

VIA ON-LINE SUBMISSION

August 8, 2011

David Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Protection of Cleared Swaps Customer Contracts and Collateral –
76 Fed. Reg. 33818 (June 9, 2011), RIN 3038-AC99

Dear Mr. Stawick:

CME Group Inc. (“CME Group”) appreciates the opportunity to comment on the Commodity Futures Trading Commission’s (“CFTC” or the “Commission”) notice of proposed rulemaking (“NPR”) regarding a new regulatory regime for the treatment of cleared swaps customer positions and related collateral. Specifically, the Commission proposes that derivatives clearing organizations (“DCOs”) and futures commissions merchants (“FCMs”) implement a “complete legal segregation model” (“CLSM”), pursuant to which the open positions and collateral of cleared swaps customers would be comingled on an operational level as is the case for cleared futures contracts today, but in the event of a default in an FCM’s cleared swaps customer account, a DCO would not be permitted to access the collateral of non-defaulting customers in order to cure the default. The Commission indicated that it is continuing to evaluate the costs and benefits of CLSM, and therefore sought further comment on alternative models, including the “legal segregation with recourse model”, the “optional approach” and the “futures model”.

CME Group is the parent of Chicago Mercantile Exchange Inc. (“CME”). CME is registered with the CFTC as a DCO, and is one of the largest central counterparty clearing services for regulated derivatives contracts. CME’s clearing house division (“CME Clearing”) offers clearing and settlement services for exchange-traded futures contracts and for over-the-counter (“OTC”) derivatives transactions, including interest rate swaps, credit default swaps, agricultural swaps and other OTC contracts.

I. Overview

CME Group still believes, as we set forth in our comments on the Commission’s advance notice of proposed rulemaking on this topic (the “ANPR”)¹, that the baseline “Futures Model” provides the best balancing of cost versus risk for the industry as a whole. Participants in the futures industry are subject to multiple layers of regulatory oversight that impose well-reasoned risk management requirements and effective compliance programs, and no futures customers have suffered a loss of collateral as a result of

¹ 75 Fed. Reg. 75162, 17 CFR Part 190, Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies (Dec. 2, 2010). A copy of CME Group’s comment letter to the ANPR may be found at: <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27179&SearchText>

an FCM's bankruptcy or default to a DCO. We recognize that certain large swaps customers are concerned about the "fellow-customer risk" presented by the comingled customer accounts that are employed in the Futures Model. The CFTC proposes to alleviate those concerns by implementing a regulatory framework that purports to provide "legal" segregation while minimally disrupting existing operational practices in the industry. We are convinced, however, that the CLSM framework will fail on both counts. The benefits it seeks to provide may be illusory, because the framework is likely to fail when it is needed most. Moreover, even to support the model on an ongoing basis will require substantial operational changes that will drive up the cost of clearing swaps – costs increases that may discourage the use of clearing or of OTC swaps for risk management and that will be wasted if CLSM cannot achieve its intended objectives.

CME Group agrees that the industry should work to identify an appropriate framework to address concerns about fellow-customer risk. Many large swaps customers currently enjoy privately-contracted forms of segregated treatment for their swaps collateral that protect their assets against the failure of a dealer counterparty. It is understandable that such customers would resist moving to a model that altered those protections. We are prepared to work with the Commission, the FCM community and interested customers in order to achieve that objective. Our immediate concern, however, is that the Commission not rush to implement a "solution" that gives superficial comfort, but may not work either operationally or legally in the event of an actual default. We are concerned that the Commission's CLSM proposal does exactly that, and its imposition at a time of great change in the industry will be both costly and risky.

We strongly urge the Commission to delay further action on altering the legal framework for the treatment of cleared swaps customer collateral. We recommend that the Commission engage in further study, and establish a review process that includes a representative group of interested parties with expertise in the area, in order to evaluate alternative approaches. In particular, we recommend that the Commission more carefully evaluate the possibility of establishing optional approaches that would allow certain customers to opt out of comingled treatment at the clearing level, as further set forth below. The Commission should proceed with appropriate implementation of swaps clearing and complete the remaining rulemakings that are required under Dodd-Frank, which this is not.

II. The CLSM Proposal

The CLSM Proposal combines enhanced record-keeping and information sharing requirements with a prohibition on a DCO's use of funds that, per the information held by the DCO at the time of an FCM default, "belong" to non-defaulting customers of the FCM. In essence, the enhanced records are intended to substitute for physical segregation of payments and collateral at the customer level. Under this approach, the NPR suggests, the fundamental structure of derivatives clearing as practiced by the industry can continue: customer assets can continue to be comingled, cash flows can continue to be netted, and the DCO will still possess sufficient information about risks and obligations to provide for settlement finality and a cost-effective approach to risk management.

While CLSM may appear reasonable on paper to persons who are not familiar with the intricacies of clearing, it ignores the complexities and extended operational timeline through which clearing for OTC derivatives and other products is conducted. We outline key components of the proposal below, followed by an explanation of its major defects.

A. Structure of the Proposal

A critical aspect of CLSM is the requirement, under proposed regulation 22.11(a)(2), that FCMs prepare and deliver to DCOs on a daily basis “information sufficient to identify the portfolio of rights and obligations” belonging to each cleared swaps customer with respect to its cleared swaps (hereafter the “portfolio report”). This information, the NPR indicates, will enable DCOs “to conform to their obligations to allocate Cleared Swaps Customer Collateral, in the event of an FCM default, pursuant to proposed regulation 22.15,”² which prohibits a DCO from using a non-defaulting customer’s collateral to settle a defaulting customer’s obligations, notwithstanding that the relevant collateral is all comingled in a single account.

In the multi-tiered world of derivatives clearing under the CEA, a DCO does not have direct relationships with customers. Rather, it looks directly to its clearing members, which must be registered as FCMs and must comply with applicable CFTC regulations, for information and processing of payments on behalf of the customers that are the beneficial holders of cleared positions. If DCOs are to be obligated to preserve the collateral of non-defaulting customers of a defaulted clearing member, they must have accurate and timely information on which to rely. The FCM’s daily portfolio report, consequently, is the basic building block of the CLSM proposal. If a default occurs, the DCO is both entitled and obligated to rely upon the defaulted FCM’s last portfolio report to define its access to customer collateral. Proposed regulation 22.15 encompasses the heart of the CLSM proposal by requiring each FCM and DCO to:

treat the value of the collateral required with respect to the portfolio of rights and obligations arising out of the Cleared Swaps intermediated for each Cleared Swaps Customer ... as belonging to such customer, and such amount shall not be used to margin, guarantee, or secure the Cleared Swaps or other obligations ... of any other Cleared Swaps Customer or Customer.

Under proposed Reg 22.15, the DCO may only access the collateral attributable to a customer that defaults, collateral that is specifically intended to cover the risk that the customer may default and that may be a substantial portion of the value of the account. The DCO may not, however, access the collateral of non-defaulting customers contained in the account, but must allocate that collateral to them, with the further goal of facilitating transfers of such non-defaulting customers’ open positions and associated collateral to non-defaulting FCMs. The DCO conducts this allocation on the basis of the prior day’s portfolio report, and the DCO itself must cover any remaining shortfall (which the proposal presumes will be attributable to the defaulting customer) out of its own funds or financial safeguards package.

A major failing of the CLSM proposal is that it does not explain exactly what the portfolio report is required to cover and how it is meant to be employed by a DCO in an FCM default. Considering the importance of the daily portfolio report to the CLSM structure, greater specificity as to the contents of the portfolio report, and key facts such as the time at which the rights and obligations are to be “marked” by FCMs and by

² 76 Fed. Reg. at 33839. The proposed rules distinguish between “depositing” and “collecting” FCMs in order to address the multiple levels of FCM clearing that may exist. The proposed regulations generally replicate FCM obligations up the tiers to the FCM that is a clearing member of the DCO. Because CME Group is primarily concerned with the clearing level, this comment letter generally refers to “FCMs” and assumes for the sake of simplicity that an FCM is a direct clearing member of the relevant DCO and also maintains direct relationships with the relevant cleared swaps customers.

when the report must be delivered, would be useful to provide for consistency in treatment across FCMs and increase the likelihood that a DCO has a complete picture when it receives clearing members' reports each day. More importantly, the Commission must clarify the manner in which a DCO is meant to rely upon the portfolio report to preserve non-defaulting customers' collateral. As we explain in detail in subsection B, we see no approach that will be both operationally workable and adequate to preserve customers' collateral in most instances. Regardless of the final interpretation, however, it is clear that the proposal imposes greater risk on DCOs, because a DCO to which an FCM has defaulted in its customer account will no longer have access to the full collateral carried in that account and will inevitably face some uncertainty as to the amount of collateral that it can access and the reliability and fairness of the records on which it must base its decisions in a crisis situation.

