

SECURITIES AND EXCHANGE COMMISSION
Release No. 34-74179; File No. SR-CME-2015-002)

January 30, 2015

Self-Regulatory Organizations; Chicago Mercantile Exchange Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Related to Enhancements to its Risk Model for Credit Default Swaps

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act” or “Exchange Act”),¹ and Rule 19b-4 thereunder,² notice is hereby given that on January 21, 2015, Chicago Mercantile Exchange Inc. (“CME”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change described in Items I, II and III below, which Items have been prepared primarily by CME. CME filed the proposal pursuant to Section 19(b)(3)(A) of the Act,³ and Rule 19b-4(f)(4)(ii)⁴ thereunder, so that the proposal was effective upon filing with the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

CME is proposing to add a new CDS Guaranty Fund charge to CDS Clearing Members that clear CDS Products that reference themselves or their affiliates and delete the current threshold-based approach. Specifically, CME proposes to add a new risk component to its CDS Stress Test Methodology to capture self-referencing risk arising from contracts that include component transactions for which the reference entity is a clearing member or one of its affiliates.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 15 U.S.C. 78s(b)(3)(A).

⁴ 17 CFR 240.19b-4(f)(4)(ii).

In addition, CME proposes to add a new stress exposure calculation to size the self-referencing risk.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, CME included statements concerning the purpose and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. CME has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

CME is proposing to add a new CDS Guaranty Fund charge to CDS Clearing Members that clear CDS Products that reference themselves or their affiliates and delete the current threshold-based approach. Specifically, CME proposes to add a new risk component to its CDS Stress Test Methodology to capture self-referencing risk arising from contracts that include component transactions for which the reference entity is a Clearing Member or one of its affiliates. In addition, CME proposes to add a new stress exposure calculation to size the anticipated maximum self-referencing risk.

Although CME does not permit a CDS Clearing Member or a customer to enter into or maintain a single-name CDS position referencing the clearing member or an affiliate, a self-referencing CDS position may arise where the CDS Clearing Member or its affiliate is the Reference Entity in respect of a component transaction within the index referenced in a CDS position. For example, such a situation may arise in the context of index CDS contracts which

reference CDS Clearing Members or their affiliates. In such cases, the CDS Clearing Member (a “CDS SR Clearing Member”), either through its own account or that of a customer, has exposure to a CDS Product that references itself or its affiliate (each, an “SR Transaction”). CME proposes to address this potential exposure to self-referencing risk by allocating an additional “jump-to-default” (“JTD”) risk for each CDS SR Clearing Member under its Stress Test Methodology. CME considers a CDS Clearing Member default to be an extreme tail risk event which is subject to the CDS financial safeguards, including mutualization across all other CDS Clearing Members via the CDS Guaranty Fund.

Currently, CDS SR Clearing Members that clear self-referencing indices for themselves or their customers are required to collateralize the self-referencing exposure in an amount specified in the CME Rules. CME is now proposing to adopt a risk-based approach without reference to any preset threshold to capture this self-referencing risk. The additional risk associated with CDS SR Clearing Members will be added to the stress scenarios used to size the CDS Guaranty Fund and CME will require each CDS SR Clearing Member to make an additional CDS Guaranty Fund Deposit to address this risk (such additional deposit, the “CDS SR Deposit”). The aggregate amount of CDS SR Deposits will be sized to cover the net self-referencing exposure of the two CDS SR Clearing Members whose combined default would create the largest possible loss to CME in extreme but plausible market conditions⁵ using the stress testing methodology and will be allocated proportionately to each CDS SR Clearing

⁵ For purposes of determining the largest potential residual losses, the self-referencing exposure of a CDS SR Clearing Member will be aggregated with that of any affiliated CDS SR Clearing Member.

