

Cleared OTC CDS Buy-side Solution Frequently Asked Questions (FAQ)

Background Information

CME Group, the world's largest and most diverse derivatives marketplace, clears both exchange-traded futures and options, as well as over-the-counter (OTC) derivatives listed for clearing only, and has developed a clearing solution for OTC credit default swaps (CDS) that is open to all market participants eligible to trade OTC CDS. The CME Clearing structure protects market participants by acting as a counterparty to, and thereby guaranteeing financial performance of every cleared trade, rigorously enforcing risk management discipline and appropriate collateralization, and supporting its performance guarantee with the resources of the world's largest clearinghouse mutualization structure.

Cleared OTC CDS can be cleared through CME ClearPort, which is a set of flexible clearing services open to OTC market participants. These services help customers substantially mitigate counterparty credit risk and provide capital efficiencies across a wide range of asset classes.

An Open-Access CDS Solution: Cleared OTC CDS

CME Clearing provides participants with an open-access clearing solution for OTC CDS. This solution builds on the existing OTC market, with CDS contracts that are economically equivalent to the current OTC contracts, and incorporates proven structural benefits of the futures market to deliver:

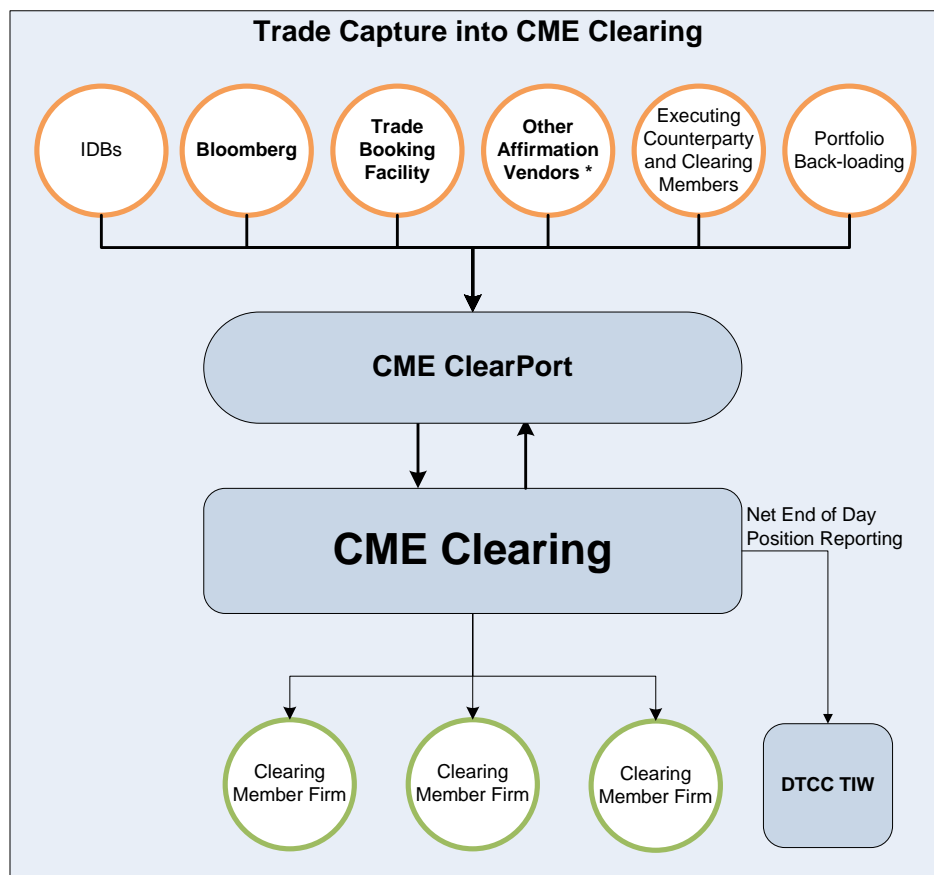
- **Customer protection:** A time-tested regulatory segregation and portability framework that protects both customer positions and margin in the event that a clearing member defaults
- **Point of trade clearing:** Clearing CDS trades real-time throughout the day, every day providing immediate cleared trade confirmation, significantly reducing the credit exposure between bi-lateral parties
- **Sound, transparent and replicable margin regime:** CME has developed a multi-factor portfolio margining regime specific to CDS products
- **Migration of existing trades:** Migration of legacy non-cleared positions to cleared trades, simplified through use of existing market infrastructure
- **Operational efficiency:** The ability for investors to leverage their existing relationships and connectivity with CME clearing members
- **Experience:** CME Group's more than 100 years of experience in clearing, settlement and risk management

CME Clearing enforces a rigorous risk management regime, featuring a newly developed multi-factor algorithm, which efficiently and accurately captures the risk of CDS portfolios. Because of this proactive and rigorous risk management process, CME has never suffered a clearing firm default in more than a century of operation

How does the Cleared OTC CDS solution work?