The NPR reasons that the risk impact to the DCO is minimized by additional changes to the regulatory structure.³ First, there are the enhanced record-keeping and information-reporting requirements described above. Second, in the event of a default in a cleared swaps customer account, the proposed rules require the defaulting FCM, on the day that it defaults, to deliver to the DCO a final set of assets supporting its cleared swaps customers' positions, and information sufficient to allocate those assets and to identify the customer or customers that defaulted to the FCM. This is intended to permit the DCO promptly to access the collateral that it is permitted to use and to allocate the remaining collateral to non-defaulting customers and port such non-defaulting customers' positions and associated collateral to another non-defaulting FCM.

An additional tool for the DCO in the CLSM proposal is the right to require a cleared swaps customer or group of customers to deposit an increased amount of collateral based on an evaluation of the credit risk posed by such customer(s), which increased amount would then be included within the customer's required collateral calculated in connection with the customer's "portfolio of rights and obligations."⁴ A DCO may also require the FCM itself to deposit additional collateral into its cleared swaps customer account, which collateral the proposal makes clear would then be accessible by the DCO in order to margin, guarantee or secure the cleared swaps of any of the FCM's cleared swaps customers.⁵ Although the NPR indicates that the use of such additional collateral requirements is not mandatory, it is offered as a mechanism to balance the increased risks that a DCO will bear under CLSM.⁶ A DCO, however, generally is not in a position to evaluate the credit risks of individual customers, a role that is that is assigned to FCMs under the CFTC's regulatory structure. This is particularly true in multi-tiered clearing, where some customers clear through a foreign broker or an FCM that, in turn, clears through another FCM that is a clearing member of the DCO. Additionally, many customers will clear through multiple DCOs and participate in the non-cleared swaps market as well. A DCO is in no position to evaluate the degree to which those activities create additional credit risk with respect to the customer.⁷

The NPR envisions that the proposed regulations implementing CLSM establish a legal framework under which the current operational practices of DCOs and FCMs with respect to futures and swaps clearing

³ See 76 Fed. Reg. at 33839 and 33846, fn. 174, discussing additional "tools" available to DCOs.

⁴ Proposed Reg. 22.13(a). 76 Fed. Reg. at 33855.

⁵ Proposed Reg. 22.13(b). 76 Fed. Reg. at 33855.

⁶ See discussion at 76 Fed. Reg. at 33855-33856.

⁷ The NPR requests comment as to whether a DCO should be permitted to impose such additional collateral requirements for reasons other than an assessment of credit risk. Considering the risks to which DCOs are exposed with respect to customer positions and a DCO's limited ability to assess a customer's credit risk specifically, we do not think the Commission should impose any limitations upon the reasons for which a DCO may impose additional collateral requirements on any customer, group of customers or FCM.

can continue with relatively little day-to-day impact from the changes, while protecting swaps customers against fellow-customer risk. The NPR further presumes that a DCO will have sufficient information immediately to allocate to each non-defaulting customer its appropriate share of the collateral in the defaulting FCM's customer account. The NPR concedes that in such allocation customers may not receive the full value of collateral that such customers previously posted. Because each customer's collateral is not physically separated, and because both the FCM and the DCO may invest customer collateral in accordance with other regulations, "what is protected is an amount (i.e., a value) of collateral, rather than any specific item of collateral."⁸ The NPR states that investment risk is not borne by the DCO, and proposed regulation 22.14(f) specifies that any shortfall in the customer collateral available on the day of an FCM's default that is caused by a loss in market value of the collateral versus that prior day (i.e., investment loss) shall be shared *pro rata* among all cleared swaps customers.⁹ However, it is not only investment risk that may produce a shortfall, as we explain below.

The NPR is clear that protecting the collateral of non-defaulting customers is the primary benefit of CLSM: "[t]he Complete Legal Segregation Model would largely eliminate this risk."¹⁰ The NPR notes that "most buy-side commenters to the ANPR valued the degree of certainty that they will not lose Cleared Swaps Customer Collateral, and several such commenters indicated that the absence of this level of certainty would impair their ability to use cleared swaps for risk management purposes."¹¹ The NPR also noted that pension funds in particular expressed concern that exposing their cleared swaps collateral to fellow-customer risk might be incompatible with their fiduciary requirements under the Employee Retirement Income Security Act.¹² A second core objective of CLSM is to permit non-defaulting customers to port their open positions and collateral to another FCM, without material disruption to their trading and collateral management activities, although the NPR is clear that DCOs are not *required* to make such transfers. The NPR describes increased portability as an additional benefit of the proposal, observing that the benefit flows both to the specifically affected cleared swaps customers and also to "the financial system as a whole (the latter by reducing the likelihood that markets would be roiled by a mass liquidation)." Avoiding such disruption, the NPR states, "therefore promote[s] the financial integrity of the markets."¹³

Unfortunately, in CME Group's view, the framework established by the CLSM concept and the proposed regulations will be wholly inadequate to achieve the Commission's desired objectives: namely, in an FCM default, the preservation of non-defaulting cleared swaps customers' collateral and the ability to port their positions and collateral to another FCM. The proposal for the DCO itself to guarantee or cover losses above margin coverage for one day's movement on a defaulting customer's positions appears straightforward, but it ignores the complexities of clearing operations. It ignores also the netting of settlement variation payments and margin requirements into a single net pay or collect figure, which may delay a DCO's realization that a customer has defaulted through one or even two clearing cycles. It instructs the DCO to rely upon a "portfolio of rights and obligations" that is, expressly, at least one

⁸ 76 Fed. Reg. at 33840.

⁹ 76 Fed. Reg. at 33840 and Proposed Reg. 22.14(f), 76 Fed. Reg. at 33856. See also footnote 185 to the NPR, which concedes that the CLSM proposal "would leave some residual fellow-customer risk because the DCO would allocate collateral between defaulting and non-defaulting customers based on the information that the FCM provided the day prior to default, so the allocation would not reflect movement in the cleared swaps portfolio of customers on the day of default." 76 Fed. Reg. at 33848.

¹⁰ 76 Fed. Reg. at 33848.

¹¹ 76 Fed. Reg. at 33849.

¹² 76 Fed. Reg. at 33821.

¹³ 76 Fed. Reg. at 33849.

clearing cycle old at the time that the DCO acts upon a default, leaving unanswered the question of how customers suffering losses because of the misallocation of collateral by the DCO may seek to recover them. It overestimates the likelihood that the prior day's "portfolio of rights and obligations" from a defaulting FCM will be accurate and complete and appears to underestimate the degree to which changes in the market (as well as customer activity) may change the figures in the portfolio report over the course of a single clearing cycle. Ultimately, we believe that it greatly overestimates the likelihood that non-defaulting customer positions and collateral that have been comingled effectively can be transferred without material disruption to such customers' interests. We address each of these concerns in turn.

B. Complexities of Multi-Tier, Multi-DCO Clearing

The CLSM proposal's seemingly simple directives concerning the portfolio report and the delivery of collateral by a defaulting FCM in a final clearing cycle ignore the operational complexities of multi-tiered and multi-DCO clearing. Most importantly, the proposal does not clarify exactly what the DCO is meant to preserve when it relies upon the portfolio report to allocate customer collateral of a defaulting FCM. There are two possibilities, each of which creates different defects that render the proposal inadequate for the purpose for which the Commission intends it. If the portfolio report and the DCO's obligation to preserve non-defaulting customers' collateral apply *only to the required margin* that must be held at the DCO in respect of each customer's open positions, then the structure will be more manageable in practice, but customers will remain exposed to some amount of fellow-customer risk as relates to the full equity value of their cleared swaps accounts at an FCM because such amounts will need to be recovered in the FCM's bankruptcy proceedings. If instead the portfolio report and the DCO's obligations are meant to apply to *all "cleared swaps customer collateral"* that is held by an FCM in respect of each customer's open positions, then the proposal theoretically provides greater protection, but it presents such a wide variety of operational problems and added costs (which the NPR fails adequately to evaluate) that it will be unworkable in practice and will fail to protect customers' interests if their FCM defaults in its customer sequestered account.

While it may not appear so to a casual reader, the impact of the distinction between those two approaches is substantial. The funds, securities and other assets that an FCM holds on behalf of a customer in respect of cleared swaps positions can be divided into several categories: accumulated net positive settlement variation in respect of open positions (also called "open trade equity"), to the extent that the customer has not withdrawn such funds from the FCM, margin amounts required to be held by the DCO, margin amounts required to be held by the FCM (to the extent greater than that required by the DCO), and excess margin. All such assets constitute "cleared swaps customer collateral" in the Commission's proposed definition and all may be aggregated and reduced to a single net cash figure. However, such funds are *not* all held at the FCM's clearing level account or accounts (*i.e.*, accounts that are subject to direct control by one or more DCOs). Furthermore, such funds are *not* all designated as being allocated to the benefit of particular open positions at a particular DCO.

