgment, please state the level of legal comfort associated with the relevant response.*

**Customer Rights to CCP Margin**

1. *Please detail the ability of customers to recover IM held at the CCP (or the CCP's custodian) upon the insolvency of the CCP (or the CCP's custodian) – distinguishing between Required Margin, CCP Excess Margin, Dealer Excess Margin and any other categories of margin where relevant – in the event their positions are liquidated rather than transferred. Consider all relevant facts, including: (i) the manner in which the IM is held at the CCP or its custodian; (ii) the nature of the customer obligations secured by liens on the IM; (iii) the composition of the IM (e.g., whether the IM consists of securities or cash); (iv) in the event of the insolvency of the CCP's custodian, any restrictions (legal or otherwise) on the ability of the CCP to recover IM from the insolvent custodian; and (v) any other matters described in your responses to the questions above that are relevant to this analysis. Analyze how these facts ultimately affect the conclusions reached.*
  - a. *What is the legal nature of the customers' rights in the IM held at the CCP (or the CCP's custodian)?*

The legal nature of the customers' rights in customer funds (whether Required Margin or otherwise) is governed by Section 4d of the CEA, CFTC Regulation 30.7 and CME Rules (as further explained in response to Question 2 below). Regarding an insolvency of a custodian, provided that the customer segregated and secured accounts at the custodian are properly identified as required under the CEA and CFTC Regulations, assets in such accounts, other than cash, at the

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custodian debtor should not be treated as assets of the debtor and should not be subject to claims of other creditors of the debtor. IM in the form of cash, held in a demand deposit account, is likely to be deemed the property of the custodian and subject to the claims of all creditors of the same class as the customers.

Please note that if there were an insolvency of a clearing organization regulated by the CFTC (an event which has never occurred), the legal proceedings would be governed by Subchapter IV of Chapter 7 of the Bankruptcy Code and by the CFTC Bankruptcy Rules in Part 190 of the CFTC's Regulations. In such a proceeding, each CM of the bankrupt DCO would have a first-priority claim as a "customer" of the DCO to collateral or "customer property" held by the DCO on behalf of the CM and its customers.

In regards to debtors that are DCOs, Section 766(i) of the Bankruptcy Code provides that the bankruptcy trustee shall distribute:

- 1) customer property, other than member property, ratably to customers on the basis and to the extent of such customers' allowed net equity claims based on such customers' accounts other than proprietary accounts, and in priority to all other claims, except claims of a kind specified in section 507(a)(2) of this title that are attributable to the administration of such customer property; and
- 2) member property ratably to customers on the basis and to the extent of such customers' allowed net equity claims based on such customers' proprietary accounts, and in priority to all other claims, except claims of a kind specified in section 507(a)(2) of this title that are attributable to the administration of member property or customer property.

Please also see our discussion of CME Rule 818 (Close-Out, Netting) in response to Question 4 below.

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- i. *To the extent relevant to this analysis, please consider whether customers hold proprietary (i.e., ownership) rights in the IM held at the CCP (or the CCP's custodian), or merely contractual rights to recovery of the IM vis-à-vis the defaulted CCP (or the CCP's custodian).*

1. *How does the selection of pledge versus title transfer for the provision of collateral security affect this determination?*

Title to customer property is not transferred. It is pledged by the customer and held by the CM to secure obligations of the customer to the dealer in respect of obligations relating to cleared CDS Positions.

2. *What are the relevant legal standards with respect to tracing or other requirements necessary to demonstrate proprietary rights in the IM?*

Internal accounting is used to trace customer rights to property. If insured, customers could recover up to the maximum permitted by the FDIC on a customer-by-customer basis.

3. *What is the practical effect of maintaining proprietary versus contractual rights?*

If the CCP is insolvent, all open positions are liquidated and net equity is returned to each customer and the CMs.

- ii. *If the distinction between proprietary versus contractual rights to the IM held at the CCP (or the CCP's custodian) is irrelevant as a legal matter, please describe the legal framework that is relevant to the analysis.*

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The legal framework relevant to the analysis is that found in the provisions of the CEA, CFTC Regulations and the Bankruptcy Code referenced in this document.

- b. *How is a shortfall in CCP Margin and other custodial property (i.e., property held in a custodial capacity for purposes unrelated to the clearing of CDS) held by the CCP (or its custodian) allocated as between the CCP (or the CCP's custodian), the CMs, the customers (as a group and individually) and other custodial claimants? Distinguish where relevant between Required Margin, CCP Excess Margin, Dealer Excess Margin and any other categories of margin.*

Although the CCP segregates customer performance bond deposits from the CM's proprietary performance bond deposits, the customer performance bond deposits for each CM are held in the aggregate, without identifying specific ownership of the deposits. If a default occurred in the CM's customer account, the CCP has the right to apply toward the default all customer performance bond deposits and positions in the defaulting CM's customer account at the CCP. Accordingly, positions and performance bonds deposited by customers not causing the default are potentially at risk if there is a default in the customer account of their CM. Additionally, customer account positions are held in aggregate without identifying which positions are held by specific customers. The CCP has the right to liquidate all customer positions and collateral. Accordingly, positions and collateral of customers not causing the default may be liquidated. This analysis is unaffected by the various categories of margin.

- i. *With what other types of custodial claimants may the customers potentially be required to share with in the event of a shortfall in custodial property?*

1. *Are there any applicable regulatory regimes that limit the claims of those who may share in CCP Margin?*

Yes, CFTC's Part 190 Regulation and Subchapter IV of the Bankruptcy Code.

- ii. *Is it possible to contractually vary the sharing regime that would otherwise apply in any particular instance (e.g., by holding CCP Margin at a third party custodian)?*

The CFTC's Part 190 Regulations cannot be varied by contract.

