July 14th, 2014

The European Banking Authority
The European Insurance and Occupational Pensions Authority
The European Securities and Markets Authority

RE: Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012 (JC/CP/2014/03)

Dear Sir/Madam:

CME Group Inc. ("CME Group")[1], on behalf of its subsidiaries, Chicago Mercantile Exchange Inc. ("CME") and CME Clearing Europe Limited ("CME Clearing Europe"), would like to express appreciation to the European Banking Authority ("EBA"), the European Insurance and Occupational Pensions Authority ("EIOPA") and the European Securities and Markets Authority ("ESMA"), together the European Supervisory Authorities ("ESA's") for the opportunity to comment on the Consultation: Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012 (JC/CP/2014/03).

Our responses to the proposed regulatory technical standards most closely align with the first two questions in document; they are below for your consideration.

Question 1. What costs will the proposed collateral requirements create for small or medium-sized entities, particular types of counterparties and particular jurisdictions? Is it possible to quantify these costs? How could the costs be reduced without compromising the objective of sound risk management and keeping the proposal aligned with international standards?

I. Firms should disclose the aggregate uncollateralized exposures created by their use of the €50M initial margin threshold and across how many counterparties it is dispersed

The opacity and lack of risk management in the non-cleared derivatives markets acted to exacerbate the financial crisis that began in 2007 and led the Group of Twenty (G20) to commit in 2009 to reform this marketplace. Initial margin requirements for non-centrally cleared derivatives are a key component of this reform program, and CME Group is largely in support of the international principles published by the Basel Committee on Banking Supervision ("BCBS") and the International Organization of Securities

[1] CME Group is the parent of Chicago Mercantile Exchange Inc. ("CME"). CME is registered with the CFTC as a derivatives clearing organization ("DCO") and is one of the largest central counterparty ("CCP") clearing services in the world. CME's clearing house division ("CME Clearing") offers clearing and settlement services for exchange-traded futures contracts, as well as over-the-counter ("OTC") derivatives transactions including interest rate swaps ("IRS") and credit default swaps ("CDS"). CME Clearing Europe Limited ("CME Clearing Europe") is a recognized clearing house with the Bank of England and is in the process of obtaining reauthorization under the European Market Infrastructure Regulation ("EMIR"). CME Clearing Europe provides clearing services for OTC derivatives in the commodity and interest rate markets and recently began clearing exchange traded derivative ("ETD") products on behalf of the new CME Europe Limited exchange.

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Commissions ("IOSCO")[2] and how they addressed the impacts of these regulations on small and medium sized firms.

An important component of the international principles was the establishment of the €50M initial margin threshold, below which two counterparties to a transaction could agree to not exchange initial margin. This threshold was determined to mitigate some of the effects that the new collateral requirements would have on the OTC marketplace, and how these requirements could inhibit certain counterparties' access to the risk management benefits that OTC derivatives can provide. CME Group believes that in the spirit of the G20 mandate, a firm should disclose the aggregate amount of uncollateralized initial margin exposure they have and across how many counterparties on a quarterly basis, along with the firms' financial statements.

Adequate disclosure around the €50M initial margin threshold is the only way for an investor, credit provider, or even a CCP to tell how a particular firm is applying this threshold across its' business, and how much exposure a firm has in this regard. The €50M threshold introduces the potential for loopholes and will incent firms to proactively manage their thresholds across the dealers they work with. Disclosure would help to negate some of these incentives and will help provide transparency across the dealer community and to counterparties in the OTC derivatives markets. Small portfolios with uncollateralized initial margin can add to very significant exposures, and adequate disclosure is the best and most transparent way to combat this.

This disclosure would cost firms no additive cost because under the ESA's proposed regulations, Article 2(5)(c), firms are required to monitor at the consolidated level how the threshold is applied. Reporting this figure would be consistent with the G20 reforms to bring new clarity to the OTC derivatives marketplace, and a sample disclosure from a firm could be as simple as follows:

> As of June 2014, Firm X has calculated an aggregated initial margin requirement of €500M for all of its non-centrally cleared OTC derivatives across X amount of counterparties, of which €400M has been collected from the respective counterparties.