Member. The required CDS SR Deposit will be allocated to each CDS SR Clearing Member in proportion to each such CDS SR Clearing Member's net self-referencing exposure.⁶

A new CME Rule 8H06 (CDS SR Deposit) has been added to reflect accurately these proposed changes to the CDS Guaranty Fund in the CME Rules, and CME Rule 8H802.B (Satisfaction of Clearing House Obligations) has been amended to reflect the introduction of the CDS SR Deposit. In addition, provisions in CME Rule 80104.A (Clearing Through Clearing Member's House (or Proprietary) Account) and CME Rule 80104.B (Clearing Through Clearing Members Customer Account) that relate to the requirement by clearing members that clear self-referencing indices for themselves or their customers to collateralize the self-referencing exposure in an amount specified in the CME Rules have been deleted.

2. Statutory Basis

CME believes the proposed rule change is consistent with the requirements of the Exchange Act, including Section 17A of the Exchange Act⁷ and the applicable regulations thereunder. The proposed rule change is designed to promote the prompt and accurate clearance and settlement of securities transactions and, to the extent applicable, derivatives agreements, contracts, and transactions, to assure the safeguarding of securities and funds which are in the

⁶ CME received a notice of non-objection to the proposed rule change contained herein from the Commodity Futures Trading Commission ("CFTC"). See Letter from Phyllis Dietz, Acting Director, CFTC, to Jason Silverstein, Executive Director and Associate General Counsel, CME (December 22, 2014). The CFTC imposed conditions in the notice of non-objection. In accordance with the CFTC conditions, CME will monitor the self-referencing risk brought by CDS SR Clearing Members on a daily basis. In the event the self-referencing potential residual loss of three or more CDS SR Clearing Members exceeds the equivalent of 50 million Euros each, CME will require additional initial margin from each such CDS SR Clearing Member to cover the incremental portion of the self-referencing risk it brings above 50 million Euros.

⁷ 15 U.S.C. 78q-1.

custody or control of the clearing agency or for which it is responsible, and, in general, to protect investors and the public interest consistent with Section 17A(b)(3)(F) of the Exchange Act.⁸

The proposed rule change accomplishes these objectives because it is intended to capture more accurately the risk associated with CDS Clearing Members that clear CDS Products that reference themselves or their affiliates. A CDS Clearing Member default may result in contagion among financial institutions, widening spreads and exposing portfolios consisting of index CDS that reference financial entities to potential wrong-way risk. For example, the default of a CDS Clearing Member based in the United States, which is not referenced in an index referencing European names, could lead to overall widening of the credit spreads among financial institutions worldwide, leading to widening of spreads in non-US indices. This may lead to variations in correlations between such non-US indices and other North American indices, potentially adversely impacting certain portfolios which are sensitive to such correlations. This increase in potential exposure caused by contagion is addressed in the Proposed CDS Risk Model and Stress Test Methodology via incorporation of stressed correlation scenarios.

CME will also promote the efficient use of margin for the clearinghouse and its Clearing Members and their customers, by enabling CME to provide appropriate portfolio margining treatment between index and single-name CDS positions and as such contribute to the safeguarding of securities and funds in CME's custody or control or for which CME is responsible and the protection of investors.⁹

⁸ 15 U.S.C. 78q-1(b)(3)(F).

⁹ Id.

CME also believes the proposed rule change is consistent with the requirements of Rule 17Ad-22 of the Exchange Act.¹⁰ In particular, in terms of financial resources, CME believes that the proposed rule change will continue to ensure sufficient margin to cover its credit exposure to its clearing members, consistent with the requirements of Rule 17Ad-22(b)(2)¹¹ and Rule 17Ad-22(d)(14),¹² and that the CDS Guaranty Fund contributions and required margin will provide sufficient financial resources to withstand a default by the two participant families to which it has the largest exposures in extreme but plausible market conditions consistent with the requirements of Rule 17Ad-22(b)(3).¹³ CME is adding a CDS Guaranty Fund deposit using this approach to address self-referencing risk, which has historically not been a material risk in relation to the CDS products cleared by CME to date. In anticipation of clearing additional products, CME proposes to replace the existing threshold-based margin requirement with a risk-based additional CDS Guaranty Fund charge. In addition, CME believes that the proposed rule change is consistent with CME's requirement to limit its exposures to potential losses from defaults by its participants under normal market conditions pursuant to 17Ad-22(b)(1).¹⁴ CME also believes that the proposed rule change will continue to allow for it to take timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of clearing member insolvencies or defaults, in accordance with Rule 17Ad-22(d)(11).¹⁵