Read technically, it appears that the proposed rules require the FCM to deliver to each DCO a report that covers *all* categories of funds and assets held and *all* cleared swaps positions: "...the portfolio of rights and obligations arising from the Cleared Swaps that such futures commission merchant intermediates for such customer."¹⁴ Consequently, the portfolio report that each DCO receives will necessarily cover both

¹⁴ Proposed Reg. 22.11(c)(2). 76 Fed. Reg. 33854.

collateral to which it has immediate access in the FCM's clearing level account, and funds to which it has no visibility or immediate access.¹⁵ While a plain reading of proposed regulation 22.11 establishes a portfolio report that is very broad in its coverage, a DCO can only act upon the basis of the funds carried at the clearing level that are within its immediate control and access. Outside of a default, from the DCO's perspective those funds will divide into required margin and excess. The excess carried at the clearing level may comprise excess margin or open trade equity or both, and it is not assigned or readily assignable by customer. Consequently, in a default situation, we read the proposed regulations as requiring a DCO to allocate to each non-defaulting customer its specific *required* margin only (any additional amounts of which should be delivered by the defaulting FCM pursuant to proposed regulation 22.14) and allocate to any defaulting customer the difference between its specific required margin and the collateral within the DCO's access and control, pursuant to the portfolio report and the information received from the defaulting FCM on the day of default under proposed regulation 22.14.¹⁶ The DCO would then be obligated to use its own funds or financial safeguards package (plus any excess in which the FCM itself held a residual financial interest) to cover any remaining loss attributable to the defaulting customer.¹⁷ The text of proposed regulation 22.14 supports this interpretation of the DCO's obligations. It requires the defaulting FCM, for the cycle of default, to deliver to the DCO the *lesser of* each customer's specific required portion of the final margin call or the amount that the FCM then holds for that customer (i.e., all collateral held for any defaulting customer).¹⁸ On its face, this instructs the defaulting FCM *not* to deliver any open trade equity or excess collateral funds that it then holds on behalf of non-defaulting customers.

If the DCO is required to preserve only the required margin, then it is at least more feasible that the DCO will be able to transfer open positions of non-defaulting customers and their associated required collateral.¹⁹ However, this leaves cleared swaps customers exposed to substantially greater continuing fellow-customer risk than is suggested in the NPR. Specifically, non-defaulting customers' open trade equity and excess collateral would remain in the defaulted FCM's cleared swaps customer account, subject to distribution in the FCM's bankruptcy proceedings. Any losses that the DCO is not obligated to cover will be distributed ratably among customers in that process. The NPR refers to investment loss, but it does not explicitly discuss the possibility for additional losses to be incurred because of the netting of settlement variation payments that occurs in the final clearing cycle, from errors in the portfolio report information or other factors. Separately, we note that a structure that leaves such assets subject to distribution in bankruptcy will discourage concerned customers from holding excess collateral or net

¹⁵ We note that it will also cover positions carried at all DCOs. We are unsure whether it is the Commission's intention to provide each DCO information about the positions that a single customer carries at any DCO.

¹⁶ If the portfolio report provides a customer-specific and DCO-specific allocation of the excess held in the clearing level account, then theoretically the DCO may also divide and transfer that collateral. However, it may be more pragmatic, in a crisis situation, for the DCO simply to leave such funds in the defaulted FCM's account for subsequent distribution by the FCM's bankruptcy trustee.

¹⁷ Excess may be allocated to the FCM itself per the portfolio report or per requirement of the DCO under proposed regulation 22.13.

¹⁸ Proposed Reg. 22.14(c)(1). 76 Fed. Reg. at 33856. We note that Proposed Reg. 22.14 does not set forth a specific time by which a defaulting FCM is required to complete the tasks set forth in the regulation; considering the circumstances, the identification of the defaulted customer and the delivery of collateral should occur immediately upon realization by an FCM that it will default.

¹⁹ We note that the DCO would likely need to accomplish such transfers at the last prior settlement price. In order for the DCO to transfer all non-defaulting customers' open positions at original trade prices, the DCO would need to be holding at the clearing level and/or immediately receive from the defaulting FCM the full amount of any net positive open trade equity for the account as a whole, and the DCO and the receiving FCM would need to have confidence in the accuracy of the defaulting FCM's books and records concerning any prior withdrawals of positive open trade equity by customers.

positive open trade equity with their FCMs, raising costs due to an increasing number of daily banking transactions and potentially creating additional risks because FCMs and customers will operate with less of the cushion that holding such excess in the clearing system provides.

The CLSM structure would work no better if, instead, the proposal intends that a defaulting FCM must deliver to the DCO *all* customer collateral for any customer for which it clears, directly or indirectly, and the DCO must preserve *all* such collateral of non-defaulting customers in its resolution of the default. First, given the prospect for multiple layers of clearing including the involvement of foreign brokers or customers, we consider it highly unlikely that an FCM that is on the verge of default (or that has already defaulted or filed for bankruptcy protection) would be able to collect and deliver to the DCO customer assets that are not within its immediate control. Second, and more importantly, it imposes unreasonable risk on the DCO – and by extension its non-defaulting clearing members – to obligate it, in the midst of a default, to allocate to and preserve for customers all forms of cleared swaps customer collateral. In such a case, a DCO would be obligated to customers with respect to funds to which it never previously had visibility or access, because such funds were held by the FCM (or even by a depositing FCM or foreign broker for which it cleared) outside of any clearing level account. This would inject substantially more risk into the system, particularly if the defaulting FCM fails to deliver to the DCO all of the collateral it is required to deliver under proposed regulation 22.14. This would also place unreasonable pressure on the level of detail and the accuracy of the portfolio report, and greatly heighten the risk associated with errors in the portfolio report information, which risks are described in greater detail below.

Moreover, the CLSM structure appears to disregard the fact that many customers will clear through multiple DCOs. An FCM's accounts at both the FCM level and the clearing level may commingle customer assets held in respect of positions at multiple DCOs. Excess collateral is unassigned and necessarily intended to be flexible, available to satisfy the requirements that may arise from any DCO. Similarly, customers that withdraw funds representing net positive open trade equity from their accounts with their FCMs do not specify from which positions such funds are withdrawn. Finally, it is the FCM, and not the customers, that determines how much excess (in respect of open trade equity or excess margin) to hold at the clearing level rather than at the FCM level. How, then, is the portfolio report that an FCM delivers to each DCO to divide such assets properly? Even more critically, how is a *defaulting* FCM to divide non-defaulting customers' cash balances (bearing in mind that customers may withdraw from their FCMs funds comprising net positive open trade equity and excess collateral) among multiple DCOs for purposes of the obligation under proposed regulation 22.14 that it "deliver" such remaining collateral to "the DCO"? The only certain way for this to occur, under CLSM, would be for each FCM to establish *separate* accounts for each DCO, increasing the number of banking transactions by an unknown order of magnitude and substantially reducing capital efficiencies for FCMs and customers alike.

Finally, all of the foregoing operational complexities are magnified in a situation where an FCM that is a clearing member of a DCO is also a collecting FCM on behalf of other "depositing" FCMs, and further exacerbated by the possibility that some FCMs are clearing on behalf of foreign brokers using omnibus accounts to clear for foreign customers.²⁰

²⁰ The obligations set forth in the NPR to deliver portfolio reports and collateral apply, of course, to FCMs. The NPR does not discuss the issue of FCMs clearing on behalf of foreign brokers. The definition of "cleared swaps customer" contained in Proposed Reg. 22.1 could be read to treat any end customer, including a foreign customer clearing through one or more foreign brokers, as a "customer" for purposes of the requirements and restrictions imposed upon FCMs and DCOs. We presume that the Commission's intention is to continue to treat omnibus accounts of a foreign broker clearing through an FCM as a single "customer" for purposes of the requirements of Part 22.

