WRITTEN TESTIMONY
OF
TERRENCE A. DUFFY
EXECUTIVE CHAIRMAN and PRESIDENT
CME GROUP INC.
BEFORE THE
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT SUB-COMMITTEE AND THE INSURANCE, HOUSING AND COMMUNITY OPPORTUNITY SUB-COMMITTEE
November 29, 2012

Chairwoman Capito, Ranking Member Maloney, Chairwoman Biggert and Ranking Member Gutierrez thank you for the opportunity to testify on the Federal Reserve Board, FDIC and OCC regulatory capital rules implementing the Basel III Interim Capital Framework. I am Terry Duffy, Executive Chairman and President of CME Group, whose clearing house division of the Chicago Mercantile Exchange Inc. ("CME or CME clearing") is among the largest central counterparty ("CCP" or "clearing house") clearing services in the world.[1] CME provides clearing and settlement services for exchange-traded contracts as well as for over-the-counter ("OTC") derivatives. In 2011, CME processed and cleared approximately 3.4 billion contracts. In its capacity as a clearing house, CME is

[1] CME Group Inc. is the holding company for four exchanges, CME, the Board of Trade of the City of Chicago Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX"), and the Commodity Exchange, Inc. ("COMEX") (collectively, the "CME Group Exchanges"). The CME Group Exchanges offer a wide range of benchmark products across all major asset classes, including derivatives based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products. The CME Group Exchanges serve the hedging, risk management, and trading needs of our global customer base by facilitating transactions through the CME Group Globex electronic trading platform, our open outcry trading facilities in New York and Chicago, and through privately negotiated transactions subject to exchange rules.

registered with the Commodity Futures Trading Commission as a derivatives clearing organization ("DCO") and also has status as a Financial Services Authority Recognized Overseas Clearing House. In July 2012, CME was designated as a systemically important Financial Market Utility under Title VIII of Dodd-Frank.

CME Group applauds the Federal Reserve Board, FDIC and OCC for deferring the final capital rules implementing the Basel III (BSCS 227) Interim Capital Framework. Both Dodd-Frank and the G-20 mandates aim to reduce systemic risk and increase transparency. Our concern is that Basel III's "one size fits all" rules for capital charges based on the risk of cleared derivatives is at odds with these objectives.

The Basel interim framework treats all cleared derivatives as if they require margin to cover a five day period of risk. This means that highly liquid derivatives contracts that trade by means of a central limit order book and that may be quickly and efficiently liquidated without substantial risk are put into the same category as OTC contracts that are not liquid or transparently traded. This blanket categorization is unrealistic and market distorting. Derivatives clearing houses recognize this distinction and require margin levels based on periods of risk that are justified by the actual risks inherent in liquidating the positions. In the U.S.

this means one or two day periods of risk for futures and five day period of risk for less liquid swaps. The failure to base capital charges on properly measured risk may have the unintended consequence of encouraging the use of higher risk instruments. This is inconsistent with both Dodd-Frank and the G-20 policy goal to reduce risks in derivatives trading by moving from opaque to transparent markets.

If the capital rules for bank holding companies diverge from the prudential rules at the clearing level for Broker-Dealer/FCM subsidiaries, consequential market distortions will follow. If clearing houses properly set margins for liquid derivatives to cover a one day risk period while banking regulators impose a capital charge based on five days, banks and their affiliated brokers, will be required to take a capital charge measured by the difference between the prudential clearing level margin for futures and the presumptive Basel III five day period of risk margin. The cost of the capital will be passed on to customers trading liquid products in the form of a demand for higher collateral or higher fees. Once again, contrary to Dodd-Frank. This may distort customers' product choices. Customers may move away from trading liquid exchange traded derivatives. There is a potential that central limit order book exchange-traded products could be more

expensive. The last thing we want to do is drive customers back into an opaque OTC market because of a "one size fits all" margin period.

Basel III's "one size fits all" margin period of risk is also inconsistent with international standards, e.g., CPSS-IOSCO Principles for Financial Market Infrastructures followed by the CME and other qualified CCPs. Those standards recognize that margin levels should correspond to risk and liquidity profiles, and unique attributes of each product and market, and that margin periods of risk will vary among products based on these differing characteristics.

Liquid central limit order book-traded and cleared derivatives, unlike OTC swaps, are standardized, have transparent pricing, and trade in deep liquid markets. They turn over almost 10 times more frequently than OTC swaps. Those characteristics permit rapid offset, liquidation or hedging in the event of an emergency. Broad participation within the exchange-traded derivatives market further demonstrates efficient position and risk management in these events. For example, following the bankruptcy of Lehman Brothers Inc. in 2008, CME took control of Lehman's proprietary positions and liquidated the portfolio the same day, with a liquidation value well within the portfolio's $2.3 billion margin requirement.

CME also maintains extensive historical price data that further demonstrates the adequacy of data used in establishing margin levels and the appropriate exposure period to capture. For instance, we maintain price data for some of the most liquid exchange traded products dating back to 1982 for the first S&P 500 index contract, 1981 for Eurodollar futures, and 1977 for the first Treasury bond futures contract.

There is no risk management benefit to banks, their affiliated brokers, or the financial system by imposing capital charges on them beyond the clearing level margin period of risk established for these liquid contracts.

CME Group has expressed these concerns in the comments filed during the Agencies rule-making[2], in discussions with Federal Reserve Board staff, and in a joint letter to the Financial Stability Board, the Basel Committee on Banking Supervision and other standard setters from CME and 11 other exchanges located

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[2] See attached letter to OCC, FED and FDIC dated October 22, 2012

Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements (OCC Docket ID OCC-2012-0009;FRB Docket No. R-1442; FDIC RIN 3064-AD96)

Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rule; Market Risk Capital Rule (OCC Docket ID OCC-2012-0010;FRB Docket No. R-1442;FDIC RIN 3064-AD97)

in each of the Americas, EMEA and APAC.[3] The World Federation of Exchanges has also raised concerns in a separate letter to them.[4]

The Agencies capital rules should be amended to eliminate the addition of four days of capital on top of one day margin for exchange traded derivatives. It should be replaced with an approach consistent with the CPSS-IOSCO Principles recognizing that adequate margin periods vary and will be set based on the liquidity, transparency and other risk-reducing characteristics of each product and market.