¹⁰ 17 CFR 240.17Ad-22.

¹¹ 17 CFR 240.17Ad-22(b)(2).

¹² 17 CFR 240.17Ad-22(d)(14).

¹³ 17 CFR 240.17Ad-22(b)(3).

¹⁴ 17 CFR 240.17Ad-22(b)(1).

¹⁵ 17 CFR 240.17Ad-22(d)(11).

B. Self-Regulatory Organization's Statement on Burden on Competition

CME does not believe that the proposed rule change will have any impact, or impose any burden, on competition. The proposed rule change reflects enhancements to CME's CDS Risk Model. Consequently, CME does not believe that the proposed rule change would significantly affect the ability of Clearing Members or other market participants to continue to clear CDS, consistent with the risk management requirements of CME, or otherwise limit market participants' choices for selecting clearing services. For the foregoing reasons, the Proposed CDS Risk Model does not, in CME's view, impose any unnecessary or inappropriate burden on competition.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments relating to the Proposed CDS Risk Model have not been solicited or received. CME will notify the Commission of any written comments received by CME.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The foregoing rule change has become effective upon filing pursuant to Section 19(b)(3)(A)¹⁶ of the Act and Rule 19b-4(f)(4)(ii)¹⁷ thereunder.

CME asserts that this proposal constitutes a change in an existing service of CME that (a) primarily affects the clearing operations of CME with respect to products that are not securities, including futures that are not security futures, and swaps that are not security-based swaps or mixed swaps, and forwards that are not security forwards; and (b) does not significantly affect any securities clearing operations of CME or any rights or obligations of CME with respect to

¹⁶ 15 U.S.C. 78s(b)(3)(A).

¹⁷ 17 CFR 240.19b-4(f)(4)(ii).

securities clearing or persons using such securities-clearing service, which renders the proposed change effective upon filing. CME believes that the proposal does not significantly affect any securities clearing operations of CME because CME recently filed a proposed rule change that clarified that CME has decided not to clear security-based swaps, except in a very limited set of circumstances.¹⁸ The rule filing reflecting CME's decision not to clear security-based swaps removed any ambiguity concerning CME's ability or intent to perform the functions of a clearing agency with respect to security-based swaps. Therefore, this proposal will not have an effect on any securities clearing operations of CME.

At any time within 60 days of the filing of the proposed change, the Commission summarily may temporarily suspend such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>), or

¹⁸ See Securities Exchange Act Release No. 34-73615 (Nov. 17, 2014), 79 FR 69545 (Nov. 21, 2014) (SR-CME-2014-49). The only exception is with regards to Restructuring European Single Name CDS Contracts created following the occurrence of a Restructuring Credit Event in respect of an iTraxx Component Transaction. The clearing of Restructuring European Single Name CDS Contracts will be a necessary byproduct after such time that CME begins clearing iTraxx Europe index CDS.

- Send an e-mail to rule-comments@sec.gov. Please include File No. SR-CME-2015-002 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC, 20549-1090.

All submissions should refer to File Number SR-CME-2015-002. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of CME and on CME's website at <http://www.cmegroup.com/market-regulation/rule-filings.html>.

All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

All submissions should refer to File Number SR-CME-2015-002 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁹

Jill M. Peterson
Assistant Secretary

¹⁹ 17 CFR 200.30-3(a)(12).