

Advisory Notice

Clearing House

08-197

TO: Clearing Member Firms

FROM: CME Clearing

SUBJECT: **CME Cleared Interest-Rate Swaps to Launch on September 2, 2008**

DATE: 8/26/08

On September 2, 2008, CME will begin clearing privately-negotiated trades in **CME Cleared Interest-Rate Swaps**, also known as **CME Swaps on Swapstream**. These products will first be present in CME's production SPAN files on this date.

At launch, there will be two "standard forward" swaps contracts available: **USD3L** – USD-denominated IMM-dated contracts on 3-month LIBOR, and **EUR6E** – EUR-denominated IMM-dated contracts on 6-month EURIBOR. Maturities going out ten years will be eligible for clearing at launch, and this will later be expanded to thirty years.

We refer to these as "standard forward" swap contracts because (a) they are standard fixed versus floating interest-rate swaps, (b) start and end dates are standardized on IMM dates, so that associated LIBOR fixing dates occur typically on the Monday prior to the third Wednesday of the month, and precisely match those of CME Eurodollar futures, and (c) you're always trading a forward-starting contract. When the start date of each contract arrives, the initial coupon is stripped and the contract "rolls" to the next shortest maturity. For example, when the first fixing date arrives for the ten-year forward-starting USD3L swap, it rolls and becomes a nine-and-three-quarter year forward-starting swap, with an adjustment to the start-of-day price to take into account the monetary impact of this roll.

Also available at launch there will be two "overnight index" swaps: **USDDF** – USD-denominated contracts on the daily Fed Funds rate, and **EUREO** – EUR-denominated contracts on the daily EONIA rate. These are spot-starting contracts which terminate on an upcoming IMM date, matching the start date for a standard forward contract. The overnight index swaps are similar to the standard forward swaps except that they roll every day, rather than only on monthly IMM dates. At launch there will be overnight index swaps with monthly maturities going out one year.

Clearing and bookkeeping processing for CME cleared interest-rate swaps is similar in many respects to that for futures. Individual contracts are identified by their clearing product code and their contract period code – the contract month in which they mature (for example, the Dec 2013 USD3L contract.) Trades and positions are marked to market daily, and the resulting settlement variation amounts are banked at each settlement cycle exactly as futures variation amounts are.

In particular, exactly as with futures, **you can trade in and trade out regardless of your trading counterparty**. In other words, you can buy today from one counterparty, and liquidate your position tomorrow opposite another counterparty. **We believe that (a) the central clearing guarantee provided by CME clearing, (b) the ability to liquidate your position simply by doing an offsetting trade, and (c) the standardization of maturities on monthly IMM dates matching those of Eurodollar futures, should combine to make CME cleared interest-rate swaps highly attractive to interest-rate market participants.**

An important point to note is that the monetary value of a basis point move in the swap price changes daily, and is expressed using a new value called the **Swap Value Factor (SVF)**, also called the **Variable Value Factor (VVF)**. The daily value for each contract's VVF is provided in the FIXML settlement price file and in the SPAN file, and is provided per 100,000 notional quantity. To calculate the variation for a trade, for example:

- Express the notional trade quantity as a positive number for a buy or a negative number for a sell.
- Subtract the trade price in percent from the daily settlement price, also in percent.
- Take the product of (a) the trade quantity, (b) the price difference, and (c) the VVF.
- Shift the decimal point of this result eight places to the left, and round to the nearest penny.

The eight-place decimal point shift takes into account (a) that prices are provided in percent rather than decimalized values, and (b) that VVF's are provided per 100,000 notional. The OTC-style rounding is done at the end of the calculation, since trade and position quantities are expressed as their exact notional amount.

On the date that a position rolls to the next-shorter maturity, the monetary effect of stripping off the first coupon is accounted for by using a different value for the start-of-day price. We call this the **adjusted start of day price**. The best way to think of this process is as follows: when you mark the start-of-day position to market, you always mark from the start-of-day price to the end-of-day settlement price; and on most days, the start-of-day price is equal to the previous day's settlement price, but on roll days, there's a special value for the start-of-day price. As with the VVF, the adjusted start-of-day price is provided in the FIXML settlement price file and on the type "82" record for the contract on the SPAN file.