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*Customer Rights to Dealer Margin*

2. *Please detail the ability of customers to recover IM held at the CM (or the CM's custodian) upon the insolvency of the CM (or the CM's custodian) – distinguishing between Required Margin, CCP Excess Margin, Dealer Excess Margin and any other categories of margin where relevant – in the event their positions are liquidated rather than transferred. Consider all relevant facts, including: (i) the manner in which the IM is held at the CM or its custodian; (ii) the nature of the customer obligations secured by liens on the IM; (iii) the composition of the IM (e.g., whether IM consists of securities or cash); (iv) in the event of the insolvency of the CM's custodian, any restrictions (legal or otherwise) on the ability of the CM to recover IM from the insolvent custodian; and (v) any other matters described in your responses to the questions above that are relevant to this analysis. Analyze how these facts ultimately affect the conclusions reached.*

As a general matter, CME is seeking approval from the CFTC to hold in the 4d or customer segregation account customer funds and property for CME cleared CDS. In particular, CME has petitioned the CFTC for an order under section 4d(a)(2) of the CEA, which provides:

It shall be unlawful for any person to engage as a futures commission merchant or introducing broker in soliciting orders or accepting orders for the purchase or sale of any commodity for future delivery, or involving any contracts of sale of any commodity for future delivery, on or subject to the rules of any contract market or derivatives transaction execution facility unless . . . (2) such person shall, if a futures commission merchant, . . . treat and deal with all money, securities, and property received by such person to margin, guarantee, or secure the trades or contracts of any customer of such person, or accruing to such customer as the result of such trades or contracts, as belonging to such customer. Such money, securities, and property shall be separately accounted for and shall not be commingled with the funds of such commission merchant or be used to margin or guarantee the trades or contracts, or to secure or extend the credit, of any customer or person other than the one for whom the same are held.

Section 4d(b) of the CEA provides that:

It shall be unlawful for any person, including but not limited to any clearing agency of a contract market or derivatives transaction execution facility and any depository, that has received any money, securities' or

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property for deposit in a separate account as provided in paragraph (2) of this section, to hold, dispose of, or use any such money, securities, or property as belonging to the depositing futures commission merchant or any person other than the customers of such futures commission merchant.

Also relevant is section 4d(a)(2) of the CEA which provides, in pertinent, part:

That in accordance with such terms and conditions as the Commission may prescribe by rule, regulation, or order, such money, securities, and property of the customers of such futures commission merchant may be commingled and deposited as provided in this section with any other money, securities, and property received by such futures commission merchant and required by the Commission to be separately accounted for and treated and dealt with as belonging to customers of such futures commission merchant.

The CFTC has previously issued 4d orders permitting CME and clearing members of its DCOs to commingle customer funds used to margin, secure or guarantee certain other cleared-only OTC swaps (*e.g.*, ethanol, grains) with other funds held in segregated accounts, subject to terms and conditions specified by the CFTC.

Prior to issuance of a 4d order, CME Rule 8F03 requires customer funds and property for OTC Derivatives to be held in a 30.7/secured account. Similar to regulations relating to customer funds held under 4d segregation, funds held pursuant to Regulation 30.7 must be held in a location/account that clearly identifies the funds as held for the benefit of customers. These funds cannot be commingled with the firm's own funds or 4d funds, and firms must calculate their obligations to customers on a daily basis.

Regulation 30.7 offers FCMs a choice in how to calculate their segregation obligations with respect to customer funds to which the Regulation applies. Most firms choose to calculate their 30.7 obligations under the "net liquidating method", which is identical to how firms calculate their 4d segregation obligations (*i.e.*, all funds received from customers are held in a segregated account). However, Regulation 30.7 provides for an "alternative method" that allows a firm to calculate its 30.7 obligations based on the margin needed for its customers' trading plus or minus unrealized gains or losses on such trading. If this alternative method is chosen by the customer's FCM, any excess amount over that sum may be used by the FCM for purposes other than the transactions of that customer, such as a margin payment for the positions of another customer with positions in the 30.7 account. However, CME rules will require that all collateral deposited by a customer in a 30.7 account to support OTC derivatives (including CDS), including any

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amount in excess of any unrealized gain or loss on such contracts, shall not be used for purposes other than the transactions of that customer.

Similar to regulations relating to customer funds held under 4d segregation, funds held under Regulation 30.7 must be held in a location/account that clearly identifies the funds as held for the benefit of customers. These funds cannot be commingled with the firm's own funds or 4d funds. Firms must calculate their obligations to customers on a daily basis.

- a. *What is the legal nature of the customers' rights in the IM held at the CM (or the CM's custodian)?*

The IM held at the CM is not part of the CM's estate. It belongs to the customers of the CM. IM held at a custodian of the CM is not part of the CM's estate and to the extent that the IM is not held in the form of a demand deposit, it should not be deemed property of the custodian. IM in the form of cash, held in a demand deposit account, is likely to be deemed the property of the custodian and subject to the claims of all creditors of the same class as the customers.

- iii. *To the extent relevant to this analysis, please consider whether customers hold proprietary (i.e., ownership) rights in the IM held at the CM (or the CM's custodian), or merely contractual rights to recovery of the IM vis-à-vis the CM (or the CM's custodian).*

1. *How does the selection of pledge versus title transfer for the provision of collateral security affect this determination?*

This question is not relevant to the CME segregated/secured account solution. A solution that affords customers nothing but contractual rights to recovery of IM is likely to place those customers into the position of a general creditor of the CM in the event of its insolvency. The IM is likely to be deemed property of the CM's estate.

2. *What are the relevant legal standards with respect to tracing or other requirements necessary to demonstrate proprietary rights in the IM?*

The CME proposal requires that all customer IM funds be placed into a customer segregated account pursuant to 4d of the CEA or into a 30.7 account pursuant to CFTC Regulations and CME Rules. All funds required to be held in such accounts, even if improperly

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removed by the CM, should be traceable and treated as customer property.

3. *What is the practical effect of maintaining proprietary versus contractual rights?*

We believe that segregated/secure treatment under the CEA affords customers a more secure environment in the event of a failure of their CM.

iv. *If the distinction between proprietary versus contractual rights to the IM held at the CM (or the CM's custodian) is irrelevant as a legal matter, please discuss the legal framework that is relevant to the analysis.*

The legal framework relevant to the analysis is that found in the provisions of the CEA, CFTC Regulations and the Bankruptcy Code referenced in this document.

b. *How is a shortfall in Dealer Margin and other custodial property (i.e., property held in a custodial capacity for purposes unrelated to cleared CDS) held by the CM (or its custodian) allocated as between the CMs, the customers (as a group and individually) and other custodial claimants? Distinguish where applicable between Required Margin, CCP Excess Margin, Dealer Excess Margin and any other categories of margin where relevant.*

In the event of the bankruptcy of a CM that is an FCM (i.e., any CM holding customer positions), the legal proceedings would be governed by Subchapter IV of Chapter 7 of the Bankruptcy Code and Part 190 of the CFTC's Regulations. In such a case, the debtor would be the FCM. Pursuant to Regulation 190.07 (which defines the term "net equity"), "the total claim of a customer against the estate of the debtor [is] based on the commodity contracts held by the debtor for or on behalf of such customer less any indebtedness of the customer to the debtor." Thus, in order to be entitled to the prioritized rights of customers in an FCM bankruptcy, an entity's claim against the FCM must arise out of a "commodity contract." That term is defined in Section 761(4) of the Bankruptcy Code to include, among other things: "with respect to [an FCM], contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade[.]"

