

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-72959; File No. SR-CME-2014-28)

September 2, 2014

Self-Regulatory Organizations; Chicago Mercantile Exchange Inc.; Notice of Filing of Proposed Rule Change, as Modified by Amendment No. 2 Thereto, Related to Enhancements to its Risk Model for Credit Default Swaps

Pursuant to the Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act” or “Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on September 2, 2014, Chicago Mercantile Exchange Inc. (“CME”) filed with the Securities and Exchange Commission (“Commission”) Amendment No. 2 to its previously submitted proposed rule change related to proposed enhancements to its risk model for broad-based index credit default swap (“CDS”) products.³ Amendment No. 2 is intended to describe CME’s proposed CDS specific risk model framework applicable only to broad-based index CDS and also provide further description and detail of certain aspects of the proposed rule change as described in Items I, II and III below, which Items have been prepared primarily by CME (the “CDS Risk Model Filing Amendment”).⁴ The Commission is publishing this notice to solicit comments on the CDS Risk Model Filing Amendment from interested persons.

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

On August 8, 2014, CME submitted to the Commission the CDS Risk Model Filing pursuant to which CME proposes to enhance its risk model for CDS (the “CDS Risk Model” and

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 34-72834 (Aug. 13, 2014), 79 FR 48805 (Aug. 18, 2014) (SR-CME-2014-28) (hereinafter referred to as the “CDS Risk Model Filing”).

⁴ On August 18, 2014, CME filed Amendment No. 1 to the proposed rule change. CME withdrew Amendment No. 1 on August 29, 2014.

such enhanced model, the “Proposed CDS Risk Model”) to enable CME to offer clearing of additional CDS instruments.⁵ The CDS Risk Model Filing is currently pending regulatory approval by the Commission. The purpose of the CDS Risk Model Filing Amendment is to propose the adoption of a CDS specific risk model framework applicable only to broad-based index CDS (the “CME CDS Risk Model Framework”) and also provide further description and detail of certain aspects of the Proposed CDS Risk Model contained within the CDS Risk Model Filing. The CDS Risk Model Filing Amendment should be read in conjunction with the CDS Risk Model Filing. All capitalized terms not defined herein shall have the meaning given to them in the CDS Risk Model Filing.

The text of the proposed amendment is also available at the CME’s website at <http://www.cmegroup.com>, at the principal office of CME, and at the Commission’s Public Reference Room.

II. Self-Regulatory Organizations 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 amendment and discussed any comments it received on the proposed amendment. 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.

⁵ See supra note 3.

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

(1) Purpose

Pursuant to this CDS Risk Model Filing Amendment, CME proposes to adopt a CME CDS Risk Model Framework for broad-based index CDS and also intends to provide further description and detail of certain aspects of the Proposed CDS Risk Model described in the CDS Risk Model Filing as further discussed below. CME also proposes to make changes to the Manual of Operations for CME Cleared Credit Default Swaps (the "CDS Manual") in connection with the proposed CME CDS Risk Model Framework.

1. CME CDS Risk Model Framework

In connection with the adoption of the Proposed CDS Risk Model, CME also proposes to adopt the CME CDS Risk Model Framework. The proposed CME CDS Risk Model Framework would apply only to broad-based index CDS products cleared by CME and would not apply to security-based swaps. CME will file a proposed rule change with the SEC in the future to implement any proposed CDS risk model applicable to the clearing of security-based swaps. The proposed CME CDS Risk Model Framework contains the details of the Proposed CDS Risk Model and existing policies relating to governance, back testing and stress testing for CDS products.

1.1 Governance

The proposed CME CDS Risk Model Framework would be governed by the CDS Risk Committee, the Stress Testing Committee and senior risk management of CME. CDS Risk Committee approval is required for all material changes to the CDS Risk Model Framework, CDS stress testing framework, and CDS back-testing framework. Any changes to the parameters

of the CDS Margin Model or CDS stress tests are approved by the Stress Testing Committee or a senior member of the Stress Testing Committee.

1.2 CDS Risk Model Framework for Cleared CDS

The proposed CME CDS Risk Model Framework includes CME's proposed enhancements to the CDS Risk Model for CDS as set forth in the CDS Risk Model Filing. In addition, CME notes that the Post Credit Risk Requirement within the Proposed CDS Risk Model is the same as the post-default charge in the current CDS Risk Model, but also applies to additional credit events such as restructuring and governmental intervention. CME addresses the risk of any CDS position referencing an entity, which has experienced a credit event as determined by the CDS contract definitions, through the post credit event risk requirement.

1.3 CDS Back-Testing

The proposed CME CDS Risk Model Framework details CME's existing back testing practices for the CDS contracts it clears. CME maintains a back-testing methodology for monitoring and testing the adequacy of its margin and/or stress requirements for CDS portfolios. CME performs back-testing on actual and hypothetical portfolios. CME performs daily performance bond coverage back-testing and any breaches are escalated to senior risk management. CME also conducts ad-hoc and event driven back-testing on an as needed basis. Back-testing results are reviewed by the Stress Testing Committee and can result in changes to model parameters or data calibration.

