

## Regulatory Newsletter

### April 2008

This newsletter is designed to provide the CME Group Community with an update on regulatory issues that affect us and our markets. On a regular basis, we will work to provide you with a better understanding of our position on regulatory issues as well as provide you a greater context around the regulatory solutions being developed in our industry. This month we set out to provide you with more information on cross-margining.

### One Pot, Two Pots – Breaking Down the Industry Debate on Portfolio Margining Across Markets

Over the past several years, significant attention has been paid to the concept of portfolio margining between futures, securities and OTC markets. But what is portfolio margining, what are its benefits and where does CME Group stand on the topic?

Portfolio margining includes all positions of an individual or entity in one portfolio, assessing the true risk of portfolios that may include individual equity securities, broad-based and narrow-based indexes, index options, index warrants, related exchange-traded funds, related index futures and options on such futures. Portfolio margining algorithms, such as CME SPAN®, accomplish this assessment by viewing the possible profits and losses of a portfolio over a number of wide-ranging scenarios and setting the margin requirement for that portfolio as the worst possible loss. In contrast to margins set by strategy-based guidelines, risk-based margining provides customers with more efficient use of capital.

#### One Pot or Two?

##### One Pot:

- Provides most optimal level of economic risk offsets with collateral shared in a single account
- Requires a single regulatory, capital, customer protection and bankruptcy approach

##### Two Pots:

- No sharing of collateral in a single account, rather guarantees between clearing organizations
- Easily accommodates differences in customer protections between regulatory systems
- Provides greater bankruptcy protections

Portfolio margining can also occur across clearing organizations – “cross-margining.” An individual clearing organization can recognize a clearing firm’s open positions at other participating clearing organizations, and clearing firms are able to offset risks of positions held at one clearing organization against those held at other participating clearing organizations. Such an arrangement reduces the need for collateral deposits by the clearing firm. CME Group has led the derivatives industry in establishing cross-margining agreements with other leading clearing houses.

CME Group’s cross-margin programs consist of both a “one pot” arrangement (with the OCC) and “two pot” arrangements (with the FICC, LCH/LIFFE and NYMEX). In a one pot arrangement, daily cash settlements of option premium, futures variation payments, exercise settlement amounts and “original” margin are netted and paid by a member into a joint bank account or from a joint bank account to a member. Cash settlements between clearing organizations are made separately and netted across all clearing members having cross-margin accounts.

For more information on CME Group regulatory policy and activities, please contact: Richard Lamm, Managing Director, Regulatory Counsel at (312) 930-2041, Anne Bagan, Managing Director, Audits at (312) 930-3140 or Stephen Szarmack, Director and Associate General Counsel at (312) 648-5422.

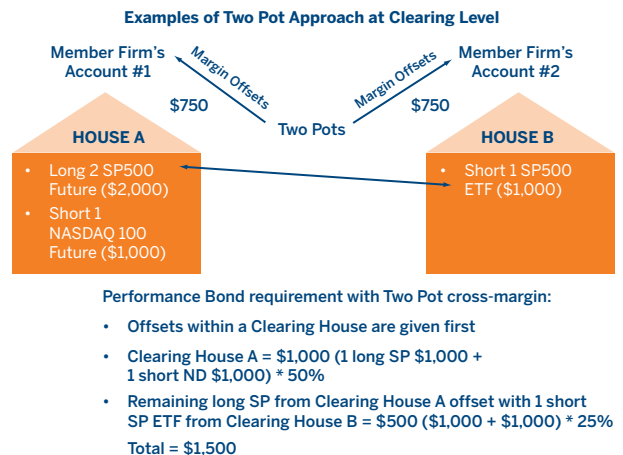
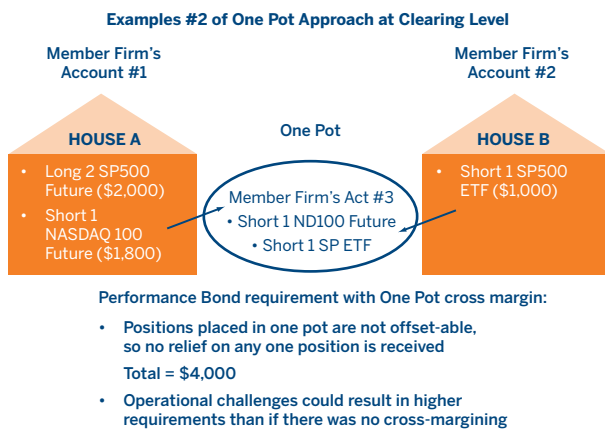
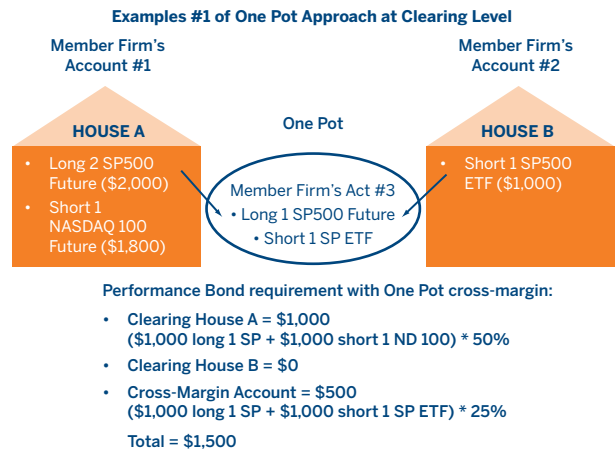
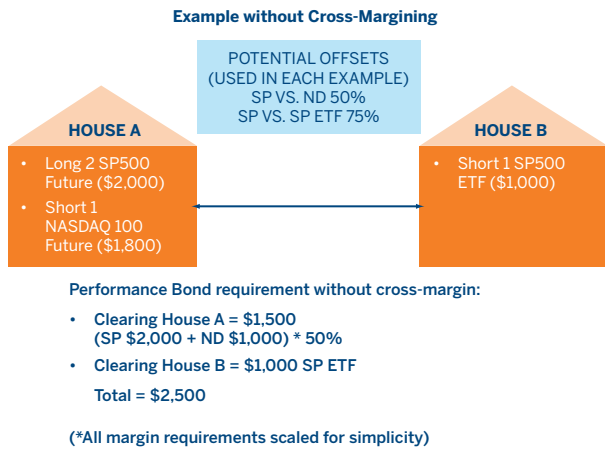
In a two pot approach, there is no sharing of collateral between clearing organizations. Instead, each clearing organization cross-guarantees to the other clearing organization the reduction in a participating clearing member's performance bond requirement.