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As explained in the CFTC's Interpretive Statement Regarding Funds Related to Cleared-Only Contracts Determined to Be Included in a Customer's Net Equity (the "Interpretive Statement", a copy of which is attached):

This definition [of "commodity contract"] contains two elements: (1) the nature of the contract; and (2) the nature of the venue whose rules govern the contract.

With regard to the first element, [OTC] contracts that are cleared-only contracts are contracts for the purchase or sale of a commodity for future delivery within the meaning of this section of the Bankruptcy Code. When cleared, they are subject to performance bond requirements, daily variation settlement, the potential for offset, and final settlement procedures that are substantially similar, and often identical, to those applicable to exchange-traded products at the same clearing house. [Citation omitted.] Although the creation and trading of these products is outside the [CFTC's] jurisdiction, the clearing of these products by FCMs and DCOs is within the [CFTC's] jurisdiction.

With regard to the second element, Section 761(7) of the Bankruptcy Code states that a "contract market" means a registered entity," and Section 761(8), in turn, provides that a "registered entity" ...ha[s] the meaning[] assigned to [that] term[] in the [CEA]." Section 1a(29)(C) of the [CEA] defines the term "registered entity" as including "a [DCO] registered under section 5b" of the [CEA].

Thus, when a contract is cleared through a DCO, such contract would be considered a "commodity contract" under Section 761(4) of the Bankruptcy Code. Therefore, an entity with a claim based on a cleared-only contract would be a "customer" within the meaning of Section 761 of the Bankruptcy Code. Further, because Part 190 of the [CFTC's] Regulations defines "customer" as having the meaning set forth in Section 761, such entity with a claim based on a cleared-only contract would also be a "customer" for purposes of Part 190 of the [CFTC's] Regulations. Based on the foregoing, such claims arising out of cleared-only contracts are properly included within the meaning of "net equity" for the purposes of Subchapter IV of the Bankruptcy Code and Part 190 of the [CFTC's] Regulations.

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With regard to the scope of the customer's net equity for purposes of its claim, the Interpretive Statement goes on to explain:

Subchapter IV of the Bankruptcy Code includes as "customers" entities with certain claims arising out of property that is not currently margining a commodity contract. Specifically, Section 761(9)(A)(ii) provides that an entity can qualify as a 'customer' based on claims arising out of any of the following: (I) the "liquidation, or change in the value of a commodity contract;" (II) a deposit of property "for the purpose of making or margining...a commodity contract;" or (III) "the making or taking of delivery of a commodity contract." Accordingly, there is no requirement that the customer's assets be margining commodity contracts on the day that the bankruptcy petition is filed. Therefore, all assets contained in such an account are property included within the customer's net equity.

The Bankruptcy Code and the CFTC's Part 190 Regulations provide a thorough system for transfer or return of customer property. CFTC Regulations further provide for separate customer account classes including, in relevant part, "futures accounts" (*i.e.*, 4d/customer segregation accounts) and "foreign futures accounts" (*i.e.*, 30.7/secured account). Customers with positions in a 30.7 account are treated no differently from customers with positions in a 4d account for purposes of the first-priority afforded to customer claims. However, if there were a shortfall in customer property in a particular account class, customers in that account class would share in the shortfall on a pro rata basis.

- i. Are there any applicable regulatory regimes that limit the claims of those who may share in Dealer Margin?*

CFTC Part 190 Regulations dictate the metes and bounds for claims against "Dealer Margin." Claims are limited to customers with net equity.

- ii. Is it possible to contractually vary the sharing regime that would otherwise apply in any particular instance (e.g., by holding Dealer Margin at a third party custodian)?*

The "sharing regime" that applies under the Part 190 Regulations in the event of a bankruptcy cannot be varied by contract.

*Legal Enforceability of Portability Framework*

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3. *Please discuss the legal enforceability of the CCP's portability framework in the event of either or both (i) a CM insolvency (or the insolvency of the CM's custodian) and/or (ii) a customer insolvency. In particular, consider how the enforceability of the portability framework is affected by the following:*

Because CME's legal relationship is with its CMs (who guarantee the obligations of their customers), a customer insolvency would not affect the "portability" of other customer accounts at CMs of CME. As noted in response to Question 6 above, Subchapter IV of Chapter 7 of the Bankruptcy Code and the CFTC Part 190 Regulations provide a thorough system for, among other things, the transfer of customer accounts in the event of an FCM bankruptcy.

- a. *Whether, if either the CCP or insolvency trustee/receiver of the CM transfers any cleared positions and margin (and any associated contractual relationships) of the defaulted CM with the CCP, it must also transfer the defaulting CM's (i) other cleared positions and margin (and any associated contractual relationships) with the CCP, and (ii) non-cleared positions (and associated margin and contractual relationships) with customers of the defaulting CM;*

If CM and the CCP defaulted simultaneously, portability of positions and margin would not be impacted if there were sufficient assets of the CCP available to cover the default. For a general discussion of portability, see our responses to questions presented in Section C.

- b. *The effect of any standstill provisions upon default, and the interplay of such provisions with any statutorily protected termination rights;*

CME Clearing is not subject to standstill provisions. We are excluded and thus free to act to enforce contracts and assert rights against the bankrupt estate. Thus, CME Clearing is able to close out the positions in the portfolio of a defaulting (bankrupt) CM.

- c. *Any affiliate and third-party liens or cross-margining and netting arrangements;*

No liens, cross-margining or netting arrangements will reach the collateral or positions controlled by CME Clearing. They should not touch Dealer Margin either.

- d. *Any setoff rights or limitations between cleared and non-cleared trades;*

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There is no opportunity for set-off against non-cleared bi-lateral transactions at the clearing level.