The ESA's have an important opportunity in these proposals to add new clarity to the OTC derivatives marketplace and CME Group asks them to consider requiring this single disclosure point in their final regulatory technical standards.

II. 100% of gross initial margin should be exchanged by both parties to a transaction to remain consistent with the International Principles (Key Principle 5)[3]

Initial margin is a vital risk mitigation technique for derivatives trading, both under a centrally cleared and non-centrally cleared environment. The final international principles from the BCBS and IOSCO recognized this and stated as follows under Key Principle 5:

> Because the exchange of initial margin on a net basis may be insufficient to protect two market participants with large gross derivatives exposures to each other in the case of one firm's failure, the gross initial margin between such firms should be exchanged.

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[2] Margin requirements for non-centrally cleared derivatives - final document; The Basel Committee on Banking Supervision and the International Organization of Securities Commissions; http://www.bis.org/publ/bcbs261.htm

[3] BCBS 261; page 19

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Some recent proposals[4] advocate a "margin sharing" model, whereby each party to a bilateral derivatives transaction posts half of the aggregate initial margin requirement into a separate custodian account that becomes property of the non-defaulting party if the other side defaults. CME's understanding of this model is that it creates a "half-defaulter-pay" model, where only half of the originally calculated initial margin requirement for a non-centrally cleared derivative is available upon a market participant default. This directly contradicts the international principles of incentivizing central clearing and risks pushing small and medium sized firms to trade products into the riskier non-cleared derivatives markets. Initial margin requirements should be calculated on an individual market participant basis, meaning two requirements for each bi-lateral transaction, and each market participant should be responsible for 100% of their margin requirements. CME Group asks that the ESA's be explicit in their final regulatory technical standards to prevent this potential regulatory arbitrage.

Question 2. Are there particular aspects, for instance of an operational nature, that are not addressed in an appropriate manner? If so, please provide the rationale for the concerns and potential solutions.

While the proposed regulations in "Chapter 2: Margin Methods" cover a broad base of requirements for initial margin models, CME Group recommends the following additional points that could help provide clarity and consistency to the models and their application in the non-centrally cleared OTC derivatives markets:

I. **ESA's should add a floor to the calibration of the initial margin model for non-cleared derivatives that ensures the initial margin calculated for a non-cleared derivative is 40.8% higher than that of a cleared derivative with similar risk characteristics when one is available at a Qualifying Central Counterparty "QCCP"[5]**

CME Group believes the initial margin requirements for a non-cleared derivative should be higher than that of a similar cleared product because cleared products are margined under models that are subject to heavy regulatory scrutiny and set at levels without commercial differentiation between counterparties. These principles eliminate a race to the bottom by CCP's for initial margin levels on cleared products, and in order to reduce risk in the non-cleared derivatives markets, those initial margin models should use cleared product initial margin levels as an appropriate benchmark. Furthermore, because initial margin models are subject to interpretation, CME believes that an explicit floor in this regard would help to provide clarity to non-cleared derivative initial margin models.

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[4] http://www.risk.net/risk-magazine/feature/2335760/dealers-push-margin-sharing-as-answer-to-collateral-crunch

[5] A qualifying central counterparty (QCCP) is an entity that is licensed to operate as a CCP (including a license granted by way of confirming an exemption), and is permitted by the appropriate regulator/overseer to operate as such with respect to the products offered. This is subject to the provision that the CCP is based and prudentially supervised in a jurisdiction where the relevant regulator/overseer has established, and publicly indicated that it applies to the CCP on an ongoing basis, domestic rules and regulations that are consistent with the Committee on Payment and Settlement Systems ("CPSS") & IOSCO Principles for Financial Market Infrastructures (PFMIs). ESMA list of CCP's eligible for QCCP designation; www.esma.europa.eu/system/files/ccps_authorised_under_emir.pdf

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An additional 40.8% requirement would follow the scaling factors recommended in the EU capital requirements regime[6], where firms are allowed to scale their derivative exposures based on the margin period of risk ("MPOR") of the product, with products under a 10 day MPOR scaled 40.8% higher than products under a 5 day MPOR. This scaling would accommodate the additional risk management techniques that exist at a QCCP that do not exist in the non-cleared derivative marketplace. These costs stem from efforts of the QCCP to maintain robust risk management standards and resources, such as contributions to a QCCP's guaranty fund. This explicit floor and additional 40.8% requirement would help incent firms to centrally clear their derivatives and provide clarity into the calibration of initial margin models. This floor could be inserted into the text of "Article 3 MRM – Calibration of the Model."