The one pot approach generally provides the most optimal level of economic risk offsets, sharing collateral between clearing organizations in a single account. However, it also includes certain costs or complications, including the need to establish clarity around a single regulatory, capital, customer protection and bankruptcy scheme, which CME Group believes will be difficult to achieve. For instance, the CFTC's customer protection scheme involves segregating customer funds from the proprietary funds of the clearing member. Because of this protection, in a bankruptcy, all customers should receive all of their assets back from the defaulting firm and be able to transfer to another firm.

Under the SEC, customer funds are protected via insurance from the Securities Investor Protection Corporation (SIPC). However, SIPC specifically excludes futures positions from its coverage. Therefore, in a bankruptcy, if the portfolios were maintained under the SEC's regime, futures would be excluded from protection. In addition, the one pot approach carries with it significant operational impacts for the participating clearing members and the end users. For example, clearing members would be required to implement new procedures associated with a third account including balancing and posting of additional collateral.

In a two pot approach, the guarantees between clearing organizations do not represent a significant risk because of the protections provided in the applicable legal agreements and the cross-margining concept that a loss at one clearing organization is offset by an equal and opposite gain at the other clearing organization. In addition, because each clearing organization can run its existing settlement cycles, member firms do not need to implement any new operational procedures and each clearing organization can manage its own collateral deposits.

### Examples of Margin Differences Between One Pot and Two Pot Approaches



Having developed and implemented both one pot and two pot cross-margining arrangements, CME Group believes that there are benefits to both approaches. However, given the regulatory uncertainty and operational issues associated with proposed one pot approaches, CME Group is in favor of a two pot approach to cross-margining and portfolio margining.

The two pot approach easily accommodates differences in the customer protection mechanisms mentioned above and capital requirement structures, and is operationally transparent to both clearing members and end users.

A two pot methodology also provides greater certainty around the application of bankruptcy provisions. Allowing the positions to be set aside in separate clearing level accounts with each participating clearing organization allows for an evaluation of risk offsets that very closely approximates those available under a one pot approach. In addition, at the end user level, customers can achieve the same offsets in requirements that they would receive in a one pot arrangement, receiving recognition of futures, options and other products in a single portfolio. The goal of the two pot

approach would be to allow one pot to hold security related positions subject to securities laws and SIPC protections while the other pot would hold futures related positions subject to the Commodity Exchange Act and CFTC segregation protections.

While some industry participants have argued that the full benefits of cross-margining are not achieved through a two pot approach, such an approach certainly provides more benefits to participants than are currently available. CME Group continues to believe that portfolio and cross-margining programs are well intentioned and could result in performance bond reductions and cost savings for participants in the securities and futures industries. However, the real benefits of any proposals have not been realized due to various regulatory uncertainties or perceived regulatory conflicts. CME Group supports the idea of a two pot approach and believes that an important first step in making portfolio margining a reality across all product groups would be for the two pot approach to be accepted by the CFTC and the SEC and for the regulatory agencies to continue discussing portfolio margining and cross-margining in an effort to resolve regulatory issues. The two pot approach to cross-margining can offer a number of distinct advantages to the *status quo* and the one pot approach. They include:

**Performance bond reductions:** Participants in a cross-margining program are able to enjoy significant performance bond reductions through offsetting positions that are cleared at two different organizations. Through existing two pot programs, accounts that have offsetting positions in highly correlated products are still able to achieve performance bond reductions via recognized spreads agreed to by the clearing organizations.

**Regulatory Clarity:** The two pot approach already crosses different regulatory jurisdictions in the U.S. and outside the U.S. It allows products to continue to be appropriately margined under the rules and regulations that are in existence under each regulatory regime. By not imposing different rules on a market, each regulator can take comfort in its current practices for regulating intermediaries and safeguarding customer accounts. This approach is also likely to hasten the approval process by the regulatory authorities.

**Operational Efficiency:** Since the positions and collateral are held separately at clearing organizations, there is no need to identify positions and bring them into a separate one pot account requiring separate collateral from existing positions that are not cross-marginable. Current account structures could continue to exist with little added programming costs and greater operational ease while still allowing for significant performance bond reductions. Each clearing organization can continue to accept its full range of collateral without restricting collateral to forms accepted by the other clearing organization.