C. Netting of Payments in Operationally Comingled Accounts

The problems described above are further compounded by the extended operational timeline for derivatives clearing and the netting of payments that makes the process efficient. It is critical to understand the operational practices and the timeline that apply to an “operationally comingled” customer account on a typical day.²¹ At the end of each trading day, CME Clearing calculates, for each FCM’s cleared swaps customer account, (i) the net position of the account as a whole, (ii) the net position of each customer in the account, (iii) the net margin requirement for each customer in the account, (iv) the sum of margin requirements for the account as a whole (which aggregates the individual net margin requirements of each customer) and the net increase or decrease in such aggregate margin requirement for the account versus the prior settlement cycle, (v) the net settlement variation payment to be credited to (a “collect”) or debited from (a “pay”) the account, and (vi) the net collect or pay for the account covering both the increase or decrease in margin required for the account and the net settlement variation collect or pay. CME Clearing provides the back office of the FCM initial information concerning these amounts during the evening following the conclusion of the trading day. CME Clearing finalizes the results of the clearing cycle by 12:00 midnight²² at the end of each trading day and transmits “settlement instructions” (a complete record of mark-to-market collects and pays, as well as a complete record of margin call/release amounts) to each of its settlement banks. Each CME clearing member generally selects one CME-approved bank to act as its settlement bank. The settlement bank must provide CME Clearing with an affirmation, by a time certain, that all amounts due and owing to CME Clearing will be paid. The affirmation by the settlement banks, which currently must be received by 7:30am each morning after a trade date, concludes that clearing cycle. Once a settlement bank affirms payment, it becomes legally obligated to complete the necessary funds transfers promptly thereafter. The payment that the settlement bank affirms for each FCM’s customer account at the clearing level is a *net* payment, not a set of individual payments representing each individual customer’s payment obligation. Under CLSM, this would not change.

The finality of each clearing cycle is the most essential feature of the clearing structure, and we do not understand the Commission to propose that a completed and final settlement cycle – that is, a settlement cycle in which all settlement banks affirm payments to CME clearing – could ever be “undone”. To do so would wreak havoc on the system. The problem that CLSM introduces into this structure is that, because of the netting of payments and the critical need for prompt finality of settlements, a clearing cycle may be completed and final before a clearing member – let alone the DCO – is aware of a substantial customer default.

As noted above, CME Clearing makes settlement instructions available to settlement banks, and to clearing members, by midnight following a trading date. A customer that is subject to a margin call from its FCM to cover increases in margin requirements and/or settlement variation losses on its portfolio generally learns of the exact amount due the morning after the trade date in question. Clearing firms and non-clearing FCMs (that clear through another FCM) have flexibility in the amount of time they allot for

²¹ For simplicity, this description disregards the possibility of an intraday settlement cycle, in which an FCM would almost certainly cover any increases in margin requirements for its customer account, without passing such obligations to its customers until the end-of-day settlement cycle. The description also disregards the complexities associated with multi-level clearing, where certain “depositing FCMs” or foreign brokers may clear indirectly through other FCMs.

²² All times described are given in U.S. Central Time.

customers to meet mark-to-market variation payments and margin calls. Most customers, accordingly, are not required to deliver funds to their FCMs in respect of the prior day's activity until *after* the settlement cycle for the activity in question has already been finalized. Additionally, at this point cleared swaps submission for the next trade date's cycle will have been open for many hours.

To appreciate the risks posed by the CLSM proposal, it is critical to understand these features of the clearing cycle. If mark-to-market and margin requirements, amounts paid or not paid by customers in respect of them and amounts held by customers for the prior period could all reliably be determined at a single point in time, before any new transactions occurred, it would be easier to identify the various risks, mitigate them and unambiguously (if not fairly) allocate them among DCOs, FCMs and customers. However, that is not how clearing operates. Instead, in nearly all cases, the FCM *and those fellow customers with net collects* effectively pre-fund amounts owed to CME Clearing in respect of customers that experienced losses or increased margin requirements (producing net pays) with respect to the prior day's activity. As a result, in some cases it is possible that by the time an FCM determines that a customer with a settlement obligation due to the FCM will default, nearly an entire trading day may have passed. Consider the following example:

Suppose that Clearing Firm has three customers, each trading the same swap product in \$1 million increments. After cleared swaps submission for Monday closes, suppose Customer A is short 2, B is long 2 and C is long 1. Suppose the settlement price of the swap on Monday is 90, and the margin requirement is 30. Monday's results record as follows:

CUSTOMER	POSITION	PRICE	REQUIRED MARGIN
A	-2	90	60
B	+2	90	60
C	+1	90	30

For simplicity, suppose Clearing Firm carries no excess at the clearing level and that no customers had any outstanding margin calls from any prior clearing cycle, such that Clearing Firm's clearing level account at the settlement bank is whole as of Tuesday morning and Clearing Firm has no residual financial interest in any of the collateral held in the account.

Suppose that for Tuesday trade date, the price increases to 100 and CME Clearing also increases the margin requirement to 40. Customer B submits an offsetting swap to close out 1 swap at 100. Accordingly, the new positions, settlement variation and margin requirements are as follows:

CUSTOMER	POSITION	PRICE	MARGIN REQ	CHANGE IN MARGIN	VARIATION (INCLUDING CLOSE-OUT PROCEEDS)	TOTAL TO (+) OR FROM (-) CUSTOMER
A	-2	100	80	+20	-20	-40
B	+1	100	40	-20*	+20*	+40
C	+1	100	40	+10	+10	0

* B's net margin requirement is reduced by the reduction in its position, and its positive variation payment is composed of a gain of 10 on its remaining swap plus a gain of 10 on the swap that it closed out. Technically B's excess margin would remain in the account unless withdrawn. For the sake of simplicity, we treat it as an amount to be paid out as a result of B's close-out transaction.

The resulting net payment owed by the account to CME Clearing is \$0. Suppose that Customer A will be unable to cover the 40 that it owes, and that Clearing Firm will also be unable to cover the loss. If Clearing Firm does not learn that Customer A will default, does not realize that A's default will cause it also to default, or fails to notify the settlement bank or CME of the impending default, then Tuesday's clearing cycle will close without a default.

Suppose that on Wednesday no positions change, but the price increases to 105:

CUSTOMER	POSITION	PRICE	MARGIN REQ	CHANGE IN MARGIN	VARIATION	TOTAL TO (+) OR FROM (-) CUSTOMER
A	-2	105	80	0	-10	-10
B	+1	105	40	0	+5	+5
C	+1	105	40	0	+5	+5

If Clearing Firm defaults *prior* to the close of Wednesday's clearing cycle, then CME would allocate to B and C their 40 of required margin, and use a combination of A's 80 in margin plus its own resources to cover any loss on closing out A's two swaps and to pay the 5 owed in variation gains that are owed to each of B and C, permitting B and C's positions and collateral to be transferred to a non-defaulting clearing member. However, if B had not immediately withdrawn its 40 in variation gains and close-out proceeds from Tuesday's clearing cycle, it would have to seek recovery of those amounts in Clearing Firm's bankruptcy proceedings. In bankruptcy, B's claim for 40 would be shared ratably among all customers with claims to recover collateral held in Clearing Firm's customer sequestered account. If Clearing Firm does not default until after the close of Wednesday's clearing cycle, the claims of its non-defaulting customers in bankruptcy will be even larger.²³

The extended operational timeline creates other practical difficulties for CLSM to work. Because of netting and the effective pre-funding of individual customer obligations that it represents, customers rarely make payments to their FCMs in respect of variation amounts owed or increases in required margin before the settlement cycle for which such amounts are due is completed and closed. Although proposed

²³ In our view, such shortfalls may prohibit transfers under the Bankruptcy Code in such a scenario, leaving the DCO no choice but to liquidate the positions and collateral in the account.

regulation 22.14 requires a defaulting FCM to transfer such funds as it has received for the cycle of default, under normal circumstances few customers would have delivered such funds by the early morning hour when the cycle is normally complete. For transfers of open customer positions, a receiving FCM is likely to require that such positions be fully collateralized, including any variation obligations or increased margin obligations with respect to the clearing cycle in which the default occurs. This leaves very little time for non-defaulting customers to post additional collateral to support their transferred positions. And if CME were to transfer, or non-defaulting FCMs were to accept, under-collateralized open positions in the midst of a financial crisis, this would create substantial systemic risk.

The NPR does not address the potential for a shortfall in an FCM's cleared swaps customer account to be exacerbated by the netting of settlement variation payments and the pre-funding of both margin and settlement variation payments by the FCM (and other customers), which are essential features of the operational comingling that the Commission seeks to preserve. It also does not evaluate the manner in which the extended timeline may impair a DCO's ability to mitigate losses or its practical ability to transfer open positions of non-defaulting customers. The fundamental concern is that the simplicity implied by the NPR's description of "complete legal segregation" ignores the complexities of operational comingling and the extended timeline over which obligations are settled by customers to FCMs and by FCMs to DCOs. Those complexities, in turn, increase customers' exposure to fellow-customer risk and also increase the risks to a DCO and its financial safeguards package. They also decrease the likelihood that a DCO will be able and willing to transfer non-defaulting customer positions and collateral, undermining the enhanced-portability objective that the Commission seeks to promote. The extended operational timeline and the degree to which price moves in the market and customer activity can produce material changes in a "portfolio of rights and obligations" further undermines the proposal's goals.