II. ESA's should align their requirements for procyclicality in the text of "Article 3 MRM – Calibration of the model" with those of the EMIR definition[7]

"Article 3 MRM – Calibration of the model," section (2), of the proposed regulations requires initial margin models to contain a minimum of 25% of data from a period of significant financial stress. CME Group interprets this requirement as an attempt to accommodate for the procyclicality of margins. In the recent technical publications by EMIR, there has been a very strong focus on having margin levels that combat procyclicality for cleared products. CCPs implement such anti-cyclical standards using one or more methods (volatility floors, longer historical lookback periods, stressed Value-at-Risk ("VaR"), etc.) and it is utmost important for non-cleared initial margin methodologies to follow similar a-cyclical requirements. Key Principle 3[8] of the final international standards call for initial margin to "limit the extent to which the margin can be procyclical"; the ESA's here should acknowledge the work done under the EMIR in this regard and align their procyclicality standards to prevent pushing small and medium sized firms back into the riskier non-cleared derivatives markets.

CME Group believes it is vital for regulators to apply consistent risk management standards in their respective jurisdictions for OTC markets and market participants. Taking a different approach and potentially providing unwarranted relief from risk management standards to the non-cleared derivatives markets directly contradicts the G20 commitment.

III. ESA's should add language to the requirement of a "one-tailed 99 percent confidence interval over a margin period of risk of at least 10 days" to ensure that 99 percent coverage is satisfied on an ex-post basis based on sample portfolios provided by the ESA's

"Article 2 MRM – Confidence interval and risk horizon" outlines the following requirement for initial margin models:

> (1) For the calculation of the initial margins, the assumed variations in the value of the contracts in the netting set are consistent with a one-tailed 99 percent confidence interval over a margin period of risk of at least 10 days.

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[6] REGULATION (EU) No 575/2013 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 26 June 2013; Article 304 calls for 10 Day MPOR products scaled at 1; 5 Day MPOR products scaled at 0.71; 40.8% represents (1 / 0.71 = 40.8%, our recommend additional amount; http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0001:0337:EN:PDF

[7] Commission Delegated Regulation (EU) No 153/2013 of 19 December 2012, Article 28; http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32013R0153&rid=1

[8] BCBS 261; page 11

CME Group acknowledges that the 99% confidence interval is in line with the international standards; and CME believes that the true test of a 99% confidence interval is proving a 99% coverage level on an ex-post basis. Calibration and thorough back testing are required to ensure that these initial margin models provide a 99% level of coverage on an ex-post basis, which can sometimes require calibration at higher confidence intervals of 99.5% or even 99.7%. Initial margin models for non-cleared derivatives should explicitly detail out these model parameters used in the calibration stage and provide thorough documentation of coverage on an ex-post basis.

Speaking specifically on calibration and back testing standards, a clear distinction needs to be made between in-sample calibration and out-of-sample testing of the 99% ex-post coverage. Calibration stages rely on historical data to set levels for expected future volatilities, back testing is separate from this and is where initial margin models have a chance to prove their realized coverage levels. ESA's should consider these two points separately in their final regulations and be more explicit. Furthermore, because ex-post testing can be subject to change depending on the portfolios used for testing, CME Group would recommend that the ESA's publish sample portfolios for all initial margin models to test against. ESA's could then publish results and this process would allow the cleanest comparison across the models and provide for the most visibility into the model calibrations.