Thank you for the opportunity to appear before you today.

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[3] See attached Joint Letter to FSB, BCBS, CGFS and CPSS dated November 27, 2012

[4] See attached WFE letter dated November 27, 2012.

VIA E-MAIL

October 22, 2012

Office of the Comptroller of the Currency
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Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
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Washington, DC 20551
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Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
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Re: Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements (OCC Docket ID OCC-2012-0009; FRB Docket No. R–1442; FDIC RIN 3064–AD96)
Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rule; Market Risk Capital Rule (OCC Docket ID OCC-2012-0010; FRB Docket No. R–1442; FDIC RIN 3064–AD97)

Ladies and Gentlemen:

CME Group Inc. ("CME Group"), on behalf of the Chicago Mercantile Exchange Inc. ("CME Inc.") clearing house division ("CME Clearing" or "CME") appreciates the opportunity to comment on the proposed regulatory capital rules that the Office of the Comptroller of the Currency ("OCC"), Board of Governors of the Federal Reserve System ("Board"), and Federal Deposit Insurance Corporation ("FDIC") (collectively, the "Agencies") published in several notices of proposed rulemakings ("NPRs") in the Federal Register on August 30, 2012. CME is among the largest central counterparty ("CCP") clearing services in the world. CME provides clearing and settlement services for exchange-traded contracts as well as for over-the-counter ("OTC") derivatives.[1] In 2011, CME processed and cleared approximately 3.4

[1] CME's parent company (CME Group Inc.) operates four separate exchanges, including CME, the Board of Trade of the City of Chicago, Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX"), and the Commodity Exchange, Inc. ("COMEX") (collectively, the "CME Group Exchanges"). The CME Group Exchanges offer a wide range of benchmark products across all

billion contracts, averaging 13.4 million contracts per day. In its capacity as a CCP, CME is registered with the Commodity Futures Trading Commission ("CFTC") as a derivatives clearing organization ("DCO") and also has status as a Financial Services Authority Recognized Overseas Clearing House.

On July 18, 2012, the Financial Stability Oversight Council designated CME Inc. as a systemically important financial market utility ("designated FMU") under Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). Provisions within section 805 of the Dodd-Frank Act, enacted by the Board through Regulation HH Designated Financial Market Utilities ("Regulation HH"), require the Board to promulgate risk management standards for designated FMUs. Regulation HH grants authority to the CFTC to act as CME's designated Supervisory Agency and prescribe regulations that integrate the CPSS-IOSCO Principles for Financial Market Infrastructures ("PFMIs") and existing prudential requirements when designing risk management standards. To recognize the systemic protections and robustness of designated FMUs who adhere to the PFMIs ("Qualified CCP" or "QCCP"), the NPRs invite capital incentives for exposures to a Qualified CCP relative to a non-Qualified CCP.

This response focuses on certain elements of the proposed capital framework that stand to motivate and influence the expansion of central counterparty clearing for derivatives. Bank capitalization requirements are a critical and fundamental element of the overall financial regulatory system. Consequently, the decisions of the Agencies concerning the capitalization framework will have a material impact on the evolution of central clearing. We believe it is particularly important that CME and other CCPs provide meaningful feedback to the Agencies at a time when crucial decisions over the future of financial regulation are being formulated.

CME recognizes the Agencies have largely adopted international capital standards proposed by Basel Committee on Banking Supervision ("BCBS"). CME actively participated in each consultative process administered by the BCBS related to *Capital requirements for bank exposures to central counterparties*. Within our responses[2] we advocated for a framework that assures greater transparency, safety and efficiency in the global financial markets and encourages greater utilization of CCPs by market participants. However, we also raised several fundamental concerns related to the capitalization of exposures to CCPs that we believe will critically influence the migration towards central clearing.

To efficiently implement the objectives stated by the G20 and installment provisions of the Dodd-Frank Act and the European Market Infrastructure Regulation ("EMIR"), CME and important market participants across key jurisdictions agree that certain aspects of the proposed capital framework may require further refinement to properly reflect the risk management benefits of CCP clearing.

Provided below are targeted responses to certain inquiries and recommendations of the NPRs. With acknowledgement to footnote 42 of the Standardized Approach NPR, our comments reflect the expected inclusion of provisions stated in BCBS227 ("BCBS interim framework").

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

[2] CME Group response to BCBS206 (http://www.bis.org/publ/bcbs206/cme.pdf), BCBS190 (http://www.bis.org/publ/bcbs190/cmegroup.pdf) and BCBS164 (http://www.bis.org/publ/bcbs165/cmegroup.pdf)

I. Capitalization of Bank Exposures to Central Counterparties

Question 12 of the Standardized Approach NPR and Question 5 of Advanced Approaches and Market Risk NPR request comment on whether the proposal provides an appropriately risk sensitive treatment of (1) a transaction between a banking organization that is a clearing member and its client and (2) a clearing member's guarantee of its client's transaction with a CCP treating these exposures as OTC derivative contracts.

The Agencies also request comment on whether the adjustment of exposure amount would address possible disincentives for banking organizations that are clearing members[3] to facilitate the clearing of their clients' transactions. What other approaches should the Agencies consider?

Recommendation #1: To acknowledge certain practices and efficiencies afforded by central clearing, we support the recognition of shorter close-out periods for cleared transactions. We further encourage the Agencies to recognize varying close-out period conventions for specific cleared products that are commensurate with the risks, liquidity profiles, applicable close-out periods and further characteristics of these products as accredited within the CPSS-IOSCO Principles for Financial Market Infrastructures.