D. Portfolio Changes

In addition to the unanswered questions concerning the application of CLSM given the complexities of clearing operations through multiple tiers, multiple DCOs and comingled accounts, the NPR fails adequately to address the consequences of the substantial changes that can occur in a diverse comingled customer account over the course of one clearing cycle. As noted above, the NPR is clear that the DCO must act on the basis of the portfolio report that was delivered to it by the defaulting FCM for the prior clearing cycle. The positions, collateral and even the customers carried in a customer omnibus account can change from one clearing cycle to another. Such changes are more likely to be substantial in a time of extreme financial stress, as may well be the background where a customer default also leads to the default of a clearing member. As noted at several points in the NPR, if an FCM is troubled, customers may rapidly close out or transfer positions to another FCM. How then, is a DCO properly to allocate collateral? Unless no activity occurs in the clearing cycle as to which the default occurs (highly unlikely), the portfolio report will necessarily describe collateral held with respect to some positions that no longer exist, will cover open trade equity and excess margin that may since have been withdrawn by customers, and will *not* cover the collateral that will be delivered to the FCM (and in turn the DCO under proposed regulation 22.14) with respect to the clearing cycle as to which the default occurs. The plain text could require a DCO to allocate collateral to customers that no longer exist in the account, or to allocate collateral posted with respect to new positions (or even by new customers) for the benefit of existing customers and positions that may no longer exist. The NPR acknowledges but greatly downplays the risks associated with such changes in a portfolio from one clearing cycle to another in footnote 185:

As noted above, this model would leave some residual fellow-customer risk because the DCO would allocate collateral between defaulting and non-defaulting customers based on information the FCM provided the day before the default, so the allocation would not reflect movement in the cleared swaps portfolio of customers on the day of default.²⁴

Although it acknowledges the risks, the NPR and the proposed regulations do not clarify how such risks are to be managed. Footnote 185 indicates that the risks associated with such changes fall to customers in the comingled account, but the NPR makes no effort to illuminate the manner in which customers that suffer losses due to such risks would be able to recover them.

In addition to the magnitude of the changes that may occur in customers' positions and collateral requirements over the course of one clearing cycle, we believe the proposal's implicit suggestion that one day's changes represent a limited amount of risk underestimates the degree to which changes in the market can create additional risk. For example, on October 13, 2008, in the midst of the financial crisis surrounding the failure of Lehman Brothers, the equity markets moved by more than 11% and the S&P 500 index experienced a 104-point daily settlement price change. This resulted in the movement of more than \$18.5 billion in settlement variation payments among CME Clearing and its clearing member firms. While this represents an extreme change relative to more normal trading days, the trading days up to and including a major default are, of course, highly likely to involve volatile price changes and substantial trading activity.

E. Accuracy of Portfolio Information

The cornerstone of the CLSM proposal is the DCO's obligation to adhere to the information set forth in the "portfolio of rights and obligations" that it receives from the FCM. Under the proposed regulations, the DCO is obligated to allocate collateral on the basis of such information because it must comply with the fundamental prohibition of proposed Regulation 22.15, which states that the amounts owing to each customer in respect of the portfolio "shall not be used to margin, guarantee, or secure the Cleared Swaps or other obligations of ... any other Cleared Swaps Customer."²⁵ In other words, the DCO is both obligated and entitled to rely upon the information that it received from the defaulted FCM. Consequently, the accuracy of such information is critical. While the FCM community will be better positioned to comment on this obligation, CME believes, based on decades of clearing experience, that it is relatively unlikely that the information received from an FCM each day will be 100% accurate. The accuracy of the information that a clearing member FCM can produce to a DCO with respect to each ultimate cleared swaps customer – presumably within hours of the conclusion of a particular trading date or clearing submission cycle – is impacted by many factors, including the number of customers for which the FCM clears, whether such customers are cleared directly by the clearing member FCM or whether it must rely on information provided by another "depositing FCM" that clears through it, whether foreign broker omnibus accounts are included, whether authorized account controllers are permitted to do post-submission give-ups and allocations and the degree to which they do so, and the overall effectiveness and accuracy of the FCM's recordkeeping systems. While the proposed approach may be effective for a relatively small number of cleared swaps customers that clear directly through a clearing member FCM,

²⁴ 76 Fed. Reg. at 33848.

²⁵ 76 Fed. Reg. at 33856.

we are concerned that in other circumstances the accuracy of the portfolio information may be undermined.²⁶

Additionally, in a situation where an FCM has defaulted on its obligations to one or more DCOs, it is entirely possible that the FCM or its parent company has been under severe financial stress for some period of time, as was the case with the failure of Lehman Brothers. In such circumstances, systems are more likely to fail, particularly to the extent that they rely upon experienced back office employees to enter data, make corrections or monitor for compliance and accuracy. Financial markets may be highly volatile (as they were around the failure of Lehman Brothers), potentially increasing the amount of activity that the stressed FCM must process and decreasingly the likelihood that equally stressed back office staff will identify and resolve reporting errors. For example, we reiterate the observations concerning the operational capacity of Lehman Brothers in the period leading up to its failure that are outlined in the Preliminary Investigation Report and Recommendations of the SIPA Trustee.²⁷ The report describes a “rushed, confused, uncertain and near-panic atmosphere” in which (i) some employees “simply did not show up for work, or showed up without any incentive” to do the work required to wind down LBI’s business, (ii) employees who did show up “would have encountered little direction from management, which was distracted”, (iii) the settlement bank “shut off access to information systems that [Lehman] ... used to monitor account activity”, and (iv) an increasing number of customers were removing their assets and accounts, particularly in connection with the insolvency proceedings of Lehman Brothers International Europe, the principal European broker-dealer affiliate, creating confusion concerning the appropriate allocation of assets.²⁸

The DCO must rely upon the portfolio information to effectuate hedging, liquidations, allocations of collateral and transfers to alternate FCMs, and indeed under the proposed regulations it is legally obligated to do so. In a default scenario, the DCO will have neither time nor legal ability to resolve any apparent errors in the portfolio information. As noted above, the NPR and the proposed regulations do not provide adequate detail about the required contents of the portfolio report and the manner in which it is to be applied by a DCO in a default situation. But it is clear, as a matter of operational necessity, that the DCO must act on the basis of the open positions in its records and can only distribute the collateral that is already in its control or that is immediately delivered to it. If the information in the portfolio report is incorrect, the DCO’s allocations will also be incorrect. While the NPR is clear that investment losses should be allocated pro rata among all customers of the defaulted FCM, it not clear concerning the risks associated with misallocation of collateral generated by errors in the portfolio information. In order to act promptly, as it must to resolve a default, the DCO must be entitled to rely upon the portfolio report, even if it is wrong. Consequently, if the portfolio report information does not match the DCO’s records as to customer positions or a substantial shortfall exists between the collateral amount specified by the portfolio report and the actual customer account collateral within the control of the DCO, the DCO may be unable

²⁶ We further note that, pursuant to proposed Regulation 22.14(c), the defaulting FCM is required, with respect to *the cycle in which it defaults*, to deliver to the DCO all required customer collateral for non-defaulting customers and such lesser amount of any collateral held for any defaulting customers. We have similar concerns about the ability of the defaulted FCM, which may already have filed for bankruptcy protection, to timely and accurately fulfill this obligation, producing yet another area of potential errors and confusion.

²⁷ This report, cited in CME Group’s comment letter on the Commission’s ANPR concerning this topic, was prepared by the Trustee assigned under the Securities Investor Protection Act to the insolvency of Lehman Brothers, Inc., the joint broker-dealer / FCM entity that was a subsidiary of Lehman Brothers Holdings. A copy of the report may be found at: <http://dm.epiq11.com/LBI/Project/default.aspx>

²⁸ Trustee’s report at 34, 60, 65-66.

or unwilling to transfer positions of non-defaulting customers and will instead liquidate the entire customer account.