To summarize and conclude, CME Group recommends that the ESA's add language to the initial margin model calibrations to specify in detail requirements for models to ensure a 99% coverage over a period of at least 10 days as evidenced by ex-post testing of sample portfolios as provided by the ESA's.

IV. Correlations employed in the portfolio margining aspects of a non-cleared derivative initial margin model should follow the same requirements as those of the EMIR technical standards for CCP's[9]

CCP initial margin models under Article 27 of the EMIR technical standards must follow strict guidelines for portfolio margining offsets. CME Group would like the ESA's to add a reference to the EMIR technical standards on portfolio margining that require any non-cleared derivative initial margin model to follow the same rules. This would ensure that a counterparty could not attain better portfolio margining through a purely non-cleared derivative portfolio relative to an entirely cleared portfolio, and thereby incenting firms to trade under the non-cleared derivatives market.

For example, offsetting interest rate swaps trades cleared at a CCP should not be forced by the EMIR technical standards to require higher initial margins than an entire portfolio of identical non-cleared interest rate swaps because that portfolio can use an initial margin model with no specific limits on portfolio margining. The spirit of the G20 commitment in 2009 was to prevent perverse incentives like these because they acknowledged the higher level of risk in the non-cleared derivatives markets relative to that of the cleared derivatives markets. The ESA's have an important opportunity to prevent this potential regulatory arbitrage, and this requirement could be added as an additional point under "Article 3 MRM – Calibration of the model."

[9] Commission Delegated Regulation (EU) No 153/2013 of 19 December 2012, Article 27; http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32013R0153&rid=1

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V. ESA's should incorporate a liquidity component into their requirements for the calibration of initial margin models.

"Article 3 MRM – Calibration of the model," section (8), outlines requirements for non-cleared derivative initial margin models to "establish transparent and predictable procedures for adjusting margin requirement in response to changing market conditions." CME Group believes that this section should include additional language around the liquidity components of the non-cleared derivative initial margin models. Liquidity of products and the size of relative portfolios are important considerations in determining initial margin requirements, and these are considerations that are typically outside the realm of requirements on "margin periods of risk" or "MPOR."

Typical VaR models scale linearly with portfolio size, however, it is well-known that the cost of liquidation increases super-linearly with size. CCP's models, therefore, apply a form of additional margins on large portfolios of even the most liquid products, and also during times of market crisis which would require significantly higher collateral. It is imperative that initial margins for non-cleared derivatives include provisions for these additional costs beyond the costs computed by the base initial margin models.

As evidenced in the financial crisis that began in 2007, non-cleared derivative transactions can take months and years for a firm to liquidate or appropriately hedge with counterparty. The 10 day MPOR under the current proposed regulations would be wholly inadequate by itself to account for the risk of these transactions, and a liquidity component to the initial margin model is where this could be accounted for. CME Group urges the ESA's to consider adding a liquidity component into their final technical standards.

Conclusion

CME Group would like to reiterate that we remain largely in support of the international principles outlined by the BCBS & IOSCO for margin requirements for non-centrally cleared derivatives and their implementation in a manner consistent with the G20 policy goals supporting the use of central clearing to mitigate risk. However, as outlined above in our response to Question 2, we have identified several key differences in the definitions of the initial margin model calibrations that could lead to incentives for market participants to remain in the riskier non-cleared derivatives markets. We believe that due to the policy goals of the G20 and the inherent riskiness of the bespoke, non-cleared market that these derivatives should be subject to enhanced margin standards or, at a minimum, initial margin calibration for non-cleared derivatives should match the levels applied to the centrally cleared marketplace. We ask the ESA's to more closely align their calibrations with that of EMIR in order to prevent regulatory arbitrage and creating incentives for market participants to remain in the non-cleared derivatives markets.

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We would be happy to further discuss and clarify any of the above issues with the EBA. If you have any comments or questions regarding this submission, please feel free to contact Kim Taylor, President, CME Clearing at +1 312 930-3156 or Kim.Taylor@cmegroup.com. Alternatively, you may contact Lee Betsill, CEO, CME Clearing Europe at +44 203 379 3120 or Lee.Betsill@cmegroup.com.

Sincerely,

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