



## Special Executive Report

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S-5652

March 1, 2011

### Changes to CME Rules for IRS Clearing

**Effective March 2, 2011**, CME is adopting the following amendments and new rules for IRS clearing, including a new subchapter to the IRS Manual. A summary of the changes is provided below

#### Amended Rules:

- Rule 8G07: The Clearing House will provide at least 20 business days to IRS Clearing Members prior to implementing certain material changes to the methodology for calculating the IRS Guaranty Fund and IRS Assessments as further proscribed in the rule. If the change is due to applicable law, regulation or regulatory request, the Clearing House will provide at least 2 business days. The amendment also provides that a withdrawing IRS Clearing Member shall give customers 10 business days to close out or transfer its positions to another IRS Clearing Member after which the withdrawing IRS Clearing Member shall have the right to liquidate any such customer position that remains open.
- Rule 8G802.A.2: After satisfaction of a defaulted IRS Clearing Member's loss from its IRS proprietary account, the Clearing House must use excess proprietary account IRS Collateral of the defaulted IRS Clearing Member to satisfy IRS losses resulting from such defaulted IRS Clearing Member's customer account prior to applying such excess to losses in other product classes.
- Rule 8G802.H: The length of the IRS Cooling Off Period is extended to 25 Business Days and the IRS Guaranty Fund contribution and IRS Assessments during an IRS Cooling Off Period will be determined on the basis of the calculations for each IRS Clearing Member determined at the beginning of the related IRS cooling Off Period.
- Rule 8G913.B: Clarifies that a withdrawing IRS Clearing Member is subject to IRS Assessments for all defaults occurring during the IRS Cooling Off Period in which it withdraws.

#### New Rule

- Rule 90000.B: Parties to an IRS transaction rejected for clearing may bilaterally agree to maintain the transaction.

#### Addition to IRS Manual

- A Close Out section is added to Chapter 9 ("End of Day Valuations") of the IRS Manual providing for a methodology for close-out of IRS contracts in the event of a determination by

CME to wind-up down the clearing operations for IRS Products or an IRS Termination Event.

The texts of the amendments and new rule are set forth below, with additions underscored.

If you have any questions, please contact Tim Doar, Managing Director, Clearing House Risk Management, at (312) 930-3162, or Jason Silverstein, Director & Associate General Counsel, at 212.299.2228.

**CME Rule 8G07 IRS Financial Safeguards and Guaranty Fund Deposit**

1. (i) The Clearing House shall establish a financial safeguards package to support IRS clearing, and each IRS Clearing Member shall make an IRS Guaranty Fund deposit with the Clearing House. An IRS Clearing Member's deposit to the IRS Guaranty Fund and assessments against it pursuant to these Rules may be used to cover losses incurred by the Clearing House if a defaulted IRS Clearing Member's assets, including amounts available pursuant to any guarantee from an Affiliate of an IRS Clearing Member, available to the Clearing House are insufficient to cover such loss, regardless of the cause of default. The Clearing House shall calculate the requirements for the IRS financial safeguards package, which shall be composed of:

  4. (a) a funded portion, determined by the Clearing House using stress test methodology equal to the theoretical two largest IRS Clearing Member losses produced by such stress test or such other methodology determined by the IRS Risk Committee (such amount, plus any additional funds required to be deposited by IRS Clearing Members as a result of the minimum contribution requirement below, the "IRS Guaranty Fund"), and
  2. (b) an unfunded portion, determined by the Clearing House using stress test methodology equal to the theoretical third and fourth largest IRS Clearing Member losses produced by such stress test (and assuming for purposes of the model that already-defaulted IRS Clearing Members will fail to contribute) or such other methodology determined by the IRS Risk Committee. Upon a default, after application of the IRS Guaranty Fund, each IRS Clearing Member (excluding any insolvent or defaulted IRS Clearing Member) shall be subject to assessment of its previously-assigned proportionate share of such amount (collectively the "IRS Assessments").
- (ii) Each IRS Clearing Member's minimum contribution to the IRS Guaranty Fund shall be the greater of:

  - (a) such IRS Clearing Member's proportionate share of the share of the theoretical two largest IRS Clearing Member losses described in paragraph (i) above, each clearing member's relative portion being based on the 90-day trailing average of its aggregate performance bond requirements and average gross notional open interest outstanding at the Clearing House (or such other shorter time interval determined by the IRS Risk Committee); or
  - (b) \$50,000,000.
2. The Clearing House shall calculate the aggregate required IRS Guaranty Fund and IRS Assessments on at least a monthly basis, as well as each IRS Clearing Member's required contribution to the Guaranty Fund and its maximum IRS Assessment. The Clearing House may calculate such requirements more frequently than monthly should the risk profile of the top two largest net debtors change by more than 10% from the calculation for the prior period. Following any recalculation the Clearing House shall provide a report to each IRS Clearing Member showing the detail of its required deposit to the IRS Guaranty Fund and its maximum IRS Assessment. The notice shall specify the amount of any required additional deposit or any excess in the then-existing deposit amount. An IRS Clearing Member shall make any required additional deposit within two business days after delivery of such report and any reported excess may be withdrawn.

3. If the Clearing House determines that an additional deposit to the IRS Guaranty Fund is required from an IRS Clearing Member due to a material change in the business of such IRS Clearing Member (for example, but without limitation, changes pursuant to a merger or a bulk transfer of customer positions), where such change produces an increase in such IRS Clearing Member's aggregate performance bond requirements of 10% or greater, the Clearing House shall notify such IRS Clearing Member of the additional requirement and the IRS Clearing Member shall make any required deposit no later than the second business day following delivery of such notice.
4. Any changes to the methodology for calculating the IRS Guaranty Fund and IRS Assessments that results in a 15% increase to the IRS Guaranty Fund and IRS Assessments over a 30 day period shall be effective on the earlier to occur of (i) the 20th Business Day following the date the Clearing House provides notice to IRS Clearing Members of such change and (ii) the date reasonably determined by the IRS Risk Committee (which shall be no less than two Business Days following notice of such change to the IRS Clearing Members) if such increase is due to applicable law, regulation or regulatory request. IRS Clearing Members shall make any required additional deposit on or prior to the date such change is effective.  
Upon receipt of notice of a 15% increase to the IRS Guaranty Fund and IRS Assessments pursuant to the preceding paragraph, a IRS Clearing Member may immediately notify the Clearing House and such IRS Clearing Member's customers of its intent to withdraw from status as a IRS Clearing Member. The notice shall specify that customers must close out or transfer to another IRS Clearing Member their affected open positions, and that the withdrawing IRS Clearing Member shall have the right to liquidate any customer positions that remain open on its books after 10 business days have passed from the customers' receipt of such notice. If any customer fails to close out or transfer to another IRS Clearing Member during such 10 business day period, the IRS Clearing Member shall have the right to liquidate any such customer position that remains open on its books.  
For the avoidance of doubt, nothing in this Rule 8G07.4 shall apply to any increase to the IRS Guaranty Fund and IRS Assessments resulting from periodic calculations of the IRS Guaranty Fund and IRS Assessments pursuant to Rule 8G07.2 or any additional deposit to the IRS Guaranty Fund required by an individual IRS Clearing Members pursuant to Rule 8G07.3.

#### **CME Rule 8G802.A.2 Application of Defaulted IRS Clearing Member's Collateral; Rights and Obligations of Clearing House**

Upon the default of an IRS Clearing Member, all assets of such IRS Clearing Member that are available to the Clearing House, including without limitation IRS Guaranty Fund deposits including any excess amounts, IRS Assessments, performance bond amounts for IRS Contracts including any excess amounts, any partial payment amounts or settlement variation gains in respect of IRS Contracts, membership requirements relating to IRS Contracts pursuant to 8F04.7 and any other amounts on deposit with the Clearing House for IRS Contracts but excluding amounts carried in any customer account class (collectively, the "IRS Collateral") shall be applied by the Clearing House to discharge any loss to the Clearing House associated with such default (an "IRS Loss") in accordance with and subject to this Rule 8G802. An IRS Loss shall include, but shall not be limited to, costs associated with the liquidation, transfer and managing of IRS Contracts of the defaulted IRS Clearing Member, hedging costs and other costs incurred by the Clearing House related to managing the risk surrounding the default of the IRS Clearing Member.