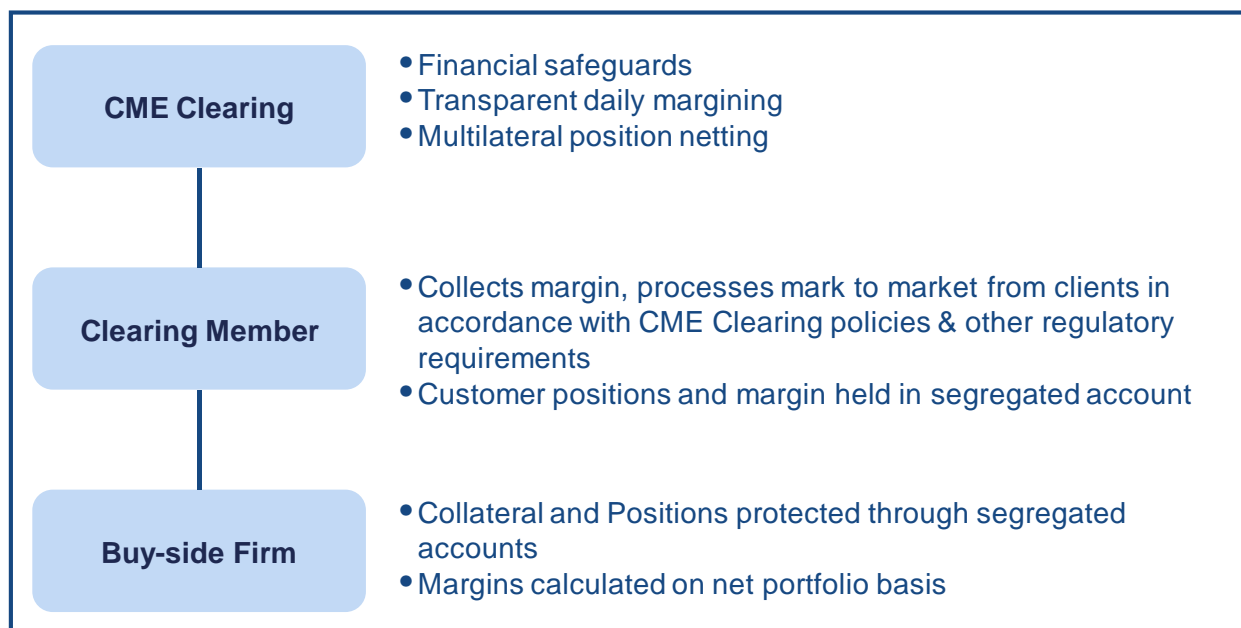
Cleared OTC CDS aligns to industry commitments by delivering a strategic vision forward. Participants continue to negotiate trades bilaterally through existing execution methods: voice, electronic, IDB, etc. At the point of trade, CME Clearing offers both web-based user interfaces as well as application programming interfaces (APIs) which provide an efficient means of submitting privately-negotiated trades to CME Clearing.

CME Clearing supports the clearing of both new trades at the point of trade as well as the submission of legacy positions, and enables trades to be submitted directly by participants through 3rd party providers. These operational efficiencies have also further enhanced and streamlined the allocations process for buy-side firms.



As a buy-side participant, how do I face CME Clearing?

CDS clearing membership with CME is open to qualified participants. Only qualified CME CDS clearing members can directly face the clearing house. Non-clearing member participants (“customers”) must clear their trades through a clearing member that is registered with the CFTC as a Futures Commission Merchant (“FCM”). Customers who are not clearing members generally contract with a clearing member that is a registered FCM to clear on their behalf. Customers may also have an account with a non-clearing member FCM that has omnibus account with a clearing member. A customer’s performance in positions in CME cleared products is financially guaranteed to CME Clearing by that clearing member, thus protecting the integrity of the Clearing House. A customer’s risk to its clearing firm is managed through applicable CFTC regulation, which mandates segregation of customer positions and property from the positions and property of the clearing firm.



What are CME’s clearing membership requirements?

CME Group currently requires that clearing members clearing CDS for solely their own account or for customers to maintain adjusted net capital of at least \$300 million, evidence appropriate experience in the CDS market commensurate with their anticipated clearing activities, participate in CME Clearing’s CDS default management and daily mark-to-market process, and have requisite risk management and operational capabilities and infrastructure in place to support CDS clearing.

What products will be cleared?