1.4 CDS Stress Testing

The proposed CME CDS Risk Model Framework details CME's existing stress testing practices for cleared CDS. CME performs stress testing at least daily and on an ad-hoc basis as appropriate. A stressed extension of the margin model is used to size the CDS Guaranty Fund

and CDS Assessments to reflect the necessary financial safeguards under extreme but plausible market conditions. As discussed in the CDS Risk Model Filing, the stress model addresses self-referencing risk arising from contracts that include component transactions for which the reference entity is a clearing member or one of its affiliates. CME also performs reverse stress testing to identify hypothetical market conditions and stress events which might result in depletion of CME's funded and/or unfunded financial resources for CDS Clearing. CME performs sensitivity analysis on exposures of clearing member portfolios to changes in a representative set of material risk model parameters. Stress testing results are reviewed by the stress testing committee.

Post implementation of the Proposed CDS Risk Model, CME's financial resources for CDS (inclusive of performance bond, CME's corporate contribution for CDS, CDS Guaranty Fund and CDS SR Deposits) would continue to enable CME to maintain sufficient financial resources to withstand a default by the two CDS Clearing Member families to which it has the largest exposures in extreme but plausible market conditions as required by Rule 17Ad-22(b)(3).⁶

2. CDS Manual of Operations

In connection with the implementation of the proposed CME CDS Risk Model Framework, CME is deleting Chapters 7 (CDS Margining) and 10 (CDS Guaranty Fund Calculation) in the CDS Manual which relate to outdated aspects of the CDS Risk Model.

⁶ 17 CFR 240.17Ad-22(b)(3).

(2) Statutory Basis

CME believes the Proposed CDS Risk Model, proposed CME CDS Risk Model Framework and the proposed changes to the CDS Manual are consistent with the requirements of the Exchange Act, including Section 17A of the Exchange Act⁷ and the applicable regulations thereunder. The Proposed CDS Risk Model, proposed CME CDS Risk Model Framework and the proposed changes to the CDS Manual are 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 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 CDS Risk Model, proposed CME CDS Risk Model Framework and the proposed changes to the CDS Manual accomplish these objectives because they are intended to more accurately capture different sources of risk through a holistic and theoretically coherent scenario-based approach that is driven by conservative statistical assumptions, which in turn allows CME to appropriately cover the risk of a wide range of theoretical and production portfolios under extreme but plausible market conditions and in historical back testing, going back to 2008. In particular, the Proposed CDS Risk Model, proposed CME CDS Risk Model Framework and the proposed changes to the CDS Manual will enhance CME's margin

⁷ 15 U.S.C. 78q-1.

⁸ 15 U.S.C. 78q-1(b)(3)(F).

methodology by more accurately addressing F/X risk and self-referencing risk presented by clearing index CDS contracts.

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

CME also believes the Proposed CDS Risk Model, proposed CME CDS Risk Model Framework and the proposed changes to the CDS Manual are consistent with the requirements of 17Ad-22 of the Exchange Act.¹⁰ In particular, in terms of financial resources, CME believes that the Proposed CDS Risk Model, proposed CME CDS Risk Model Framework and the proposed changes to the CDS Manual 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, both as modified by the proposed rule change, 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 In addition, CME believes that the Proposed CDS Risk Model, proposed CME CDS Risk Model

⁹ Id.

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).

Framework and the proposed changes to the CDS Manual are 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 CDS Risk Model, proposed CME CDS Risk Model Framework and the proposed changes to the CDS Manual 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

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

CME does not believe that the Proposed CDS Risk Model, proposed CME CDS Risk Model Framework and the proposed changes to the CDS Manual will have any impact, or impose any burden, on competition. The Proposed CDS Risk Model and proposed CME CDS Risk Model Framework reflect enhancements to CME's CDS Risk Model. CME does not believe that any increase in margin or CDS Guaranty Fund contributions, 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, proposed CME CDS Risk Model Framework and the proposed changes to the CDS Manual do not, in CME's view, impose any unnecessary or inappropriate burden on competition.

¹⁴ 17 CFR 240.17Ad-22(b)(1).

¹⁵ 17 CFR 240.17Ad-22(d)(11).

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

Written comments relating to the CDS Risk Model Filing Amendment 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

Within 45 days of the date of publication of notice of the CDS Risk Model Filing¹⁶ in the Federal Register or within such longer period up to 90 days (i) as the Commission may designate if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

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
- Send an e-mail to rule-comments@sec.gov. Please include File No. SR-CME-2014-28 on the subject line.

¹⁶ See supra note 3.

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-2014-28. 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-2014-28 and should be submitted on or before [insert date 10 days from publication in the Federal Register].¹⁷

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁸

Kevin M. O'Neill
Deputy Secretary

¹⁷ The Commission believes that a 10-day comment period is reasonable, given the nature and content of the amendment. It will provide adequate time for comment.

¹⁸ 17 CFR 200.30-3(a)(12).