*e. Any mandatory setoff requirements for CMs or customers under applicable law;*

A CM is expressly prohibited under the CEA and CFTC Regulations from using customer funds for its own purposes. If, however, the customer fails to pay a CM, a CM may use any collateral and margin remaining after liquidating the customer's positions to set-off amounts owed to the CM.

*f. Any pledge arrangements or other provisions for collateral security between CMs and customers related to cleared transactions; and*

All rights with respect to customer collateral are governed by Section 4d of the CEA and CFTC Regulation 30.7 to the exclusion of any private arrangements.

*g. Whether the CM is acting as principal (rather than as agent) vis-à-vis the CCP in respect of customer transactions.*

CMs clearing customer business act as agents for undisclosed principals (*i.e.*, their customers), vis a vis CME Clearing and guarantee their customers' performance to CME Clearing. The agency relationship facilitates customer segregation protection, bankruptcy portability of customer positions and favorable capital treatment for the CM. It also facilitates operational simplicity and efficiency by avoiding the necessity of the CMs booking a string of back to back transactions between the CM and CCP, CM and customer. This structure also facilitates improved systemic risk protection by providing bankruptcy protections and certainty to the CCP in the event of a CM default. The CM will face CME Clearing as a principal for its proprietary business.

#### Legal Enforceability of Novation/Netting Framework

4. *Please discuss the legal enforceability of the CCP's novation and netting framework in the event of either or both (i) a CM insolvency (or the insolvency of the CM's custodian) or (ii) a customer insolvency, giving due regard to the CCP's ability (and, in the event of a customer insolvency, a CM's ability) to exercise its legal and contractual remedies on (a) IM held at the CCP (or the CCP's custodian) and (b) IM held at the CM (or the CM's custodian).*

In connection with netting, because CME Clearing's legal relationship is with its CMs, a customer insolvency would not impact CME Clearing's netting framework. CME Rule

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818 addresses close-out and netting as between CME and its clearing members. (Note that, in the context of CME Rules, the terms "Exchange" and "Clearing House" are interchangeable.) CME Rule 818 states, in relevant part:

**818. CLOSE-OUT NETTING**

**818.A. Bankruptcy of the Exchange** If at any time the Exchange: (i) institutes or has instituted against it a proceeding seeking a judgment of insolvency or bankruptcy or any other relief under any bankruptcy or insolvency law or other similar law affecting creditors' rights, or a petition is presented for its winding up or liquidation, and, in the case of any such proceeding or petition presented against it, such proceeding or petition results in a judgment of insolvency or bankruptcy or the entry of an order for relief or the making of an order for the Exchange's winding-up or liquidation, or (ii) approves resolutions authorizing any proceeding or petition described in clause (i) above (collectively, a "Bankruptcy Event"), all open positions in the Clearing House shall be closed promptly.

**818.B. Default of the Exchange**

If at any time the Exchange fails to comply with an undisputed obligation to pay money or deliver property to a Clearing Member that is due and owing in connection with a transaction on the Exchange or cleared by the Exchange, for a period of thirty days from the date that the Exchange receives notice from the Clearing Member of the past due obligation, the Clearing Member's open proprietary account and customer (including, for this rule, CFTC Regulation Section 30.7 secured) positions at the Clearing House shall, at the election of that Clearing Member, be closed promptly.

**818.C. Netting and Offset**

At such time as a Clearing Member's positions are closed, the obligations of the Clearing House to a Clearing Member in respect of all of its proprietary positions, accounts, collateral and deposits to the security deposit fund shall be netted, in accordance with the Bankruptcy Code, the Commodity Exchange Act and the regulations adopted thereunder in each case, against the obligations of that Clearing Member in respect of both its proprietary account and its customers' positions, accounts, collateral and its then matured obligations to the security deposit fund to the Clearing House and to the Exchange. All obligations of the Clearing House to a Clearing Member in respect of its customer positions, accounts, and collateral shall be separately netted against the positions, accounts and collateral of its customers in accordance with the requirements of the Bankruptcy Code, the

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Commodity Exchange Act and the Regulations adopted thereunder in each case. At the time a Bankruptcy Event takes place, the authority of the Clearing House, pursuant to Rule 802, to make new assessments and/or require a clearing member to cure a deficiency in its security deposit, arising after the Bankruptcy Event, shall terminate. All positions open immediately prior to the close-out shall be valued in accordance with the procedures of Paragraph D of this Rule.

**818.D. Valuation**

As promptly as reasonably practicable, but in any event within thirty days of the: (i) Bankruptcy Event, or (ii) if a Clearing Member elects to have its open positions closed in a default as described in Paragraph B of this Rule, the date of the election, the Exchange shall, in a manner that is consistent with the requirements of the Commodity Exchange Act and the regulations adopted thereunder (including, without limitation) Part 190 of the Regulations, fix a U.S. dollar amount (the "Close-out Value") to be paid to or received from the Exchange by each Clearing Member, after taking into account all applicable netting and offsetting pursuant to paragraph C of this Rule.

The Exchange shall value open positions subject to close-out by using the market prices for the relevant market (including without limitation, any over the counter markets) at the moment that the positions were closed-out, assuming the relevant markets were operating normally at such moment. If the relevant markets were not operating normally at such moment, the Exchange shall exercise its discretion, acting in good faith and in a commercially reasonable manner, in adopting methods of valuation to produce reasonably accurate substitutes for the values that would have been obtained from the relevant market if it had been operating normally at the moment that the positions were closed-out.

In determining a Close-out Value, the Exchange may consider any information that it deems relevant. Amounts stated in a currency other than U.S. Dollars shall be converted to U.S. Dollars at the current rate of exchange, as determined by the Exchange. If a Clearing Member has a negative Close-out Value it shall promptly pay that amount to the Exchange.

In a bankruptcy of CME or one of its CMs, CME Rule 818 should be found to be a "master netting agreement" as defined in section 101(38A) of the Bankruptcy Code because the Rule is an agreement between the CME and the CMs that provides for the "exercise of rights, including rights of netting" in connection with certain commodity

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contracts and swap agreements. Similarly, CME and each CMs should be deemed to be a "master netting agreement participant," as defined in section 101(38B) of the Code, because each would be "an entity that, at any time before the date of the filing of the petition, is a party to an outstanding master netting agreement with the debtor."