CME agrees that the final rules should incorporate shorter close-out periods for certain cleared and cleared-only derivative transactions relative to un-cleared bilateral transactions. To provide greater harmonization among various regulatory standards applicable to CCP clearing, we further recommend the Agencies utilize close-out period assumptions commensurate with the risks, liquidity and transparency, market composition and concentration characteristics of products that already exist in a cleared environment, relative to products recently introduced to centralized clearing. CME believes the BCBS interim framework's blanket assignment of a 5-day margin period of risk ("MPOR") for all cleared transactions lacks appropriate consideration for exchange traded derivatives and certain products that exemplify analogous features ("ETDs"), for instance, that exist in a central limit order book environment with substantial transaction volumes, with

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[3] The NPRs make multiple references to banking organizations as clearing members. To date, CME has not accepted U.S. insured depository institutions as clearing members due to certain issues arising from the Federal Deposit Insurance Corporation's receivership and conservatorship procedures. Specifically, we understand that all counterparties of a bank – including any CCP that has accepted the bank as a clearing member – are subject to a one-business day stay in insolvency. We recommend an exception to this stay for CCPs. This would be consistent with the exception for clearing organizations in the Orderly Liquidation Authority provisions of Dodd-Frank Act, which states:

> . . . *if the receiver fails to satisfy any such margin, collateral, or settlement obligations under the rules of the clearing organization, the clearing organization shall have the immediate right to exercise, and shall not be stayed from exercising, all of its rights and remedies under its rules and applicable law with respect to any qualified financial contract of the covered financial company, including, without limitation, the right to liquidate all positions and collateral of such covered financial company under the company's qualified financial contracts, and suspend or cease to act for such covered financial company, all in accordance with the rules of the clearing organization.*

§ 210(c)(8)(G). We also note that the Committee on Payment and Settlement Systems' ("CPSS") and Technical Committee of the International Organization of Securities Commissions' ("IOSCO") April 2012 *Principles for Financial Market Infrastructures* ("PFMIs") provide that a Financial Market Infrastructure ("FMI") (a term that includes CCPs) "should have a high degree of certainty that [actions taken under its default rules] will not be voided, reversed, *or subject to stays, including with respect to resolution regimes applicable to its participants.* Ambiguity about the enforceability of procedures could delay and possibly prevent an FMI from taking actions to fulfill its obligations to non-defaulting participants or to minimize its potential losses." See paragraph 3.1.9 (emphasis added).

I. Capitalization of Bank Exposures to Central Counterparties, cont.

commensurate historical price and liquidity characteristics that demonstrate a shorter close-out period is appropriate.

For instance, the evaluation of the market depth and product turnover draws further distinction between ETDs and over-the-counter ("OTC") derivatives. A TABB Group study[4] performed in 2010 indicated that ETDs turned over almost 10 times more frequently than OTC derivatives over the course of a year, with OTC derivative notional values turning over 2.7 times per year whereas ETDs notional values turned over 25 times per year. In addition to the higher notional turnover demonstrated by the ETD market, the study further notes transaction volumes of 3 billion in the ETD market versus 16 million in the OTC market.

Moreover, the clearing for ETDs is characterized as "positional" in nature as compared to the "transactional" nature of clearing for OTC derivatives. Positional-based clearing provides natural and automatic compression for long and short positions of the same contract that are novated into a single open position whereas transactional-based clearing maintains each open trade as an individual gross position. Although compression is available for some market participants in the OTC cleared environment, it remains a highly specialized and at times manual process that may challenge the efficiency for porting and liquidation. Therefore, the more compressed nature of ETDs provides greater efficiency, transparency and access to price and volume information in liquidation scenarios due to the breadth of the central limit order book. This further motivates and allows access to a broader group of market participants to partake in auctions whereby they can efficiently manage or liquidate the resulting exposure. As of 2010 the Tabb Group study estimates the number of market participants in the ETD market to be 5 million as compared to 30,000 in the OTC market.

Further, broad market participation within the ETD market further demonstrates efficient management of positions in both stressed and default scenarios. CME has encountered several scenarios in which large central limit order book product portfolios were liquidated in less than one day at a cost within margin requirement. For example, following the bankruptcy of Lehman Brothers Inc. in 2008, CME took control of Lehman's positions and conducted an auction that was completed the same day with a liquidation value well within the portfolios' $2.3 billion USD margin requirement.

CME maintains extensive historical price data that further demonstrates the adequacy of data in establishing margin levels and the appropriate exposure period to capture. For instance, we maintain price data for some of the most liquid exchange traded products dating back to 1982 for the first S&P 500 index contract, 1981 for Eurodollar futures, and 1977 for the first Treasury bond futures contract. With regard to daily volume, CME's Eurodollar, S&P and Treasury contracts combine for an average daily volume of approximately 7 million contracts in 2012, accounting for approximately 60% of CME's total average daily volume.[5]

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[4] A TABB Group Study: *The Global Risk Transfer Marker: Developments in OTC and Exchange-Traded Derivatives*, November 2010

[5] CME Group data October 19, 2012 YTD

I. Capitalization of Bank Exposures to Central Counterparties, cont.

With consideration to the above arguments, we recommend the Agencies provide greater consideration to the distinct characteristics of ETDs in establishing the appropriate MPOR and agree that for cleared swaps that aforementioned certain liquidity characteristics of ETDs a 5-day MPOR is appropriate.

In addition to demonstrable characteristics evidencing shorter close-out periods for ETDs, we call further attention to international guidance issued by CPSS-IOSCO and adopted by the Fed through Regulation HH with regard to designated FMU's adherence to the PFMIs. Consistent with key considerations detailed in Principle 6: Margin of the PFMIs, CME prescribes initial margin requirements that are, along with additional risk-based considerations, commensurate with the risk, liquidity, and close-out periods applicable to the variety of products and asset classes transacted on our exchanges. As described in Principle 6: Margin Requirements 3.6.3 "... OTC derivatives require more-conservative margin models because of their complexity and the greater uncertainty of the reliability of price quotes. Furthermore, the appropriate close-out period may vary among products and markets depending upon the product's liquidity, price and other characteristics."