The minimum price fluctuation is 0.001 (one-tenth of a basis point). Adjusted start of day prices on roll days may be expressed to 0.00001, so there are **five** implied decimal places in prices for these products in the SPAN file.

At launch, clearing will be limited to privately-negotiated trades, which will be cleared as the OPNT (over-the-counter privately-negotiated trade) trade type. OPNT's for CME cleared interest-rate swaps may be submitted:

- By traders or brokers reporting the trade through Swapstream
- By traders or brokers reporting the trade through the Trade Reporter interface of CME's EOS Trader application
- By traders or brokers writing directly to CME's Clearing 360 API
- By the selling clearing firm directly into Front-End Clearing (FEC)

In the first three cases, the clearing firm on each side must accept the trade via FEC, and it does not become a cleared trade until **both** clearing firms have accepted it. If the trade is being submitted directly by the selling clearing firm, then the buy firm must accept it.

Market participants may also wish to take their book of existing bilateral interest-rate swaps, and replace them with positions in CME cleared swaps. A special screen is provided in FEC to facilitate this process, which allows market participants to specify details of this conversion and calculates the associated cash adjustment amounts.

Once the trade is cleared, standard FIXML trade confirmation messages are transmitted to clearing firms so the trade may be loaded to books.

CME cleared interest-rate swaps are handled in SPAN in a manner quite analogous to that for FXMarketSpace spot FX contracts. All risk arrays and other SPAN rates for these swaps are provided per 100,000 notional. So processing CME cleared interest-rate swaps in SPAN is as simple as dividing the notional position quantity by 100,000, and flowing the result through SPAN normally. The 100,000 divisor is provided in the SPAN file in the Equivalent Position Factor field on the type "P" record. Note that the product type code in FIXML and SPAN is **IRS**, the industry-standard abbreviation for an interest-rate swap.

At launch, CME cleared interest rate swaps are "non-seg" products. As with other non-seg products, firms may designate individual trades either as customer or house trades, but customer trades will be posted in clearing to a special "D" house position account. The FIXML Trade Register file will indicate both the origin on the trade (the origin of the account as the clearing firm knows it) and the origin on the position account (the origin as clearing knows it.)

Market participants wishing to participate in this market must register by executing a **CME Cleared Swap Agreement**, a three-way agreement between the customer, the clearing firm, and CME. The customer registration agreement is at:

www.cmegroup.com/trading/interest-rates/files/CME_Cleared_Swap_Agreement.pdf

For more information, please see:

- The main page for CME Cleared Interest-rate Swaps at:
 - www.cmegroup.com/clearedswaps or
 - www.cmegroup.com/trading/interest-rates/swaps/swapstream.html
- Detailed contract specs at:
 - www.cmegroup.com/trading/interest-rates/files/CME_Cleared_InterestRate_SwapContractSpecs.pdf
 - Also see *Clearing New Product Summary NP08-10* at:
<http://www.cme.com/clearing/clr/npadv/files/NPAdv08-10.pdf>
- Detailed specifications about clearing and bookkeeping processing for CME cleared interest-rate swaps are available in *Clearing Advisory 07-173* at:
 - <http://www.cme.com/clearing/clr/clradv/files/Chadv07-173.pdf>
- Information about FIXML settlement price files for CME cleared swaps is available in *Clearing Advisory 08-129* at:
 - www.cme.com/clearing/clr/clradv/files/Chadv08-129.pdf

Or contact:

- **In North America:**
Swapstream **212-851-8296** or
 - [Steve Dayon](#) 312-466-4447
 - [Ron Peterson](#) 212-897-5285
 - [Pete Barker](#) 312-930-8554
 - [Elizabeth Flores](#) 312-338-2801
- **In Europe:**
 - [Robert Hammond](#) 44-207-796-7100
 - [Jeremy Solle](#) 44 207-796-7209
 - [Andrew Moreton](#) 44 207-796-7214
 - [Kim Short](#) 44 207-796-7213
 - [Paul Skipp](#) 44 207-796-7219

Or call: CME Clearing at 312-207-2525.