An IRS Loss arising in the defaulted IRS Clearing Member's proprietary account class shall be satisfied from the IRS Collateral. An IRS Loss arising in the defaulted Clearing Member's customer account class shall be satisfied by application of performance bond, excess performance bond and settlement variation gains ("IRS Customer Collateral") held in the customer account class in

which the IRS Loss is generated, if such IRS Loss must be satisfied prior to finalization of IRS Losses in the defaulted clearing member's proprietary account and the determination whether any IRS Collateral remains that may be used to satisfy such IRS Loss.

During the clearing cycle in which the default occurs and any subsequent clearing cycles in which the Clearing House is managing and/or liquidating open positions in respect of the defaulted IRS Clearing Member, the Clearing House shall satisfy any settlement variation payment obligations related to IRS Contracts owed by the defaulted IRS Clearing Member to the Clearing House, or other realized losses of or expenses to the Clearing House with respect to the default only from the IRS Collateral, IRS Customer Collateral or other assets allocated to IRS Contracts, unless and until assets from other product classes become available pursuant to the rules governing default management for such other product classes.

After finalizing the IRS Loss of the defaulted IRS Clearing Member's proprietary account, the Clearing House shall reserve any excess IRS Collateral that remains first, to satisfy any IRS Loss arising in the defaulted IRS Clearing Member's customer account class for IRS Contracts, and second, to satisfy any losses to the Clearing House arising in other product classes, provided however that such excess IRS Collateral shall not be applied to an IRS Loss arising from the customer account class until after application of IRS Customer Collateral held in such customer account class ~~or a determination is made by the Clearing House that such IRS Collateral will not be required to satisfy any other losses to the Clearing House.~~

Any gains or excess performance bond or other collateral within the defaulted IRS Clearing Member's customer account class following final resolution of the defaulted clearing member's IRS Loss in such customer account class shall remain in such customer account class, where it may be used to satisfy losses to the Clearing House arising in such account class with respect to other product classes. Such assets shall not be added to the defaulted IRS Clearing Member's collateral generally. For the avoidance of doubt, as set forth in 8G802.G, the Clearing House shall not use performance bond amounts or other collateral in any customer account class of the defaulted IRS Clearing Member to satisfy a payment obligation to the Clearing House in respect of the defaulted IRS Clearing Member's proprietary account.

Should an IRS Loss continue to exist after application of the amounts above, any remaining deficiency shall be satisfied pursuant to the procedures in Rule 8G802.B. Any such amount shall continue to be a liability of the defaulted IRS Clearing Member to the Clearing House, which the Clearing House may collect from any other assets of such clearing member or by process of law

### **CME Rule 8G802.H Multiple Defaults**

"The provisions set forth in Rule 8G802.A and 8G802.B shall apply with respect to each default by an IRS Clearing Member. If more than one IRS Clearing Member default occurs at a time or in close sequence, including a default that occurs by reason of an IRS Clearing Member's failure to satisfy an assessment demand, the Clearing House shall manage the defaults separately. Upon a default, non-defaulted IRS Clearing Members shall be subject to a maximum obligation to contribute to the IRS Guaranty Fund and to fund IRS Assessments equal to the aggregate amounts set forth in Rules 8G07 and 8G802. This maximum shall apply from the date of the original default until the later of (i) the 20th-25th Business Day thereafter and (ii) if another clearing member is in default during the 20-25 Business Days following the initial or any subsequent default, the 20th-25th Business Day following the last default (the "IRS Cooling Off Period"), regardless of the number of defaults that occur during such IRS Cooling Off Period.