Section 561(c) of the Code defines a "contractual right" to include, among other things, "a right set forth in a rule or bylaw of a [DCO]" or of a "multilateral clearing organization (as defined in the Federal Deposit Insurance Corporation Improvement Act of 1991)." CME is both a DCO and a multilateral clearing organization as defined in FDICIA. Therefore, because Rule 818 is a rule of CME, it should be deemed to be a "contractual right," as well as a master netting agreement and the netting provisions should generally be protected under section 561 of the Bankruptcy Code.

- a. *How would challenges to the validity or enforceability to an underlying bilateral transaction (prior to novation) – e.g., if a transaction was entered into in bad faith, fraudulently, or in contemplation of insolvency – affect the enforceability of the novated transaction, in the event of either or both (i) a CM insolvency or (ii) a customer insolvency?*

Once a transaction is accepted for clearing by CME, the original transaction is deemed null and void pursuant to CME Rules. All customers and clearing members must agree, as a contractual matter, to be bound by CME Rules. Any disputes relating to the original transaction prior to novation would be a matter between the parties to that transaction and would not affect the enforceability of the transaction cleared by CME. This is reflected in cases in which customers allege that their FCM defrauded them in connection with futures contracts cleared by CME or another DCO. *See, e.g. Eastern Trading Co. v. Refco, Inc.*, 229 F.3d 617 (7th Cir. 2000). In such cases, a customer may seek damages from its FCM, but the commodity contracts themselves remain enforceable. This would be true regardless of the solvency or insolvency of an FCM or its customer.

### Considerations Relating to Netting vis-à-vis the CCP

5. *Please evaluate, from an accounting and regulatory capital perspective, the ability of CMs to net (i) proprietary positions against other proprietary positions and (ii) customer positions against proprietary positions, in each case vis-à-vis the CCP, upon a CCP default or insolvency.*

While from a margin perspective, proprietary positions of the CM can be netted against the proprietary positions of its affiliates, CFTC (and SEC) regulations do not allow such treatment for capital purposes. Positions for each legal entity must be reviewed

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separately in determining the impact to capital. CMs are required to take capital deductions for the risk exposure associated with their proprietary positions. The risk exposure for positions of their affiliates is assessed in determining capital requirements. Proprietary/affiliate positions can never be netted against the positions of customers. CMs must include the risk exposure for customer positions in determining their capital requirements. Please also see our response to Question 5.b in Section A above.

*Enforcement and Monitoring Mechanisms*

- 6. Please describe any enforcement or monitoring mechanisms (imposed by the CCP, applicable regulatory authorities or otherwise) designed to ensure that CMs (and their custodians, to the extent applicable) comply with their obligations in respect of any legal or contractual requirements described in your response above.*

Any suspected violation of the CEA or CFTC regulations by a clearing member or custodian firm (including but not limited to violations of provisions requiring segregation of customer funds) may result in an investigation by the CFTC's Division of Enforcement. If such investigation causes the CFTC to conclude that a clearing member or custodian has in fact violated the CEA or CFTC Regulations, the Division of Enforcement may bring charges against such firm and seek various sanctions, including but not limited to civil monetary penalties, cease and desist orders, restitution for affected customers, and temporary or permanent suspension of any related CFTC registrations.

In addition in its role as an SRO, CME has broad powers to monitor clearing member activities, audit their books and records for financial and regulatory compliance, and to take enforcement action against CM who fail to satisfy financial, risk management or regulatory requirements. CME's Audit Department operates a sophisticated financial surveillance program of all of its CMs. The Audit Department routinely inspects the books and records of its CMs to ensure, among other things, their compliance with segregation requirements. These inspections are risk-based, focusing on those areas of greatest concern to CME Clearing. Violations of segregation requirements are considered by the CFTC and CME to be serious infractions and can result in significant penalties. In addition, for those CMs who are members of other exchanges, CME shares the results of its examinations.

*Legislative or Regulatory Reforms*

- 7. As requested above, please identify in your responses above any areas of legal uncertainty and the level of legal comfort provided on various aspects of the proposed framework. Please consider whether there are any legislative or regulatory reforms that would be helpful to clarify or improve the legal framework governing any of the*

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*foregoing issues and areas of legal uncertainty identified above. If so, describe any such proposed reforms in detail.*

Revising bankruptcy and insolvency laws has been a popular topic following the collapse of Lehman and its 80-plus entities around the globe, with a particular emphasis on efforts to harmonize international legal standards when dealing with a global company. As the Lehman proceedings helped to make clear, U.S. bankruptcy and insolvency laws (including the CFTC's Part 190 Rules) provide the best customer protection mechanisms currently available. Given the small number of FCM bankruptcies and the complete absence of DCO bankruptcies, the legal precedent in this area is limited. As a result, a certain amount of "legal uncertainty" exists with regard to a variety of issues that could arise in the bankruptcy of an FCM or a DCO.

The Bankruptcy Code, however, is not in need of reform with regard to the rights of customers holding positions in OTC derivatives (including CDS) cleared by CME. Because the CFTC was fairly newly created when Congress enacted the commodity broker section of the Bankruptcy Code in 1978, Congress avoided drafting detailed statutory sections to address every possibility. Instead, it created a framework in which the CFTC could promulgate rules within the bounds of Subchapter IV of Chapter 7. Here, the CFTC's Bankruptcy Interpretative Statement explains the analysis that would apply in the event of the bankruptcy of a commodity broker holding customer positions in cleared-only OTC derivatives. Short of a controlling court decision, we believe that the CFTC's Interpretive Statement and the cogent legal analysis contained therein provide as much legal certainty as possible on these issues.

### Other Considerations

8. *Please feel free to elaborate on any topic you deem to be relevant to the analysis of customer protection or systemic risk issues.*

From a very broad perspective, CME believes that utilizing CFTC regulation and CFTC customer protection standards offers the industry a flexible, adaptable method to achieve a variety of industry objectives with respect to the question of how to best deploy clearing solutions for OTC products. For example, positioning the alignment of diverse OTC asset classes into the same regulatory account structures offers the prospect to achieve, in varying degrees, risk offsets, diversification benefits, multi-lateral netting, and capital efficiencies for clearing firms and market participants.