We do not understand the Commission's proposal to require that the DCO insure each customer against the risk of loss due to errors in the portfolio report produced by its FCM, and we believe that such an allocation of risk would be unreasonable. The proposed regulations do require the DCO to "take appropriate steps to confirm that the information it receives is accurate and complete, and ensure that the information is being produced on a timely basis," which verification requirement is in turn passed down through any additional layers of FCM clearing.²⁹ The NPR provides no additional information concerning the "appropriate steps" for a DCO to take, although it does state that "it is not the responsibility of the DCO ... to monitor or to calculate the extent to which a Cleared Swaps Customer has, in fact, posted excess of sufficient collateral." 76 Fed. Reg. at 33829. The Commission will need to provide further clarity as to what it intends each DCO to accomplish under the verification requirement. We note that FCMs are subject to compliance audits that are conducted for each FCM by the DCO serving as its "designated self-regulatory organization". Such routine DSRO audits generally occur annually. Requiring the DSRO auditor to more frequently audit an FCM's compliance with respect to the delivery of portfolio reports to multiple DCOs would add a new and complex dimension which would, of course, substantially increase costs. In any event, there is no practical way for a DCO – particularly in the midst of an imminent or pending default – to ensure that each preceding day's portfolio report information for the defaulting FCM was accurate and complete.³⁰

F. Likelihood of Transfer

For all of the forgoing reasons, CME Group believes that the likelihood that the Complete Legal Segregation Model will facilitate prompt transfers of open positions and associated collateral is significantly lower than implied in the NPR, leaving cleared swaps customers less secure than they anticipate. The risk of ultimate financial loss to customers due to a fellow-customer default is reduced but certainly not eliminated under CLSM. As noted above, there are a variety of circumstances under which there could be a shortfall in customer collateral that the DCO would be required under the proposed regulations to "allocate" ratably among non-defaulting customers. We anticipate that in a crisis situation, a DCO will only transfer positions of non-defaulting customers if those positions are fully collateralized at the receiving FCM. Non-defaulting customers may be obligated immediately to make up the shortfall in order to effectuate the transfer. Those customers that are not able to do so would likely have their positions liquidated by the DCO. Additionally, if there are apparent errors in the portfolio report on which the DCO must rely, the DCO may similarly conclude that its safest and most equitable response is to liquidate the positions in the customer account of the defaulted FCM and use only the collateral that is attributed to the defaulting customer per the report, leaving the remaining proceeds of liquidation to be distributed by the FCM's bankruptcy trustee. Accordingly, we believe that the operational realities of clearing and the need for prompt resolution of any default make it unlikely that a DCO will be able to transfer open customer positions in a customer account that is in default. The DCO's primary obligation, first and foremost, is to contain systemic risk. In a crisis environment, the additional activities required to

²⁹ 76 Fed. Reg. at 33839, discussing Proposed Reg. 22.11(e) and its intended application.

³⁰ The Commission's expectations with respect to the "appropriate steps" that each DCO must take to evaluate the accuracy of the portfolio reports, along with clarity as to the specific contents of those reports, will of course have a substantial impact upon costs. If the portfolio reports are to provide a full breakdown of all forms of collateral at all levels of clearing for each end customer, allocated specifically to each DCO, then the requirements to audit for accuracy and do so more frequently will increase costs exponentially.

achieve customer transfers –allocating non-defaulting customers’ collateral individually, securing additional collateral and information from a failed clearing member, securing additional collateral if necessary directly from customers, identifying a new clearing member or clearing members to receive such positions and collateral and then completing the transfers – would, we believe, expand overall risks rather than contain them.

G. Legal Segregation with Recourse Model

The NPR seeks comment on whether the Commission should adopt, as an alternative to CLSM, the “Legal Segregation with Recourse” Model. This alternative model is identical to CLSM, except that it permits non-defaulting customers’ collateral to be accessed in the event of a default, but only at the end of the DCO’s “waterfall”, after other resources in the DCO’s financial safeguards package are exhausted. Consequently, all of the operational risks and costs described in Part II of this letter with respect to CLSM apply equally to the Legal Segregation with Recourse Model. Because the DCO ultimately is able to access the collateral of non-defaulting customers in order to avoid its own default and insolvency, the model theoretically lessens the degree to which DCOs would need to increase their financial safeguards packages and/or margin requirements, one improvement over CLSM from this perspective. However, because the amount of collateral attributable to non-defaulting customers that ultimately will remain is unknown, the prompt transfer of those customers’ open positions to other non-defaulting FCMs is even less likely than under CLSM.

CME Group urges the Commission to reject the Legal Segregation with Recourse Model for all of the same reasons that CME Group urges the Commission to reject the CLSM proposal. Moreover, as an alternative to CLSM, the benefits that Legal Segregation with Recourse would offer in terms of cost reduction are, we believe, too uncertain to justify selecting this model over any other.

CME Group agrees that either “Legal Segregation” model would, on its face, lead to greater protection of cleared swaps customer collateral against fellow-customer risk than the Futures Model. CME Group also agrees that these models are more likely to facilitate portability of cleared swaps customer positions than the Futures Model, in the event of an FCM default in its cleared swaps customer account – but the degree to which transfer rather than liquidation is likely is highly limited and would depend entirely on the facts and circumstances that appear at the time of an FCM default. Accordingly, we feel strongly that the increased protection and possible enhancement to portability are not sufficient to satisfy the concerns of the customers that raised these issues. In short, the Complete Legal Segregation Model is a proposal that appears satisfactory on paper, but disregards a large number of practical realities. The Legal Segregation with Recourse Model suffers from the same defects, though without purporting to provide as much protection for non-defaulting customers’ collateral. We are concerned that the CLSM proposal, as outlined in the proposed regulations, will add costs and operational complexity to swaps clearing, but will fail exactly at the moment that it matters most.

CME Group believes that the only approach that will adequately protect cleared swaps customers against fellow-customer risk, without needlessly increasing costs or operational burdens, is one that allows those swaps customers that are most concerned to secure such protection to “opt out” of the comingled swaps customer accounts maintained by their FCMs into separate, fully segregated accounts.

III. The Optional Model

CME Group believes there would be advantages to establishing a legal and regulatory framework that would permit certain cleared swaps customers that desire or require for any reason full physical segregation of their cleared swaps contracts and associated collateral to opt out of the comingled customer account of their FCM. The right of the customer to opt out would be subject to the consent of both the DCO and the relevant clearing member FCM. The requirements to support such accounts would still inject additional risk costs and operational costs into the system, but such costs would be substantially lower than for a full physical segregation model, and the optional nature of the program would permit many of the additional costs to be allocated only to those parties choosing to participate. Moreover, we believe that a targeted physical segregation program could be accomplished in the near term.

A. Benefits and Costs

The most important benefit of such a framework is that it would work in actual practice. In a default situation, the DCO would be able immediately to “transfer” the physically segregated customers of a defaulted FCM to the control of a non-defaulted FCM without undue financial or operational risk. Furthermore, if the FCM defaulted because of the failure of an individually segregated customer to meet its obligations to the DCO, the DCO could also more easily transfer the comingled customer account carrying the cleared swaps contracts and associated collateral of those customers that did not opt out, providing those customers with additional protection against the failure of a segregated customer. In such a model, the necessary information will exist at the clearing level to identify the defaulting customer account at the moment of default. There would be no delay in critical information reaching the DCO, no risk that the DCO cannot properly identify the collateral that it can use to cure the default and separate it from the collateral that it cannot use, no need for the DCO to allocate shared investment losses or other losses prior to “allocating” collateral, and no additional operational friction from the requirement that the DCO “unscramble the eggs” in the midst of a crisis – which friction would be significant even if the DCO had completely accurate information concerning collateral attribution for the exact moment of the default and no shortage of any kind to allocate among non-defaulting customers.

We believe an opt-out model would both limit the additional costs imposed on the industry and allow those costs to be allocated in a manner that more closely aligns to the benefits being provided. Certainly an opt-out model would be less costly than a full physical segregation model for all customers, which we believe is the only other model that would truly provide thorough protection against fellow-customer risk at the moment that such protection is actually needed. The operational costs of the separate account would be borne primarily by the customer that elected to opt-out, its FCM and the DCO. Depending on how many customers opted-out, increases in guaranty fund requirements or margin requirements to cover additional risk may be reduced, and again it will be possible to target any such increases at the participants in the opt-out system.

A further benefit of an appropriately structured opt-out model is that it would better preserve the existing business model of the FCM community. As noted in our comment letter on the ANPR, we are concerned that the increased costs of a mandatory individual segregation model (either “legal” segregation or full physical segregation) could force smaller FCMs out of the business or discourage new entrants. While we expect that DCOs would be, and should be, required to support opt-out models, we do not believe that it would be necessary for the Commission to require that all FCMs support such a model. Because the

customers most likely to opt-out are large pension funds and asset managers with broad and diverse financial services needs, we have no doubt that multiple FCMs affiliated with major financial institutions would compete to secure such customers' business even in the absence of a requirement that they do so. Such FCMs are already better-positioned than many smaller FCMs to support an individual segregation model. Those FCMs that chose not to support the model could continue to offer cost-effective clearing services to those customers that do not use individual segregation. Additionally, the credit quality and risk management practices of FCMs will continue to be relevant considerations for those customers that do not opt out, preserving another area of competition among FCMs.

B. Possible Structure for Individual Opt-Out

CME Clearing has engaged in initial customer discussions concerning the structure of an opt-out model. One possible approach would be the use of multi-party agreements among the DCO, a settlement bank designated as custodian, the customer and the customer's sponsoring FCM clearing member. The DCO would offer a model agreement to customers and FCMs and designate settlement banks that agree to participate in the program. The DCO's rules would likely be amended to support the program as well.³¹

A separate account at the settlement bank would be established for each opt-out customer pursuant to the rules of the DCO and the multi-party agreement executed by the customer. Operationally, the account would be managed in the same way at the clearing level as a comingled FCM customer account, except that it would be designated in the name of the customer or the DCO and not the FCM. The DCO would calculate separate variation payment and margin requirements for the account, and process separate banking instructions for settlements in respect of each clearing cycle. The customer's FCM would have control rights with respect to the account, permitting it to process transactions and perform other services for the customer with respect to its cleared swaps activity. The FCM may advance funds on the customer's behalf in order to cover any net payment obligations of the opt-out account to the DCO for particular settlement cycles.³² The FCM would also be required to guarantee the obligations of the account to the DCO, and the risks presented by each such FCM's opt-out accounts will be included in determining its required contribution to the DCO's financial safeguards package.