CME Group has the broadest approved initial CDS product scope of all the central counterparty clearing offerings. CME Group's initial product scope includes:

- CDX Indices: IG, HVOL, and HY; Series 8 and higher; 3, 5, 7, and 10 year tenors
- iTraxx Indices: Europe, HVOL, and XO; Series 7 and higher; 3, 5, 7, and 10 year tenors
- iTraxx Indices: Financial Sr. and Financial Sub; Series 7 and higher; 5 and 10 year tenors
- All single name constituents, with standard coupons, in the offered CDX and iTraxx indices for any IMM maturity date up to ten years
- Select liquid single names, with standard coupons, that are not included in the listed indices with IMM maturity date up to ten years

What is the margining framework?

Customers benefit from the CME Clearing framework because the performance bond, or “margin” methodology utilized by CME Clearing on its clearing members, is consistent, transparent, and published so that all market participants can estimate their own margin requirements. CME Clearing's newly-developed multi-factor CDS margining algorithm, which is also available for use on a PC-platform, has been vetted with outside expert consultants. See www.cmegroup.com/cds for a copy of the consultant analysis.

While clearing members may choose to assess a higher margin level on their customers (to account for clearing members' counterparty risk assessment of their customers), CME Clearing's published margin levels serve as a benchmark to which all market participants can refer.

Each individual customer receives the full benefit of any risk offsets in their account as recognized by the portfolio-based, multi-factor, risk-based margin calculation.

Where is my margin held?

Clearing members must appropriately and separately account for customer segregated and customer secured positions and property from proprietary positions and property on their own books and records, and at their custodians as well. Each clearing member generally will have two clearing level accounts for CDS: proprietary non-segregated, customer segregated, or, until CFTC issues an order under Section 4d of the Commodity Exchange Act allowing CDS to be held in the customer segregated account with U.S. futures and options, a customer secured account pursuant to CFTC Regulation 30.7.

Until such time as the CFTC issues a 4d order, CME Rule 8F03 requires customer funds and property for OTC Derivatives (including CDS contracts) to be held in a 30.7/secured account.

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

For more information on the Regulatory Treatment of Cleared OTC Transactions, please review the FAQ at http://www.cmegroup.com/clearing/files/CME-226_Cleared_OTC_Transactions_QxA.pdf

How am I protected if my clearing member defaults?

The CME Clearing mutualization framework relies on several layers of protection for market participants. In the case of a clearing member default due to its house activity, CME Clearing may take the following actions to satisfy the obligation: (i) take control of or liquidate any proprietary positions of that clearing member; (ii) apply the defaulting clearing member's security deposit and membership shares; (iii) apply CME Clearing's surplus funds of \$100 million; and (iv) apply CME Clearing's \$8 billion guaranty fund. In this default scenario, customers' positions and margin will be transferred to a solvent clearing member.

How am I protected if a customer of my clearing member defaults?

In the remote contingency that (i) a default occurred in the clearing member's customer account; and (ii) the defaulting customer's clearing member failed to meet its customer's obligations, CME Clearing will seek to liquidate the clearing firm's proprietary positions and property, including the defaulting firm's security deposit and membership shares. CME Clearing may then utilize non-defaulting customer positions and property of the clearing member to satisfy the obligation. If the obligation is still not satisfied, CME Clearing would then apply its \$100 million surplus funds and then its \$8 billion Security Deposit, or "guaranty fund".

In the more than 110-year history of CME Clearing, there has never been a failure by a clearing member to pay settlement variation or meet a performance bond call, nor has there ever been a clearing member failure resulting in a loss of customer funds.

How will CME determine end-of-day settlement prices?

CME CDS clearing members will be required to submit actionable CDS price levels for the full term structures for all indices and single-name reference entities by seniority, restructuring type, and currency eligible for clearing.

CME Clearing publishes settlement prices daily; these prices form the basis of the margin assessments, both initial and variation, it makes on its clearing members.

Are Cleared OTC CDS trades the same as futures trades?

No. They are privately negotiated swap trades that are centrally cleared by CME Clearing with all the accounting and processing benefits available on cleared contracts, while maintaining the flexibility and financial performance of an OTC CDS.

The CDS standard contract terms are designed to replicate the current OTC contracts as closely as possible.

How does CME Group’s Cleared OTC CDS solution add value and compare to OTC CDS contracts?

CME Cleared OTC CDS	Bilateral OTC CDS Contracts
Standardized coupons	Standardized coupons
Full multilateral netting - CME is the counterparty to every trade	Bilateral contracting
Adherence to ISDA DC determinations	Adherence to ISDA DC determinations
Hardwired to ISDA auction protocol	Hardwired to ISDA auction protocol
Daily mark to market	Collateralization requirements based on bilateral agreements
Transparent and replicable margin methodology	Collateralization requirements based on bilateral agreements

Who do I contact to learn more about CME Clearing’s CDS Solution?

Please contact:

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You may also visit www.cmegroup.com/cds

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