INVESTMENT COMPANY INSTITUTE

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September 20, 2023

SEC and CFTC Approve CME Group's and DTCC's Enhanced Treasury Cross-Margining Arrangement

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TO: Fixed-Income Advisory Committee
Money Market Funds Advisory Committee RE: SEC and CFTC Approve CME Group's and DTCC's Enhanced Treasury Cross-Margining Arrangement

The SEC and CFTC (collectively, the "agencies") recently approved proposals by the Fixed Income Clearing Corporation (FICC) and CME Group,[1] respectively, to amend and restate the cross-margining arrangement between FICC and CME Group (the "Restated Arrangement"). The Restated Agreement[2] (i) expands the scope of CME products eligible for cross-margining, (ii) replaces the methodology for calculating the margin reductions that would apply to a cross-margining participant's eligible positions, and (iii) improves the default management and loss sharing processes that FICC and CME will engage in if a common member defaults. The filings also relocate certain timing and operational aspects of the cross-margin arrangement to a supporting service level agreement (SLA).[3] The rule changes will become effective in January 2024.

Products Eligible for Cross Margining

The Restated Agreement will allow clearing members of CME and of FICC's Government Securities Division (GSD) to cross-margin an increased range of products, including CME Group SOFR futures, Ultra 10-year US Treasury note futures, and FICC-cleared US Treasury notes and bonds (which would continue to be eligible for cross-margining).[4] Repo transactions that have Treasury collateral with a time to maturity that exceeds one year will also be eligible for the new cross-margining arrangement.[5] The new set of products eligible for cross-margining would be listed in exhibits to the Restated Agreement.[6]

Methodology for Calculating Margin Requirements for Cross-Margined Positions

The methodology to calculate the margin reduction that would apply to a cross-margining participant's eligible positions is based on the combined portfolio of eligible products of a common member (i.e., both the products cleared at FICC and the related products cleared at CME) with a value-at-risk ("VaR") methodology. The adopted methodology calculates portfolio margin reductions based on correlations at the security level. FICC and CME will separately calculate the potential margin reduction resulting from offsetting positions in a common member's portfolio using their respective margin methodologies and agree to reduce the member's margin requirement by the more conservative amount (i.e., the smaller reduction).[7]

Default Management and Loss Sharing

The Restated Agreement makes clear that a joint liquidation is the preferred means of liquidation of cross-margining positions in the event of a member default. This differs from the Current Agreement, which does not contain express language requiring CME and FICC to attempt to conduct a joint liquidation. Additionally, the Restated Agreement provides that when one of the clearing entities suspends a common member, that member will be required to repay the margin reduction realized under the cross-margining arrangement. If the common member fails to repay the margin reduction, then both clearing entities must suspend and liquidate the member's portfolio.

The Restated Agreement also further specifies loss sharing provisions, including the exchange of variation margin in the case of a common member default. After a default where the clearing entities pursue a joint liquidation, if one clearing entity faces a loss greater than (or gain less than) their share of total losses (gains), then the other clearing entity would pay the difference to ensure that each clearing entity was responsible for its respective portion of losses or gains. The agreement would also simplify the sharing of losses where FICC and CME liquidate the defaulter's cross-margin positions separately (i.e., because they determined that it was not feasible/advisable to do a joint liquidation).[8]

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Notes

[1] Self-Regulatory Organizations; The Fixed Income Clearing Corporation; Order Granting Approval of Proposed Rule Change to Amend and Restate the Cross-Margining Agreement between FICC and CME, Exchange Act Rel. 34-98327 (Sept. 8, 2023) ("SEC Approval Order"), available at https://www.sec.gov/files/rules/sro/ficc/2023/34-98327.pdf. CME Group submitted the arrangement to the CFTC pursuant to CFTC Regulation 40.5, which provides that the submission is "deemed approved" 45 days after receipt by the CFTC, absent CFTC action. The CME-FICC cross-margining arrangement was deemed approved by the CFTC on September 1. See CME Group's Request for Approval (July 17, 2023), available at https://www.cmegroup.com/content/dam/cmegroup/market-regulation/rule-filings/2023/7/23-301.pdf.

[2] CME and FICC currently have a cross-margining arrangement in place which is governed by a cross-margining agreement between CME and FICC dated January 2, 2004, as amended (the "Current Agreement"). The Current Agreement was last amended in 2014.

[3] The SLA would cover operational issues such as the creation and maintenance of special accounts for managing settlement and liquidation of a defaulting common member's cross margin positions, as well as the operational steps involved in managing the default of a common member. The SLA would also define the times by which FICC and CME would be

expected to exchange certain information and reports.

[4] Specifically, the following CME products will become eligible for cross-margining under the Restated Agreement: CBT 3YR 3-year T-Notes Futures, CBT TN Ultra Ten-Year T-Note Futures, CBT UBE Ultra U.S. Treasury Bond Futures, CBT TWE 20-Year U.S. Treasury Bond Futures, CBT 41 30 Day Federal Funds Futures, CME SR1 One-Month SOFR Futures, and CME SR3 Three-Month SOFR Futures. Eligible products cleared at FICC would not change and would remain comprised of all U.S. Treasury securities cleared by FICC's GSD,

[5] FICC products like Treasury bills (maturity of one year or less) and Treasury Inflation-Protected Securities (TIPS), as well as certain CME products not used under the Current Agreement, will no longer be eligible for cross margining under the Restated Agreement.

[6] The Restated Agreement and the SLA provide a mechanism for changing the list of eligible products.

[7] By contrast, the methodology under the Current Agreement involves a series of complex steps to allow FICC and CME to separately consider offsets for their respective products.

[8] By providing that, in the case of separate liquidations, if either FICC or CME has a net gain and the other has a net loss, then the CCP with the net gain would make a payment to the CCP with the net loss.