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## Appendix

### Eligible contract participant

The term “eligible contract participant” means—

(A) acting for its own account—

(i) a financial institution;

(ii) an insurance company that is regulated by a State, or that is regulated by a foreign government and is subject to comparable regulation as determined by the Commission, including a regulated subsidiary or affiliate of such an insurance company;

(iii) an investment company subject to regulation under the Investment Company Act of 1940 (15 U.S.C. 80a–1 et seq.) or a foreign person performing a similar role or function subject as such to foreign regulation (regardless of whether each investor in the investment company or the foreign person is itself an eligible contract participant);

(iv) a commodity pool that—

(I) has total assets exceeding \$5,000,000; and

(II) is formed and operated by a person subject to regulation under this chapter or a foreign person performing a similar role or function subject as such to foreign regulation (regardless of

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whether each investor in the commodity pool or the foreign person is itself an eligible contract participant);

(v) a corporation, partnership, proprietorship, organization, trust, or other entity—

(I) that has total assets exceeding \$10,000,000;

(II) the obligations of which under an agreement, contract, or transaction are guaranteed or otherwise supported by a letter of credit or keepwell, support, or other agreement by an entity described in subclause (I), in clause (i), (ii), (iii), (iv), or (vii), or in subparagraph (C); or

(III) that—

(aa) has a net worth exceeding \$1,000,000; and

(bb) enters into an agreement, contract, or transaction in connection with the conduct of the entity's business or to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by the entity in the conduct of the entity's business;

(vi) an employee benefit plan subject to the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1001 et seq.), a governmental employee benefit plan, or a foreign person performing a similar role or function subject as such to foreign regulation—

(I) that has total assets exceeding \$5,000,000; or

(II) the investment decisions of which are made by—

(aa) an investment adviser or commodity trading advisor subject to regulation under the Investment Advisers Act of 1940 (15 U.S.C. 80b-1 et seq.) or this chapter;

(bb) a foreign person performing a similar role or function subject as such to foreign regulation;

(cc) a financial institution; or

(dd) an insurance company described in clause (ii), or a regulated subsidiary or affiliate of such an insurance company;

(vii)

(I) a governmental entity (including the United States, a State, or a foreign government) or political subdivision of a governmental entity;

(II) a multinational or supranational government entity; or

(III) an instrumentality, agency, or department of an entity described in subclause (I) or (II);

except that such term does not include an entity, instrumentality, agency, or department referred to in subclause (I) or (III) of this clause unless (aa) the entity, instrumentality, agency, or department is a person described in clause (i), (ii), or (iii) of paragraph (11)(A) of this section;

(bb) the entity, instrumentality, agency, or department owns and invests on a discretionary basis \$25,000,000 or more in investments; or (cc) the agreement, contract, or transaction is offered by, and entered into with, an entity that is listed in any of subclauses (I) through (VI) of section 2

(c)(2)(B)(ii) of this title;

(viii)

(I) a broker or dealer subject to regulation under the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) or a foreign person performing a similar role or function subject as such to foreign regulation, except that, if the broker or dealer or foreign person is a natural person or proprietorship, the broker or dealer or foreign person shall not be considered to be an eligible

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contract participant unless the broker or dealer or foreign person also meets the requirements of clause (v) or (xi);

(II) an associated person of a registered broker or dealer concerning the financial or securities activities of which the registered person makes and keeps records under section 15C(b) or 17(h) of the Securities Exchange Act of 1934 (15 U.S.C. 78o-5 (b), 78q (h));

(III) an investment bank holding company (as defined in section 17(i) of the Securities Exchange Act of 1934 (15 U.S.C. 78q (i)); [1]

(ix) a futures commission merchant subject to regulation under this chapter or a foreign person performing a similar role or function subject as such to foreign regulation, except that, if the futures commission merchant or foreign person is a natural person or proprietorship, the futures commission merchant or foreign person shall not be considered to be an eligible contract participant unless the futures commission merchant or foreign person also meets the requirements of clause (v) or (xi);

(x) a floor broker or floor trader subject to regulation under this chapter in connection with any transaction that takes place on or through the facilities of a registered entity or an exempt board of trade, or any affiliate thereof, on which such person regularly trades; or

(xi) an individual who has total assets in an amount in excess of—

(I) \$10,000,000; or

(II) \$5,000,000 and who enters into the agreement, contract, or transaction in order to manage the risk associated with an asset owned or liability incurred, or reasonably likely to be owned or incurred, by the individual;

(B)

(i) a person described in clause (i), (ii), (iv), (v), (viii), (ix), or (x) of subparagraph (A) or in subparagraph (C), acting as broker or performing an equivalent agency function on behalf of another person described in subparagraph (A) or (C); or

(ii) an investment adviser subject to regulation under the Investment Advisers Act of 1940 [15 U.S.C. 80b-1 et seq.], a commodity trading advisor subject to regulation under this chapter, a foreign person performing a similar role or function subject as such to foreign regulation, or a person described in clause (i), (ii), (iv), (v), (viii), (ix), or (x) of subparagraph (A) or in subparagraph (C), in any such case acting as investment manager or fiduciary (but excluding a person acting as broker or performing an equivalent agency function) for another person described in subparagraph (A) or (C) and who is authorized by such person to commit such person to the transaction; or

(C) any other person that the Commission determines to be eligible in light of the financial or other qualifications of the person.

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## Appendix

### CME Acceptable Collateral & Applicable Haircuts

As part of its financial safeguards package, CME Clearing ensures that each clearing member maintains a diversified portfolio of collateral. Additionally, haircuts are applied to acceptable collateral to ensure that upon liquidation in a time of market stress, cash received would equal the performance bond value of the security.

Haircuts are established and reviewed based on volatility using several VaR methodologies and historical observations for varying periods of time and confidence intervals. The VaR methodologies utilized to assess the risk associated with unusual observations include Extreme Value Theory (EVT), Exponentially Weighted Moving Average (EWMA), and Normal Mixtures.

Collateral haircuts are reviewed at least once a month or more frequently as warranted by current market conditions.

All collateral is marked to market on a daily basis and can be re-priced more often as necessary. Underlying collateral is also monitored for any issuer risks that might affect the potential total value of the instruments. This includes reviewing pricing anomalies, liquidity, and the total composition and credit risk of the collateral.

Below are CME's acceptable collateral types and applicable haircuts.