Further consistent with Principle 6: Margin Close-out period 3.6.7,[7] in establishing initial margin requirements, CME provides extensive consideration to historical price and liquidity data that are further stressed and meticulously back-tested to ensure the appropriate exposure period is adopted. Proper appreciation for certain products that demonstrably adhere to the PFMIs and demonstrate a risk profile that does not require a 5-day MPOR would ensure that capital disincentives aren't introduced that undermine the efforts and sensible conclusions of other broad-based regulatory efforts (not least the Dodd-Frank Act and EMIR). As currently proposed, the capital framework appears inconsistent with various frameworks governing margin requirements for cleared exchanged-traded derivatives and therefore invites disproportionate capital requirements that are in conflict with clearing incentives.

The Agencies may attach confidence in the applied methodologies through a CCP's adherence to the PFMIs that, among other considerations, prescribe stringent confidence intervals, exposure coverage, back-testing analysis and independent model validations for margin models. CME notes that adherence to such principles, in addition to other PFMIs, is necessary to be considered a Qualified CCP, a designation we aspire to achieve.

[7] PFMI Principle 6: 3.6.7. Close-out period. A CCP should select an appropriate close-out period for each product that it clears and document the close-out periods and related analysis for each product type. A CCP should base its determination of the close-out periods for its initial margin model upon historical price and liquidity data, as well as reasonably foreseeable events in a default scenario. The close-out period should account for the impact of a participant's default on prevailing market conditions. Inferences about the potential impact of a default on the close-out period should be based on historical adverse events in the product cleared, such as significant reductions in trading or other market dislocations. The close-out period should be based on anticipated close-out times in stressed market conditions but may also take into account a CCP's ability to hedge effectively the defaulter's portfolio. Further, close-out periods should be set on a product-specific basis because less-liquid products might require significantly longer close-out periods. A CCP should also consider and address position concentrations, which can lengthen close-out timeframes and add to price volatility during close outs.

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I. Capitalization of Bank Exposures to Central Counterparties, cont.

Question 13 of the Standardized Approach NPR and Question 6 of the Advanced Approaches and Market Risk NPR request comment on the proposed calculation of risk-based capital requirements for exposures to a QCCP. The Agencies question if there are specific types of exposures to certain QCCPs that would warrant an alternative risk-based capital approach.

Recommendation #2: To acknowledge the protections afforded to client accounts under regulations of the SEC and CFTC and to further distinguish additional client protections asserted by certain account structures, we request the Agencies confirm, through adoption, the stated eligibility criteria as provided for on page 52906 and 52988 of the Standardized Approach NPR and Advanced Approaches and Market Risk NPR, respectively.

Throughout the NPRs the Agencies draw distinction between typical CCP account structures where the clearing member acts as a financial intermediary ("principle model") and where the clearing member guarantees the performance of the client ("agency model"). As referenced in prior comment letters, greater credence should be afforded to QCCPs that employ an agency model whereby the clients' trades are effectively a trade between the client and the CCP, not least to appreciate the client protection scheme promulgated by the SEC and CFTC. In the event of a clearing member default, the structure of an agency relationship between the clearing member and its clients would facilitate various operational efficiencies including, but not limited to, the protection and portability of client positions and collateral. This agency relationship is fundamental to the operation of CME and is imbued throughout the rules of CME Group and the Commodity Exchange Act as well as the regulations of the CFTC.

CME supports the Agencies' statement within the preamble that the omnibus account structure in the United States would satisfy this requirement due to customer protections afforded under existing Securities and Exchange Commission ("SEC") and CFTC regulations including the CFTC's Part 190 Bankruptcy Rules (17 C.F.R. Part 190). To provide further clarity and provide assurance, we request the Agencies explicitly adopt the preamble's position in the final standards.

Recommendation #3: To recognize the distinction among the various components of trade exposure, we recommend the Agencies decouple the link between risk weights assigned to collateral trade exposure and those assigned to other components of trade exposure.

Under proposed sections _35(b)(3)(i) and _133(b)(3)(i), if collateral posted to a QCCP by a client is not protected from losses in a joint default scenario, the client's entire trade exposure—including collateral, current exposure, and potential future exposure—is ineligible for the 2 percent risk weight. CME believes that this result improperly conflates collateral-related exposure with other components of trade exposure. While protections against joint default may affect the safety of client collateral, such protections are demonstrably disconnected from the risk associated with current credit exposure and potential future exposures. Accordingly, CME recommends that the Agencies decouple the risk weight for client collateral from the risk weight for other components of a client's trade exposure.

II. Capitalization of Default Fund Contributions to Central Counterparties

Question 13 of the Standardized Approach NPR and Question 6 of the Advanced Approaches and Market Risk NPR request comment on the proposed calculation of risk-based capital requirements for exposures to a QCCP. The Agencies question if there are specific types of exposures to certain QCCPs that would warrant an alternative risk-based capital approach.

Recommendation #4: To recognize the robust and proven risk management models employed by Qualified CCPs, compliant with CPSS-IOSCO Principles for Financial Market Infrastructures and onward by prudential regulators, the Agencies should permit Qualified CCPs to apply approved Internal Models to quantify exposures related to CCP default fund contributions.

CME continues to champion the installation of a risk sensible approach to quantify capital requirements arising from clearing member default fund contributions. This position is supported by overwhelming industry feedback and by initial results of Quantitative Impact Studies administered by the BCBS. The current framework should be recalibrated to best appreciate the varying structures, practices, credit quality and financial resources afforded by a Qualified CCP. The primary components employed by CCPs to mitigate counterparty credit exposures, in addition to enterprise risk management practices, are funded initial margin, variation margin and clearing member default fund contributions; additionally, some CCPs contribute their own resources to the default waterfall, which should be taken into consideration as well (collectively, "aggregate CCP resources").