The maximum does not limit IRS Clearing Members' obligations to restore their IRS Guaranty Fund contributions as set forth in Rule 8G802.F, except that if the IRS Clearing Member's required IRS Guaranty Fund contribution would exceed the maximum, the IRS Clearing Member's IRS Guaranty Fund requirement shall be reduced accordingly for the remainder of the IRS Cooling Off Period. Following an IRS Cooling Off Period, the Clearing house shall notify each IRS Clearing Member of its IRS Guaranty Fund deposit obligation and its IRS Assessments exposure.

The aggregate maximum contribution for the IRS Cooling Off Period shall be based upon each IRS Clearing Member's IRS Guaranty Fund requirement and IRS Assessments in effect at the time of the original default, provided that if an IRS Clearing Member's IRS Guaranty Fund requirement and IRS Assessments is increased during the IRS Cooling Off Period due to material changes in its own business creating a material shortfall as to the requirement (as described in Rule 8G07) then the maximum shall be based on the revised requirement. ~~For the avoidance of doubt, if IRS Guaranty Fund requirements and IRS Assessments are revised for all IRS Clearing Members (as described in Rule 8G07) during the IRS Cooling Off Period, then the new requirements shall be used by the Clearing House to determine the relevant portions under Rule 8G802.A and Rule 8G802.B of each IRS' Clearing Member's IRS Guaranty Fund contribution that is used or assessed IRS Assessments, but IRS Clearing Members' maximums during the remainder of the IRS Cooling Off Period shall not be impacted by the new requirements.~~

The CME IRS Contribution shall be limited to an aggregate maximum of \$100,000,000 during the Cooling Off Period, regardless of the number of defaults that occur during such Cooling Off Period."

### **CME Rule 8G913.B. Release of Guaranty Fund Deposit, Membership and Assignments**

When an IRS Clearing Member withdraws from clearing membership for IRS Products (whether voluntarily or involuntarily), its IRS Guaranty Fund deposit or any other deposits required by the Clearing House, and any remaining assets available to the Clearing House associated with IRS Products will be released when Clearing House staff determines that the following has occurred: (1) all contracts and obligations with the Clearing House relating to IRS Products have been settled and paid, (2) all sums owing to the Clearing House relating to IRS Products have been paid, (3) all obligations to other members and customers arising out of claims directly related to IRS Contracts have been paid or otherwise provided for, (4) all obligations to other members and customers arising out of other arbitration claims relating to IRS Products filed pursuant to Chapter 6 or Rule 8G600 have been paid or otherwise provided for, and (5) the requisite liquidity providers for the Clearing House have released the security interest in such IRS Clearing Member's "assets" associated with the clearing of IRS Products in accordance with the terms of the liquidity facility described in Rule 817; provided, however, that in the event that Clearing House staff determines that all of the foregoing other than (4) have occurred, the IRS Risk Committee may in its discretion authorize the release of such property.

Generally, no such property shall be released prior to the 60th day following the effective date of the IRS Clearing Member's withdrawal. Notwithstanding the above, Clearing House staff may grant an exemption to the above restriction for good cause shown. Further, for purposes of the paragraph above, if the withdrawing IRS Clearing Member will not remain a clearing member in any other capacity with the Exchange, all obligations of the withdrawing IRS Clearing Member to the Exchange, of whatever nature or kind, shall be accelerated and become due and payable upon the effective date of withdrawal. If the IRS Clearing Member will remain a clearing member for other product classes other than IRS Products, the foregoing sentence shall apply only to obligations related to the clearing of IRS Products.