C. Legal Framework for Individual Opt-Out

The NPR expresses concern that an optional model that allows some swaps customers individually to "opt out" of the comingled customer account does not comport with the requirement under Section 766(h) of the Bankruptcy Code that the trustee in a commodity broker liquidation "distribute customer property ratably to customers."³³ While we agree that further evaluation is required as to the legal framework for an opt-out model and the manner in which the Bankruptcy Code and the CFTC's Part 190 regulations

³¹ Additional suggestions and information concerning how such a model might work are outlined in the comment letter submitted by Jerrold Salzman, a copy of which may be found at:

<http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47948&SearchText>

³² Determining the optimal cash flow structure for opt-out accounts is obviously an area that requires further evaluation. The FCM may or may not advance funds on behalf of the opt-out customer, and such advances might be drawn directly from the FCM's account rather than from the opt-out account. A key feature of an opt-out structure, however, is that the customer would never pass its own funds through its FCM to support its obligations to the DCO, but rather would deposit such funds directly in the segregated account. This limitation ensures that at no time will the FCM hold any obligation owed to the opt-out customer that would need to be included in the FCM's calculation of its own net capital requirements or the amounts required to be carried in its customer sequestered accounts. The assets in the opt-out customer's separate account would not be considered sequestered assets of the FCM.

³³ 11 U.S.C. 766(h). See discussion at 76 Fed. Reg. at 33829.

would apply, we believe that the property contained in an individually segregated customer account as described above would not need to be subject to ratable distribution. First, if FCM's role with respect to an opt-out customer is to process transactions conducted through the opt-out account and perform other back-office services, serve as guarantor of the opt-out account's obligations to the DCO, and perhaps to advance funds in support of the account's obligations, but never to receive funds owed to the account by the DCO or from the customer with respect to amounts owed by the account to the DCO, and never to hold assets in the account in its own name, then the opt-out customer does not clearly qualify as a "customer" of the FCM for purposes of the Code. A "customer" is defined, with respect to an FCM, as:

... [an] entity for or with whom such futures commission merchant deals and that holds a claim against such futures commission merchant on account of a commodity contract made, received, acquired, or held by or through such futures commission merchant ...³⁴

Moreover, the property contained in the account would not qualify as "customer property" under the Code, not only because the opt-out customer is not a "customer" within the meaning of the Code, but because the debtor FCM has no role in "receiving, acquiring or holding" such property on behalf of the customer. Under the Code, "customer property" is defined as:

Cash, a security, or other property, or proceeds of such cash, security or other property, received, acquired, or held by or for the account of the [FCM], from or for the account of a customer.³⁵

For those reasons, to the extent that an opt-out customer suffers a loss, its "claim" with respect to such loss would run against the DCO rather than the FCM, again removing the opt-out customer and the property in its account from the relevant definitions in the Code. These conclusions, we believe, could be further strengthened by additions to the rules of the DCO and the terms and conditions of a multi-party agreement establishing the opt-out account, which agreement would state that the opt-out customer would have no claim against the FCM with respect to any losses suffered in connection with commodity contracts made, received, acquired or held in such account. Additionally, the CFTC is granted explicit authority under Section 20 of the CEA to provide by "rule or regulation" that "certain cash, securities, other property, or commodity contracts are to be included in or excluded from customer property or member property."³⁶ Consequently, we believe that the CFTC could take further action to provide additional certainty of the treatment of property in an opt-out customer's account.

Again, CME Group urges the Commission to work with the industry, including DCOs, FCMs and interested buy-side participants, to further explore an opt-out solution that would provide true certainty that customers electing such an option (and thereby agreeing to bear any associated costs) would not suffer material disruptions to their trading activities or loss of their collateral were the FCM guaranteeing such account to the DCO to default in its comingled customer account. Our purpose in the framework we have suggested is not to assert that we are certain of each aspect of how an opt-out model would work in practice and in law, but to indicate that there are alternate paths that have not adequately been considered in the Commission's process and that deserve further analysis and comment by the public.

For example, we note that the provisions cited above that – we believe – would protect property held in an appropriately-structured opt-out account in an FCM bankruptcy do not apply in the same manner in the

³⁴ 11 USC 761(9).

³⁵ 11 USC 761(10).

³⁶ 7 USC 24(a)(1).

case of a DCO bankruptcy. A DCO bankruptcy is a matter that the CFTC has conceded would be a matter of first impression.³⁷ At first glance, we believe that the Commission could exercise its authority under Section 20(a) of the CEA to include such property within the definition of “customer property” and exclude such property from the definition of “member property” solely for purposes of the application of the Code in a DCO bankruptcy. Alternatively, it is possible that opt-out customers could be defined as a special class of clearing member at the DCO, thereby qualifying the property in the opt-out account as “member property” in the case of a DCO bankruptcy.³⁸ We acknowledge that in neither case would the opt-out customer’s desire to preserve its collateral against losses due to fellow-customer risk be fully satisfied. *However, the Commission’s CLSM proposal similarly does not fully protect non-defaulting customers against fellow-customer risk in the case of a DCO bankruptcy.* By making the inability of the DCO to access non-defaulting customers’ collateral to satisfy obligations to the DCO the cornerstone of the protection that the proposal provides, the CLSM proposal attempts to ensure that customers of a defaulted DCO will not have material claims to assert in the bankruptcy of their FCM. It does not change the status of that property, including any property that is transferred by the DCO, as “customer property” that is subject to ratable distribution. Consequently, in a catastrophic failure where a customer default leads to an FCM default that in turn leads to a DCO bankruptcy, the CLSM proposal does nothing to limit possible customer losses when compared to the existing baseline “Futures Model”.

D. Optional DCO Model Selection

The NPR also seeks comment on the practicability of establishing an “optional” model by allowing each DCO (rather than FCMs or customers) to select either CLSM or the Legal Segregation with Recourse Model. This approach is highly impractical, for a multitude of reasons. As described above, we do not believe that either the Complete Legal Segregation Model or the Legal Segregation with Recourse Model will work in practice. Both models disregard the complexities of the operational timeline, the netting of cash flows in operationally comingled accounts and the substantial risks associated with a DCO being legally obligated to rely on inaccurate or incomplete information. Additionally, we agree with the NPR’s implicit conclusion that for such an optional model to be effective no FCM could operate as a clearing member of DCOs that select different models. In essence, to offer its customers the choice that the proposal aims to permit, an FCM would have to divide into two separate legal entities, one to clear at DCOs offering CLSM and the other to clear at DCOs offering Legal Segregation with Recourse.

This approach would fragment the marketplace and inject enormous additional costs because FCMs would lose the capital efficiencies associated with operating as clearing members of multiple DCOs, among other costs. It is also likely that the benefits of creating such a regulatory structure would be illusory. At present, there are a limited number of DCOs that are clearing the major categories of swaps products, and so it is possible that all of the DCOs currently offering swaps clearing services would choose to offer CLSM, undermining any incentive to FCMs to make the necessary changes to support this form of “optional” model.

³⁷ See 75 Fed. Reg. at 17299-17300, discussing DCO insolvency questions in the context of the Commission’s publication of final rules concerning the customer sequestered account class.

³⁸ It appears that this second approach would produce the anomalous result that an opt-out customer would enjoy greater protection of its collateral than a comingled customer in an FCM bankruptcy, but lesser protection than comingled customers in a DCO bankruptcy.

IV. Statutory Considerations

In introducing CLSM, the NPR cites two elements of the segregation requirement set forth in the Dodd-Frank Act with respect to cleared swaps that it distinguishes from the parallel language contained in the CEA that applies to futures. With respect to futures contracts, Section 4d(b) of the CEA prohibits a DCO:

...that has received any money, securities, or property for deposit **in a separate account as provided in paragraph (2) of this section**, to hold, dispose of, or use any such money, securities, or property as belonging to the depositing [FCM] or any person other than **the customers** of such [FCM]. (Emphasis added).³⁹

With respect to cleared swaps, new Section 4d(f) prohibits a DCO:

...that has received any money, securities, or property for deposit **in a separate account or accounts as provided in paragraph (2) of this section**, to hold, dispose of, or use any such money, securities, or property as belonging to the depositing [FCM] or any person other than **the customer** of such [FCM]. (Emphasis added).⁴⁰

The Commission asserts that the addition of the words “or accounts” and the change from “customers” to “customer” indicates a Congressional intent that the Commission restructure the customer protection approach that has long existed for cleared futures and apply a different approach to cleared swaps. We disagree.