We were encouraged to hear the BCBS interim framework contemplated an alternative methodology; however we remain apprehensive that this method, method two, prudently considers aggregate CCP resources, a similar shortfall observed in superseded versions of method one, and might introduce incentives that are adverse to the intention of the capital standards. Similarly, we maintain that method one is risk insensitive and stands to create a variety of perverse incentives for clearing members to reduce both default fund contributions and margins or increase margins at the expense of reduced default fund contributions.

We further understand that the BCBS and CPSS-IOSCO have formed a working group to reconsider the interim methodologies and other certain aspects of the BCBS interim framework. CME supports exploring alternative solutions and would encourage the opportunity to discuss and jointly assess how each alternative translates into regulatory capital requirements to ensure a sensible and risk prudent measure is ultimately adopted. We encourage the Agencies to adopt a method that holistically considers the aggregate CCP resources (and corresponding conformance to the PFMIs) to ensure fair consideration is accorded to CCPs that employ varying methodologies when sizing margin and default fund requirements.

Consistent with the practices of the current bank capital framework, the Agencies should permit Qualified CCPs to utilize approved internal models. Further to QCCP adherence to the PFMIs, the use of internal models could be conditioned on observance to applicable CFTC and SEC (or other applicable) regulations and supervisory requirements governing risk modeling. To the extent the Agencies require review of any QCCP internal models, the Agencies could arrange an examination in coordination with Title VIII designated FMU review procedures. Acknowledging certain QCCPs may not maintain a level of expertise to qualify for internal models, the Agencies could prescribe a fallback to the prevailing interim methodologies.

III. Additional Recommendation

Recommendation #5: To better recognize acceptable collateral standards employed by certain Qualified CCPs, the Agencies should consider adjusting holding period assumptions under certain models to better align with the liquidity characteristics of such collateral.

The standard supervisory market price volatility haircuts described in the Standardized Approach NPR, as originally designed for the bilateral market, however, applicable to certain cleared transactions, prescribes a 10-day holding period assumption in computing the applicable haircut. We are concerned that these haircuts lack consideration to the profile and characteristics of collateral policies adopted by CCPs and that are further governed by prudential regulation. For example, the overwhelming majority of collateral on deposit at CME can be liquidated to cash on a same day basis under stressed market scenarios. CME routinely conducts liquidation drills with qualified, independent third parties to assess the liquidity profile of its collateral holdings. To complement our liquidity resources, CME maintains a committed, secured credit facility sized with consideration to assets that could challenge same day liquidation in a stressed market environment. The facility gives CME access to proceeds of a draw within 60 minutes of borrowing. Additionally, CME contracts with liquidation agents to facilitate prompt liquidation of collateral in a clearing member default. We therefore request the Agencies consider adjusting the holding period assumptions or allow CCPs to utilize alternative methods to compute appropriate haircuts for cleared transactions.

CME recognizes that the standard haircut schedule was designed to achieve a balance between simplicity and risk-sensitivity. However, for instance, the standard supervisory haircut table assigns mutual funds the most punitive haircut applicable to any security in which the funds invest. For money market funds ("MMFs"), that generally invest in short-term government securities, certificates of deposit, commercial paper, and other low-risk securities, the haircut table could assign a 25 percent haircut that appears to discount the enhanced standards and criteria relative to other mutual funds. In the U.S., it is accepted market practice to utilize MMFs to meet margin requirements; however, punitive haircut treatment could invite collateral inefficiencies to clearing. The distinctive features of MMFs, as governed and further enhanced in response to the 2008 credit crisis by SEC rule 2a-7,[8] provide a principled basis to distinguish MMFs from all other mutual funds.

We believe, the Agencies can effectuate this distinction without fundamentally altering the table. CME recommends that the Agencies bifurcate the "mutual funds" row of the standard supervisory haircut table into two rows, one labeled "money market funds" governed by SEC rule 2a-7 and the other labeled "other mutual funds." This treatment would parallel the current separation of equities into "main index equities" and "other publicly-traded equities." For MMFs, CME suggests a risk weight that reflects the cash-like characteristics of these instruments. As a starting point, the Agencies might consider the haircut assigned by the Federal Reserve Discount Window to the instruments that money market funds

[8] SEC Rule 2a-7 provides that MMFs may invest only in securities rated in one of the two highest short-term rating categories or, if unrated, of comparable quality to such securities; must invest at least 97 percent of their assets in securities rated in the highest short-term rating category or, if unrated, of comparable quality to such securities; must maintain a maximum weighted average maturity of 60 days and a maximum weighted average life of 120 days; and cannot invest more than 0.5 percent of their total assets in securities of a single issuer that is rated in the second-highest short-term rating category or, if unrated, of comparable quality to such securities.

invest in, namely Certificates of Deposit, Bankers' Acceptances, Commercial Paper, and Asset Backed Commercial Paper (currently 3 percent).[10]

IV. Conclusion

CME reiterates our support of the Agencies' efforts to provide greater incentives for central clearing, consistent with CPSS-IOSCO standards, and the need for careful evaluation of the motivations inspired by the proposed adjustments to the capital framework.

CME would like to thank the Agencies for the opportunity to provide these comments. We would be happy to further discuss and clarify any of the above issues with agency staff. If you have any comments or questions regarding this submission, please feel free to contact Tim Doar, Managing Director and Chief Risk Officer by telephone at (312) 930-3162 or by e-mail at Tim.Doar@cmegroup.com.

Sincerely,

Tim Doar
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[10] CME also notes that the baseline 25 percent haircut proposed for corporate debt securities regardless of credit quality or maturity is unusually severe compared to the Agencies' existing rules and both existing and proposed international agreements. Under the Agencies' current Internal-Ratings-Based and Advanced Measurement Approaches rules, only *below-investment-grade* corporate debt receives a 25 percent haircut. Short-term corporate debt that is investment grade currently receives a haircut in the low-to-mid single digits. Likewise, under Basel II, Basel III, and the recently-published BCBS consultative document *Margin requirements for non-centrally-cleared derivatives* (July 2012), short-term, high quality corporate debt is assigned standard supervisory haircuts in the low-to-mid single digits.