For purposes of Rule 8G802 ~~and 8G07~~, the IRS Guaranty Fund contributions ~~and IRS Assessments~~ of a non-defaulted IRS Clearing Member that has withdrawn shall not be accessible by the Clearing House to satisfy any losses in respect of the default of another IRS Clearing Member where such default occurred after the IRS Cooling Off Period as of which the withdrawing IRS Clearing Member had liquidated or transferred all of its open customer and house positions in IRS. ~~For the avoidance of doubt, a withdrawing IRS Clearing Member shall be subject to IRS Assessments for all defaults occurring during the Cooling Off Period in which such IRS Clearing Member withdraws. Products and (ii) after the effective date of its withdrawal, a non-defaulted IRS Clearing Member that has withdrawn shall not be subject to IRS assessments or obligations to restore its Guaranty Fund Deposits pursuant to Rule 8G802.F!~~

### **CME Rule 90006.B IRS Transactions Not Accepted for Clearing**

Notwithstanding any provision to the contrary in the Rules or in the Exchange User License Agreement (as may be amended from time to time), the parties to a bilateral IRS transaction submitted for clearing and which has not been accepted for clearing by the Clearing House pursuant to these Rules may separately agree that such trade is a valid, binding agreement between the parties which is un-cleared and which has no affiliation with the Clearing House."

### **CME IRS Manual Chapter 9 End of Day Valuations; Close Out Value**

#### **Close-out Value**

In the event of a determination by CME to wind-up down the clearing operations for IRS Products or an IRS Termination Event pursuant to Rule 8G28, CME Clearing will conduct a final settlement cycle to determine a final Close-out Value for open positions in IRS Products. Open positions in IRS Products will be closed-out at the Close-Out Value and removed from the clearing system. Each position account containing an open position in an impacted IRS Product shall be subject to the determination of the Close-out Value in U. S. Dollars and termination of that position in accordance with the following special settlement cycle procedures.

CME Clearing shall take the following actions in determining the Close-out Value:

- In order to allow for proper hedging of IRS positions, CME will announce the decision to conduct the special settlement cycle and determine a Close-out Value for IRS Products by no later than 9:00 a.m. EST that Business Day.
- CME Clearing will notify IRS Clearing Members that a Close-out Value for remaining positions in IRS Products will occur in conjunction with the current Intra-day ("ITD") settlement cycle. The current ITD settlement cycle is the 12:00 noon EST settlement cycle and not a separate settlement cycle.
- The ISDA published 11:00 a.m. EST curve fixing on the day of the announcement will be used for calculating the Close-out Values.
  - Similar procedures will be defined for other currencies, once CME Clearing is operational in the respective currencies.
  - Once OIS-based settlement is operational, close-out requires both Libor and basis swap curves. Therefore, it will require further determination of the appropriate Close-out Value procedure.
- A Close-out Value for each position account shall be determined in accordance with the money calculation procedure contained in Chapter 6 of this Manual of Operations for CME Cleared Interest Rate Swaps. The money calculation shall

include variation margin cash flow amount, coupon payment amount, and PAI amount from the preceding Business Day closing value to the date of the final Close-out Value.

- The net banked cash flow shall be banked consistent with Rule 8G28 and concurrent with the ITD banking cycle, approximately 3:00 p.m. EST that Business Day.

Close-out CME Settlement Curve:

USD Instrument Description	Type
O/N Interbank Money Market	Yield
T/N Interbank Money Market	Yield
0 X 3 FRA	Yield
Front Month Quarterly Eurodollar Future	Future
2nd Eurodollar Future	Future
3rd Eurodollar Future	Future
4th Eurodollar Future	Future
5th Eurodollar Future	Future
6th Eurodollar Future	Future
2Y Swap Rate	Yield
3Y Swap Rate	Yield
4Y Swap Rate	Yield
5Y Swap Rate	Yield
6Y Swap Rate	Yield
7Y Swap Rate	Yield
8Y Swap Rate	Yield
9Y Swap Rate	Yield
10Y Swap Rate	Yield
15Y Swap Rate	Yield
20Y Swap Rate	Yield
30Y Swap Rate	Yield

The Close – out Value settlement curve will be constructed using the above benchmark instruments at 11:00 a.m. EST. Inputs for the Money Market and FRA benchmark instruments will be pulled from various wire service feeds. CME will use the daily Eurodollar settlement procedure at 11:00 a.m. EST along with the ISDA published 11:00 a.m. EST swap fixings.