First, the clause in the two provisions that refer to “account” or “account or accounts” each in turn refer back to a preceding paragraph (2) of the relevant subsection of the CEA, which paragraphs contain the basic segregation requirement applicable to FCMs. The Dodd-Frank Act makes no relevant changes to either paragraph, which requires segregation of customer collateral and specifically prohibits comingling with the FCM’s collateral, but not the collateral of other customers, which is specifically *permitted* by the following paragraph of each of the futures and swaps sections of the statute.⁴¹ We think it is impossible to read any Congressional intent, let alone to pursue a change of such magnitude, into the addition of the words “or accounts”. It is factually true that FCMs establish multiple actual segregated accounts for several reasons: bookkeeping convenience, as required by the CFTC’s regulations with respect to different customer account classes, and for purposes of clearing through multiple DCOs, to name a few. This statutory language has always been understood to require segregation of customer property from the FCM’s property, whether in one or in multiple accounts. It has never been suggested to require segregation of each customer’s property into its own account, and indeed the Commission does not suggest otherwise in the NPR. Instead, the CLSM proposal continues comingling of cleared swaps customer collateral in a single account, as is expressly permitted by the statute.

We also cannot support the NPR’s suggestion that the elimination of a single letter “s” can amount to evidence of Congressional intent that the Commission institute wholesale changes to the manner in which customer funds are managed for cleared swaps transactions as distinguished from cleared futures transactions. The NPR suggests that another basis for Congress to seek a distinction between the treatment of customer funds for cleared swaps versus futures may be that “individual collateral protection

³⁹ 7 USC 4d(b).

⁴⁰ 7 USC 4d(f).

⁴¹ See 7 USC 4d(a)(2), covering futures, and 7 USC 4d(f)(3)(A), covering swaps.

[is] currently available in the swaps markets” as contrasted to the futures markets, where it has long been understood that a DCO may access customer funds contained in an FCM’s segregated customer account (or accounts) to satisfy obligations to the DCO arising out of that account class. Again, we respectfully disagree. Congress may have been aware of the distinction, and it is possible that the concerns that have been expressed to the Commission would also have been expressed to Congress. However, we find it impossible to accept that if had Congress been aware of the concerns and determined to act, it would have done so by eliminating a single letter “s” in a statute that contains derivatives regulation reform running many hundreds of pages.

Federal lawmakers can and will be explicit about customer protection concerns and about changes that they expect regulatory agencies to effectuate in implementing regulatory reform. The Dodd-Frank Act contains dozens of separate provisions instructing the CFTC to promulgate rules implementing a particular statutory objective, but a wholesale change to the customer protection regime under which FCMs and DCOs operate is not one of them. Moreover, Congress would not need to look far to identify language addressing customer protection issues. The very paragraph (2) cited in the provisions on which the NPR relies for its evidence of Congressional intent expressly prohibits the use of the customer property contained in the account (or accounts) “to margin or guarantee the trades or contracts, or to secure or extend the credit, of any customer or person other than the one for whom the same are held.”⁴² This prohibition, which is quite specific about the protection of the interests of one customer versus the interests of other customers, has long been understood to prohibit *an FCM* from using one customer’s funds to satisfy the collateral requirements applicable to other customers. However, it has never been understood to prohibit a DCO from accessing customer funds contained in an FCM’s segregated customer account (or accounts) to satisfy obligations to the DCO arising out of that account class.

Finally, we note that Congress *did* clearly instruct the CFTC to pursue certain changes that would impact the handling of customer funds. For example, Congress explicitly instructed the Commission and the Securities and Exchange Commission to pursue a solution to permit portfolio margining of customer funds: “...the Commission shall consult with the Securities and Exchange Commission to adopt rules to ensure that [transactions subject to portfolio margining and accounts in which they are held] are subject to comparable requirements to the extent practical for similar products.” To further implement that goal, Congress also explicitly instructed the Commission to exercise its authority under Section 20(a) of the CEA to include any securities that are held in a portfolio margining account that is carried as a futures account within the definition of “customer property” for purposes of the Bankruptcy Code.⁴³ Congress’ clear and explicit instructions to the Commission on the subject of effectuating portfolio margining between futures accounts and securities accounts makes it highly doubtful that Congress intended such subtleties as the change of one word from the plural to the singular to be read by the Commission as direction to alter the well-established legal regime that applies to the treatment of customer funds in the event of an FCM bankruptcy.

V. The Futures Model

For all of the reasons noted above, CME Group urges the Commission to continue to apply the baseline “Futures Model” to cleared swaps contracts. As set forth in our comment letter on the ANPR, the Futures

⁴² 7 USC 4d(a)(2). The comparable provision for swaps is *identical* but for the addition of the word “swaps” before the word “customer”. 7 USC 4d(f)(2)(B).

⁴³ See Sec. 713(a), (b) and (c) of the Dodd Frank Act, amending new paragraph (C) to section 15(c)(3) of the Securities Exchange Act of 1934 and new paragraph (h) to section 4d of the CEA.

Model has been highly effective to protect customer interests in past clearing member failures, so much so that that the Trustee under the Securities Investor Protection Act for the Lehman Brothers Inc. bankruptcy recommended that the model employed on the futures side for sub-categories of customer property be evaluated for adoption with respect to securities positions and associated collateral as a means of permitting more prompt distribution and bulk transfer of categories of customer property not directly impacted by the insolvency.⁴⁴ More importantly, for the reasons described above in this letter, continuing to apply the Futures Model to swaps clearing is the *only* approach that provides both legal and operational certainty to all parties in the event of an FCM default.

VI. Conclusion

No participant in the financial services industry could fail to appreciate the enormous change that the Dodd-Frank Act will bring to the trading and risk management of swaps products. For the past two years, CME Group has devoted substantial efforts to working with the swap dealer community, FCMs and customers to develop and implement its swaps clearing offering. We recognize that swaps customers are accustomed to very different practices as relates to the pricing, structuring, collateralization, risk management, mark-to-market and settlement of swaps products as compared to traditional exchange-traded futures products. Where possible, we have adapted our practices and offering to better serve swaps customers' needs, and we will continue to do so. The practices and legal framework that have served the futures industry for many decades will not always be a good fit for swaps customers with different needs and objectives. We support further exploration of these issues and the development of solutions that will meet the needs of all market participants, provide legal certainty as to the outcomes in an FCM insolvency, and also be subject to effective implementation on an operational level without broadly imposing unnecessary costs or creating undue operational risk.

We urge the Commission not to implement the amendments to 17 CFR Parts 22 and 190 that are proposed in the NPR. The Dodd-Frank Act does not seek to change the legal framework for the treatment of cleared swaps customer collateral when compared to futures customer collateral. Instead, we urge the Commission to identify objectives, participants and a reasonable timeline for completing an analysis and developing recommendations concerning whether and in what manner the treatment of customer collateral for cleared swaps should be altered. In such a process, no option, including seeking appropriate amendments to the CEA or the Bankruptcy Code, should be viewed as "off the table". In the meantime, the Commission should proceed to implement swaps clearing employing the baseline "Futures Model" and support voluntary efforts by DCOs, FCMs and customers to establish individual opt-out accounts on a pilot program basis. The Commission should not mandate any permanent changes to this long-successful framework unless it is clear that a new approach will work both legally and in practice, taking into consideration the complexity of the operational requirements for cleared derivatives and the costs that will be incurred by all parties in making substantial changes.

⁴⁴ See Preliminary Investigation Report and Recommendations of the SIPA Trustee at 130. A copy of the report may be found at: <http://dm.epiq11.com/LBI/Project/default.aspx>

David Stawick
August 8, 2011
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CME Group thanks the CFTC for the opportunity to comment on this matter. We would be happy to discuss any of these issues with CFTC staff. If you have any comments or questions, please feel free to contact me at (312) 930-8275 or Craig.Donohue@cmegroup.com; or Ann Shuman, Managing Director and Deputy General Counsel, at (312) 648-3851 or Ann.Shuman@cmegroup.com.

Sincerely,

A handwritten signature in black ink that reads "Craig S. Donohue". The signature is written in a cursive, flowing style.

Craig S. Donohue

cc: Chairman Gary Gensler (via e-mail)
Commissioner Michael Dunn (via e-mail)
Commissioner Bart Chilton (via e-mail)
Commissioner Jill Sommers (via e-mail)
Commissioner Scott O'Malia (via e-mail)
Ananda Radakrishnan (via e-mail)
Robert Wasserman (via e-mail)
Jon DeBord (via e-mail)
Martin White (via e-mail)
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