November 27, 2012

Mark Carney
Chairman, Financial Stability Board (FSB)

Stefan Ingves
Chairman, Basel Committee on Banking Supervision (BCBS)

William Dudley
Chairman, Committee on the Global Financial System (CGFS)

Paul Tucker
Chairman, Committee on Payment and Settlement Systems (CPSS)

Masamichi Kono
Chairman, IOSCO Technical Committee

RE: BCBS 227 Interim Capital Framework

Dear Sirs:

The undersigned represent derivatives exchanges from jurisdictions across the world and a majority of the global exchange-traded derivatives (ETD) market. We support the G-20 objectives to strengthen the international financial system through regulatory reforms that will increase transparency in derivatives markets and reduce systemic risk. Although the well-established and highly regulated ETD markets did not contribute to the financial crisis, there are countless aspects of the current regulatory reform framework that will impact our markets and our customers. International standard setters and regional and national regulators must make every effort to avoid unintended consequences and ensure an appropriate level of regulatory consistency across jurisdictions. These objectives are critical to preserving the price discovery and risk management benefits that liquid and transparent ETD products provide for wholesale financial markets and the broader economy.

As described in detail below, we are concerned that provisions in BCBS 227 (Interim Capital Framework) that require capital to cover a 5-day margin period of risk (MPOR) for all cleared derivatives will significantly increase costs for ETDs and potentially make ETDs more expensive relative to cleared products that do not share the same liquidity, transparency and other risk-reducing characteristics. This result cuts directly against G-20 policy objectives to move opaque markets onto transparent trading venues. It is also inconsistent with the CPSS-IOSCO Principles for Financial Market Infrastructure (PFMI), regional and national regulatory frameworks, and clearing house risk-management practices which all appropriately recognize that that ETDs are less risky and therefore should be eligible for less burdensome margin treatment than other derivatives.

Unfortunately, the Interim Capital Framework is near final implementation in many jurisdictions. We urge the FSB and relevant international standard setting bodies to act quickly to eliminate the inappropriate one-size-fits-all approach by modifying the blanket 5-day requirement for all cleared instruments *before* regional and national capital requirements are finalized. The BCBS should

consult with the industry and other standard setters to develop an alternative approach consistent with the PFMI and based on criteria reflective of the risk profile of the derivative product.
We are cognizant that inconsistent or conflicting provisions under banking, derivatives or other international standards have and will inevitably continue to arise due to the breadth and depth of the global reform effort. The FSB plays a critical role in monitoring the policy development work of the international standard setting bodies to ensure proper coordination. We commend the FSB for establishing its OTC Derivatives Working Group (ODWG) to look holistically at reforms to identify overlaps, gaps or conflicts in national frameworks that might compromise the achievement of the G-20 commitments.

We express our deep concern with the 5-day requirement within the broader context of other critical capital, margin, and market structure issues that are currently under deliberation by international standard setters. We urge the FSB and ODWG to ensure continued progress towards resolving other issues with BCBS standards that have the potential to undermine clearing of standardized products and access to client clearing. We also support international level efforts to appropriately calibrate market structure approaches across jurisdictions in order to avoid an un-level global playing field, market distortions, and regulatory arbitrage.

The Interim Capital Framework will Increase the Cost of ETDs and Could Potentially Make ETDs More Expensive than Less Liquid and Less Transparent Products

The Interim Capital Framework establishes capital requirements for banks' exposures to CCPs and to clients for whom they perform clearing services as direct clearing members of CCPs.[1] There are two related aspects of the BCBS standards that are going to significantly increase costs for ETDs, and could potentially make ETDs more expensive than less liquid and transparent products from a capital standpoint:

- First, the Interim Capital Framework will require clearing members to hold capital equivalent to a 5-day MPOR for all client "cleared derivative" positions.[2] Under the existing capital framework, products that demonstrate certain characteristics such as those exhibited by cleared ETDs are afforded capital treatment that matches the risk of the product. This would no longer be the case under the Interim Capital Framework.

- Second, under the bank capital framework, clearing members generally can reduce the 5-day capital requirement by applying the margin used to collateralize client positions. Under the PFMI and related national derivatives laws, cleared ETDs typically carry a 1-day or 2-day margin requirement versus the 5-day margin requirement assigned to cleared OTC products.[3] Applying the different margin requirements applicable to cleared products against the standard 5-day capital requirement could potentially result in higher costs for ETDs relative to products that do not share the same liquidity and transparency characteristics.

We understand the attraction of a simplistic capital rule that can be applied across jurisdictions without regard to the strength of the local clearing and regulatory regimes. However, applying this general and inflexible approach could unnecessarily drive trading to less transparent and less liquid venues, cutting against the goals to reduce systemic risk and increase transparency that are central to the G-20 mandates.

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[1] BCBS, *Capital Requirements for Bank Exposures to Central Counterparties*, July 2012 (BCBS 227).
[2] BCBS 227, Paragraph 113, Clearing Member Exposures to Clients.
[3] ESMA 2012/600 Draft technical standards under the Regulation (EU) no 648/2012 of the EP and of the EC on OTC Derivatives, CCP's and TR's, Art. 26 no 1 and 4; Commodity Exchange Act, Part 39, Section 39.13(g)(2)(ii)(a), 76 FR 69334 (11/8/2011).

Making ETDs More Expensive Cuts Directly Against the G-20 Objectives to Increase Price Transparency

The G-20 mandate called for all standardised OTC derivative contracts to be traded on exchanges or electronic trading platforms where appropriate, by the end of 2012 at the latest.[4] The FSB's recently published progress report on implementation of OTC derivatives market reforms recognizes the particular uncertainty that exists regarding future requirements for trading products subject to the clearing mandate on organized platforms.[5] For example, the Commodity Futures Trading Commission's (CFTC) Swap Execution Facility (SEF) rules are not yet finalized in the U.S., basic elements of Organized Trading Facilities (OTF) are still being debated at the EU legislative level under MiFID II/MiFIR, and a trading requirement has not been proposed in Asian jurisdictions.