---

**Foreign Sovereign Cash - Selected sovereign cash of the following currencies:**

Australian dollar, British pound, Canadian dollar, Euro, New Zealand dollar, Norwegian Krone, Swedish Krona, Swiss franc	3% haircut
Japanese yen	5% haircut
Mexican peso	15% haircut

Haircuts are applied only when performance bond cash is utilized to meet PB requirements in other currencies

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**Foreign Sovereign Debt - Selected Sovereign debt of Canada, France, Germany, Sweden and United Kingdom:**

Discount bills	3% haircut
0-5 years	5.50% haircut
5-10 years	7% haircut
10-30 years	8.50% haircut
>30 years	10% haircut

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**U.S. Treasuries:**

U.S. Treasury Bills	No haircuts applied to market value	
U.S. Treasury Notes & Bonds	1-5 years	3% haircut
	5-10 years	3.5% haircut
	10-30 years	5% haircut
	Off the run securities	0.5% additional haircut
U.S. Treasury Strips (Principal & Coupon)	10% haircut applied to market value of security	

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**U.S. Government Agencies:**
**Concentration Limits:**

Limited to the combination of letters of credit and government agencies of no more than 50% of clearing member's core performance bond requirement in excess of \$5 million. This restriction does not apply to the clearing firm's reserve performance bond or concentration requirements.

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<b>Discount notes</b> (with remaining maturity of no more than 12 months) Issued by Federal Farm Credit Banks, Federal Home Loan Bank System, Federal Home Loan Mortgage Corp. and Federal National Mortgage Assoc	3% haircut on market value (0.5% added if security is off the run)								
<b>Callable and Non-callable:</b> Fannie Mae Benchmark Bills Freddie Mac Reference Bills Federal Home Loan Bank Bills Federal Farm Credit Bank Bills	3% haircut on value of Agency Bills (0.5% added if security is off the run)								
<b>Callable and Non-callable:</b> Fannie Mae Benchmark Notes and Bonds Freddie Mac Reference Notes and Bonds Federal Home Loan Bank Notes and Bonds Federal Farm Credit Bank Notes and Bonds	<table border="0"> <tr> <td style="text-align: right;">&lt;1 year</td> <td style="text-align: right;">3% haircut</td> </tr> <tr> <td style="text-align: right;">1-5 years</td> <td style="text-align: right;">4.5% haircut</td> </tr> <tr> <td style="text-align: right;">5-10 years</td> <td style="text-align: right;">6% haircut</td> </tr> <tr> <td style="text-align: right;">Off the run securities</td> <td style="text-align: right;">0.5% additional haircut</td> </tr> </table>	<1 year	3% haircut	1-5 years	4.5% haircut	5-10 years	6% haircut	Off the run securities	0.5% additional haircut
<1 year	3% haircut								
1-5 years	4.5% haircut								
5-10 years	6% haircut								
Off the run securities	0.5% additional haircut								

**Select Mortgage Backed Securities**

Fannie Mae (FNMA) Freddie Mac (FHLMC) Ginnie Mae (GNMA)	10% haircut applied to market value of security
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**Letters of Credit**

Issued in the Exchange's name by approved banks Concentration Limits	Limited to combination use of letters of credit and government agencies of no more than 50% of clearing member's core performance bond requirement in excess of \$5 million. <ul style="list-style-type: none"> <li>• Up to 50% of a firm's Core Requirement</li> <li>• Up to 100% of a firm's Reserve Requirement</li> <li>• Up to 100% of a firm's Concentration Requirement</li> </ul>
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**Stocks**

Selected from those in the S&P 500 Index. CME does not accept stock issued by firms that are clearing members or stock issued by CME. Concentration Limits	<ul style="list-style-type: none"> <li>• 30% haircut of market value</li> <li>• 0% of a firm's Core Requirement</li> <li>• Up to 100% of a firm's Reserve Requirement</li> <li>• Up to 100% of a firm's Concentration Requirement</li> </ul>
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**Specialized Collateral Programs/ Interest Earning Facilities**
**IEF2 (Money Market Mutual Funds)**

- 3% haircut

**Diversification Requirements:**

The combined investment of customer segregated and proprietary non-segregated Performance Bond cash for each clearing member will be subject to the following:

- With total investments of less than \$100 million, there are no diversification requirements.
- With total investments of greater than \$100 million, but less than \$200 million, there is a maximum investment limit of \$100 million in any one fund.

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- For investments greater than or equal to \$200 million, there is a 50% maximum investment in any one fund.

**Concentration Limits:**

- A clearing member firm will be prohibited from investing an amount which will create a position which is greater than 5% of the specific fund’s total assets.
- The aggregate limit, of any one fund, of IEF2 deposits as held by CME will not exceed 15% of a fund’s total assets.

**IEF3 and IEF4**

Specialized CME collateral programs that permit CME clearing firms to pledge Reg. 1.25 collateral that CME does not accept directly. IEF3 & IEF4 utilize various services and methods of processing that are most typically associated with tri-party repo. CME currently utilizes two custody agents, The Bank of New York and JP Chase, to support the IEF3 and IEF4 programs.

**IEF3 Overview**

Each morning, CME and the firm must agree as to the amount to be utilized in IEF3. For example, if the firm wishes to increase the amount of assets pledged under IEF3, then by 9:00 a.m. CST, the clearing firm will enter a ‘transfer deposit’ transaction into the Clearing 21 Banking and Asset Management application for the IEF3 asset type. CME will then debit the firm’s cash account at the custody agent. Upon confirmation of cash deposited by the custodial bank, the firm will receive performance bond credit for its IEF3 collateral.

Throughout the business day, CME will have cash on deposit in its account with the bank. At the end of the day, and by no later than 3 p.m. CST, the firm will pledge acceptable collateral to the CME securities account at the bank. The bank will fully price and haircut the value of the acceptable pledged collateral and will ensure that it is equal to or greater than the cash deposit. The cash will be re-delivered by the bank to the firm.

There is a daily unwind in this program and on the following morning, the firm will redeliver cash to the CME account at the bank, and the bank returns pledged collateral to the firm.

**IEF4 Overview**

IEF4 does not have a cash component. The firm pledge securities at a point during the day, but by no later than 3 p.m. CST. Upon pledge of the securities, the bank will fully price and haircut the value of the acceptable pledged collateral.

Unlike IEF3, the firm will receive performance bond credit for assets pledged under IEF4 when the custodian confirms that the value of assets pledged under IEF4 meets that the firm’s targeted IEF4 deposit. Also unlike IEF3, the pledge of securities under IEF4 is not required to be unwound each day.