In contrast, there has been significant progress across jurisdictions in implementing mandatory clearing of OTC derivatives. Although this progress furthers one critical G-20 goal to reduce systemic risk through central clearing, raising the cost of ETDs cuts directly against another key G-20 objective to increase price transparency. The BCBS standards should promote price transparency by incentivising the use of more liquid and transparent products rather than create economic disincentives to use ETDs.

CPSS-IOSCO and National Regulators have Recognised that Cleared Products with Certain Characteristics Warrant Shorter MPORs in Relation to Other Cleared Transactions

International frameworks and regional regulations recognize that products with different risk profiles warrant different levels of collateralization. In particular, these different risk profiles are clearly recognized within the PFMI. For example, Principle 6 states that, "A CCP should establish margin levels that are commensurate with the risks and unique attributes of each product, portfolio and market it serves."[6] The explanatory notes elaborate further, "...the appropriate close-out period may vary among products and markets depending upon the product's liquidity, price and other characteristics."[7]

This principle is reflected in regional and national derivatives laws and general CCP practice in setting margin: cleared ETDs typically carry a 1-day or 2-day MPOR versus the 5-day MPOR assigned to cleared bi-lateral trades. These distinctions are made on the basis that:

- ETDs have transparent pricing in deep, liquid markets which turn over almost 10 times more frequently than OTC derivatives.[8]

- ETDs are more standardized than other cleared products, providing greater efficiency, transparency and access to price and volume information in liquidation scenarios due to the concentration of interest in fewer distinct contracts.

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[4] G-20 Leaders' Statement, The Pittsburgh Summit, September 24 – 25, 2009, p. 9.

[5] FSB, *OTC Derivatives Market Reforms, Fourth Progress Report on Implementation*, 31 October 2012, p. 36. "Trading infrastructure is less developed than infrastructure for central clearing and trade reporting, owing to uncertainties about the scope and form of future regulatory frameworks for organized platform trading."

[6] PFMI, March 2011, Principle 6, p. 40.

[7] PFMI, March 2011, Principle 6, Explanatory Note 3.6.3, p. 41.

[8] TABB Group, *The New Global Risk Transfer Market: Transformation and the Status Quo*, August 2012.

- ETDs are efficiently liquidated and pose less risk than privately negotiated, highly customized, infrequently traded derivatives. Exchange trading and clearing of standardized products results in immediate netting of offsetting positions and thus permits swift, efficient liquidation of the portfolio.

We Urge the FSB to Resolve this Inconsistency at the International Level to Avoid the Potential for Conflicting Jurisdictional Approaches

We believe this issue requires immediate enhanced cooperation and action among the BCBS, CFGS, CPSS, and IOSCO due to the challenges faced in obtaining appropriate resolution at national levels. The BCBS Interim Capital Framework should be amended to modify the 5-day capital charge for clearing members using ETDs and replace it with a standard consistent with the PFMI and based on the risk profile, transparency and other characteristics of the product. As operators of global markets, we want to correct this disparity between international standards at the international level. Any alternative could result in inconsistent national outcomes and work against the G-20 objectives to promote adherence to international standards and further international harmonization.

* * *

We greatly appreciate your consideration and are available to discuss this issue further at your convenience.

Edemir Pinto, Chief Executive Officer,
BM&F Bovespa

Fernando Centelles, Chief Executive Officer,
MEFF

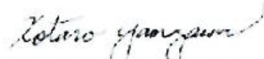
Chong Kim Seng, Chief Executive Officer,
Bursa Malaysia Derivatives

Jorge Alegria, Chief Executive Officer,
MexDer

Phupinder S. Gill, Chief Executive Officer,
CME Group

Hans-Ole Jochumsen, Executive Vice President,
NasdaqOMX

Christopher Fix, Chief Executive Officer,
Dubai Mercantile Exchange

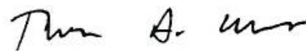


Kotaro Yamazawa, Managing Director,
Osaka Securities Exchange

Andreas Preuss, Chief Executive Officer,
Eurex

Yeo Lian Sim, Chief Regulatory and Risk Officer,
SGX

Finbarr Hutcheson, Chief Executive Officer,
NYSE Liffe



Tom Kloet, Chief Executive Officer,
TMX Group

Paris, 27 November 2012

Mark Carney
Chairman, Financial Stability Board (FSB)

Stefan Ingves
Chairman, Basel Committee on Banking Supervision (BCBS)

William Dudley
Chairman, Committee on the Global Financial System (CGFS)

Paul Tucker
Chairman, Committee on Payment and Settlement Systems (CPSS)

Masamichi Kono
Chairman, IOSCO Technical Committee

RE: Advancing the G20 OTC Market Reforms by Correcting Inconsistencies in Derivative Margin Frameworks to Reflect Liquidity and Efficiency of Exchange Traded Derivative Markets

Dear Sirs:

The World Federation of Exchanges (WFE) is the global association representing the interests of 59 publicly regulated stock, futures, and options exchanges, as well as the central clearing houses that many of these exchanges operate. Collectively, WFE members represent the vast majority of the global exchange-traded equities and derivatives markets. The International Options Markets Association (IOMA) is the WFE's global association of options and futures exchange leaders. The member list of WFE is included in the annex to this letter.

During and immediately following the global financial crisis in 2008, the WFE vigorously advocated for reform and regulation of the OTC derivatives markets, which were identified as having made significant contributions to financial turmoil. WFE applauded the OTC reform commitments made by the G20 Finance Ministers at their November 2009 meeting in Pittsburgh. In support of the G20 commitments to increase transparency in derivative markets and to promote central clearing, our associations and members have continually engaged with global standard setters as well as national and regional policymaking bodies to implement regulatory reforms and address gaps and redundancies in national approaches and global frameworks.

With respect to risk management and margin standards, the WFE encourages the Financial Stability Board (FSB) to ensure that inconsistencies in the international guidelines in relation to exchange traded derivative (ETD) margin standards and banking regulatory capital standards do not undermine the G20 commitments of moving standardized derivatives to central clearing and, when appropriate, to highly transparent trading platforms such as the regulated exchanges operated by WFE members.

Specifically, we ask that the FSB coordinate and collaborate with the Basel Committee on Banking Supervision (BCBS), the Committee on the Global Financial System (CGFS), the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissioners (IOSCO) to resolve differences between the initial margin approach set out in the CPSS-IOSCO Principles for Financial Market Infrastructure (PFMIs) (and reflected in some national regulatory rules or proposals for ETDs) and the conflicting Basel Committee on Banking Supervision (BCBS) Interim Capital Framework.

The Interim Capital Framework referred to above seeks to apply a blanket 5-day margin period of risk standard to highly liquid and transparent ETDs. The CPSS-IOSCO PFMIs appropriately distinguish between the risk profiles of ETDs and cleared OTC products.[1] CPSS-IOSCO PFMI's are reflected in regional and national margin and risk management regulatory frameworks around the world. These margin frameworks recognize the deep liquidity, transparent pricing, significant turnover rates, and overall efficiency of most ETDs relative to OTC derivatives and, in some cases, apply a 1 to 2-day margin period at risk standard for ETDs.[2]

The significant liquidity and turnover advantages of ETD markets are confirmed by a recent study commissioned by the WFE and completed by the TABB Group which estimates that there are approximately 9,800 OTC trades per day across all OTC asset classes contrasted with nearly 6.2 million trades per day in global interest rate futures market alone. This equates to a 630 times greater turnover rate for exchange traded interest rate contracts compared to the turnover rate of all of the asset classes that make up the OTC derivatives market.[3] Due to their significant liquidity and turnover advantages as well as the extensive

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[1] *CPSS-IOSCO Principles for Financial Market Infrastructure*. "When setting margin requirements, a CCP should have a margin system that establishes margin levels commensurate with the risks and particular attributes of each product, portfolio, and market it serves. Product risk characteristics can include, but are not limited to, price volatility and correlation, non-linear price characteristics, jump-to-default risk, market liquidity, possible liquidation procedures (for example, tender by or commission to market-makers), and correlation between price and position such as wrong-way risk. Margin requirements need to account for the complexity of the underlying instruments and the availability of timely, high-quality pricing data. For example, OTC derivatives require more-conservative margin models because of their complexity and the greater uncertainty of the reliability of price quotes" (Explanatory Note 3.6.3). "A CCP should adopt initial margin models and parameters that are risk-based and generate margin requirements that are sufficient to cover its potential future exposures to participants in the interval between the last margin collection and the close out of positions following a participant default. Initial margin should meet an established single-tailed confidence level of at least 99 percent with respect to the estimated distribution of future exposure." (V. Appendix 3.6.6).

[2] ESMA 2012/600 Draft technical standards under the Regulation (EU) no 648/2012 of the EP and of the EC on OTC Derivatives, CCP's and TR's / Art. 26 no 1 and 4 Title: 17 CFR Parts 1, 21, 39 and 140 Derivatives Clearing Organization General Provisions and Core Principles. U.S. Federal Register Citation: 76 FR 69334 (11/8/2011).

[3] TABB estimates that there are 4300 trade per minute in the global interest rate futures markets which equals an average of 6,192,000 trades in a 24 hour period. TABB estimates that 6.8 trades per minute occur in the

availability of pricing data, ETDs are usually efficiently liquidated and generally pose less risk than privately negotiated, customized, and less frequently traded OTC derivatives.

If adopted by the BCBS and implemented by national bank regulators, the static 5-day margin period of risk standard will not only be in conflict with the CPSS-IOSCO PFMIs but also have the effect of increasing costs for client users of ETDs. [4] This may force exchange users (e.g. manufacturers, food producers, employee pension funds, and investors) to either discontinue critical hedging practices or move activity to the less transparent OTC derivative markets. Such outcomes would clearly undermine the G20 OTC market reform commitments.

The WFE respectfully requests global standard setters to eliminate the 5-day margin period of risk banking capital standard for exchange traded derivatives and demonstrate international support for the more appropriate 1 to 2-day standard for the highly liquid, transparent, and efficient exchange traded derivative markets. This standard should apply across all methods permitted under the Basel framework to compute counterparty credit risk exposure for ETDs. Such action by global standard setters will be instrumental in advancing the G20's commitment to bring increased transparency and the safety and soundness of central clearing to the global derivatives market and broader financial system.

As the global associations for exchanges and clearing houses, the WFE and IOMA appreciate your consideration and stand ready to lend our members' collective expertise to this critical discussion.

Cordially yours,

Huseyin Erkan
Chief Executive Officer
Word Federation of Exchanges

Jorge Alegria Formoso
Chairman, IOMA, and
Chief Executive Officer, MexDer

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entire OTC market which equals 9,792 trades in a 24 hour period. See pages 40-41: *The New Global Risk Transfer Market: Transformation and the Status Quo*, TABB Group, August 2012.

[4]The Interim Capital Framework establishes capital requirements for banks' exposures to CCPs and to clients for whom they perform clearing services as direct clearing members of CCPs. There are two drivers that will result in higher capital requirements for ETDs, or prompt a significant increase in collateralisation requirements established by banks offering clearing services: 1)The Interim Capital Framework will require clearing members to hold capital equivalent to a 5-day margin period of risk (MPOR) for all client "cleared derivative" positions. Under the prior capital framework, products that demonstrated certain characteristics such as those exhibited by cleared ETDs were afforded capital treatment that matched the risk of the product; and 2) The Interim Capital Framework allows clearing members to offset this 5-day capital requirement with the margin held against the client positions.[4] Under the PFMIs and related national derivatives laws, cleared ETDs typically carry a 1-day or 2-day margin requirement versus the 5-day margin requirement assigned to cleared OTC products.[4] This offset results in a 4-day or 3-day capital charge for ETDs versus 0-day charge for cleared OTC. *BCBS, Capital Requirements for Bank Exposures to Central Counterparties, July 2012 (BCBS 227)*