Below are securities accepted in the IEF3 & IEF4 programs that are not accepted directly by CME:

**Select Mortgage Backed Securities**

	Minimum Acceptable Rating Moody’s/S&P		Concentration Limit per Issuer	< 1 Year Haircut	1 – 5 Years Haircut	5 – 10 Years Haircut	>10 Years Haircut
	Long Term	Short Term					
<b>GSE Debentures (FNMA, FHLB, FHLMC,</b>	Aa2/AA	A1/P1		25%	25%	25%	25%

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<b>FFCB)</b>							
<b>GSE Mortgage Backed Securities (FNMA, FHLMC, GNMA)</b>	Aa2/AA	A1/P1		25%	25%	25%	25%
<b>Municipal Debt</b>	Aaa		\$ 37.5M	25%	25%	25%	25%
<b>Commercial Paper</b>		A1/P1	\$ 37.5M	25%	N/A	N/A	N/A
<b>Corporate Debt</b>	Aa2/AA		\$ 37.5M	25%	25%	25%	25%

**Limits Monitored by CME:**

- Overall limit is \$300 million total amount of IEF3 & IEF4 that a firm may have in both of these programs
- IEF3 & IEF4 may only be used to meet 50% concentration requirement and for customer segregated requirements only
- No Private Placement

**Restrictions Monitored by Custodian:**

- No Asset Backed Securities.
- Must have an active price as provided by Industry Pricing Standard.
- No securities should have affiliations with any entities whose names are listed on the tri-party account name.

**IEF5**

IEF5 is a cash deposit account maintained with a sponsoring bank's institutional trust department and recorded on the trust ledger of the bank. The yield is based off of the daily fed funds effective rate. JPMorgan Chase and Fifth Third Bank currently sponsor the program.

**Concentration Limits:**

CME will utilize the following limits in conjunction with a \$1 billion overall limit for the firm, for both origins on a combined basis.

- Up to 50% of a firm's Core Requirement
- Up to 100% of a firm's Reserve Requirement
- Up to 100% of a firm's Concentration Requirement

The aggregate limit of IEF5 deposits as held by CME at each bank will not exceed 10% of a bank's tier 1 capital. Additionally, the bank's tier 1 capital is reduced 10% for each rating below AAA.

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## **Appendix Participation Requirements**

### ***What is the due diligence process for reviewing prospective clearing members?***

We follow the same due diligence procedures as we use for clearing members clearing futures and options. We will review their application, financial wherewithal (statement submissions), disciplinary history, etc.

CME Clearing enforces requirements for clearing member firms' financial resources and creditworthiness by establishing capital requirements and monitoring a firm's financial status. The Clearing House Risk Committee meets routinely to establish and review the capital requirements level. The current capital requirements established by the Clearing House Risk Committee are as follows:

- OTC clearing members must have minimum net capital of \$300 million; or,
- 
- Firms must meet their minimum regulatory capital requirements.

### ***Additional current requirements upon OTC clearing participants are:***

- A \$2,500,000 minimum security deposit is required for any clearing member clearing OTC products.
  - The size of each participant's security deposit is determined by its percentages of overall volume and open interest, and can fluctuate accordingly.
  - Clearing members clearing CDS products are subject to an additional \$5 million security deposit (a minimum of \$7.5 million in total.)
- Membership deposits of at least \$5 million.
- Must be in "good standing" with whatever regulatory regime it is under.

Because all of the factors mentioned above are considered by the Clearing House Risk Committee when establishing capital requirements, CME is able to maintain a fair level for its very diverse group of clearing participants.

A rigorous application process reviews an applicant's disciplinary history, business lines and other relationships in addition to financial and capital requirements. Prior to becoming a clearing member, participants receive an overview of the clearing system. New firms are subject to a risk audit and required to provide the Clearing House with an operational blueprint that details the names of all service providers and third party vendors, business continuity and disaster recovery plans, general infrastructure and an organizational chart that highlights management's industry experience.

### ***Are there different standards in place for buy-side participants?***

No.

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**Appendix****Good Location for Segregation and Good Location for Capital****Good location for Segregation:**

CFTC Regulations and interpretations provide that customer segregated funds and collateral may be held by banks, trust companies, clearing organizations (DCOs) and futures commission merchants (FCMs). These cash or safekeeping accounts must be held for the FCM or DCO and titled "Customer Segregated Funds" and the depository/custodian must acknowledge in writing that the funds are held for customers of the FCM or DCO pursuant to the Commodity Exchange Act and the depository/custodian has no right of set off against such assets.

Banks and trust companies include (a) US regulated banks and trust companies and (b) foreign based banks (i) which have in excess of \$1 billion of Tier I capital OR whose commercial paper or long term debt in rated in one of the two highest rating categories by a Nationally Recognized Statistically Rating Organization (NRSRO) AND (ii) the funds are held in the country of origin of the applicable currency OR held in a CFTC designated money center country (i.e. Canada, France, Italy, Germany, Japan or the United Kingdom).

**Good location for Capital:**

SEC and CFTC regulations and interpretations provide that unrestricted funds and collateral which are good for regulatory capital by a broker-dealer or FCM may be held by financial institutions including banks, trust companies, clearing organizations, broker-dealers, foreign brokers, and futures commission merchants but restrictions apply if the financial institution is affiliated with the broker-dealer or FCM or is located outside of the US. Collateral may be subject to haircuts depending on type of security and maturity.

- Funds and collateral held by non-affiliated financial institutions regulated by a US regulatory authority are allowed without restriction.
- Funds and collateral held by non-affiliated financial institutions located in SEC designated major money market center countries (i.e. Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and United Kingdom) are allowed without restriction provided the financial institution either (a) has corporate issued notes which are rated investment grade by at least two NRSROs, the bank has shareholder's equity of \$1 billion and it is subject to the supervision of a sovereign national governmental authority OR (b) has shareholder's equity of \$1.5 billion and is subject to the supervision of a sovereign national governmental authority. If the non-US financial institution does not meet either



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of these tests, the funds are allowed for capital to the extent they represent normal day-to-day operating deposits and are not maintained for investment purposes.

- Funds and collateral held by non-affiliated financial institutions which are not located in SEC designated major money market center countries are allowed for capital to the extent that they represent normal day-to-day deposits and are not maintained for investment purposes.
- Proprietary (non-customer) funds held by an affiliated financial institutions are allowed for capital to the extent they represent normal day-to-day deposits and are not maintained for investment purposes.