8011-01p

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-68529; File No. SR-CME-2012-34)

December 21, 2012

Self-Regulatory Organizations; Chicago Mercantile Exchange Inc.; Notice of Filing of Proposed Rule Change Related to the Liquidity Factor of CME's CDS Margin Methodology

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),[1] and Rule 19b-4 thereunder,[2] notice is hereby given that on December 10, 2012, Chicago Mercantile Exchange Inc. ("CME") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared primarily by CME. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I.   Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

CME proposes to make an adjustment to one particular component of its current CDS margin model. The text of the proposed rule change is below. Italicized text indicates additions; bracketed text indicates deletions.

****

CME CDS Liquidity Margin Factor Calculation Methodology

The Liquidity Factor will be calculated as the sum of two components:

(1)   A concentration charge for market exposure as a function of absolute Spread DV01 (a portfolio sensitivity to 1% par spread shock); and

(2)   A concentration charge for portfolio basis exposure as a function of Residual Spread DV01 (which is the difference between the Gross Spread DV01 and the Net Spread DV01 of the portfolio).

---

[1]   15 U.S.C. 78s(b)(1).

[2]   17 CFR 240.19b-4.

CME will also establish a floor component to the Liquidity Factor using the current Gross Notional Function with the following modifications: (1) the concentration scalar will be removed; and (2) the maximum DST would be replaced by series-tenor specific DST values based on the series and tenor of the relevant HY and IG positions, as applicable.

****

The text of the proposed change is also available at CME's website at

http://www.cmegroup.com, at the principal office of CME, and at the Commission's Public

Reference Room.

II.   Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, CME included statements concerning the purpose of

and basis for the proposed rule change and discussed any comments it received on the proposed

rule change. The text of these statements may be examined at the places specified in Item IV

below. CME has prepared summaries, set forth in sections A, B, and C below, of the most

significant aspects of such statements.[3]

    A.   Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

CME's currently approved credit default swap margin methodology utilizes a "multi-

factor" portfolio model to determine margin requirements for credit default swap ("CDS")

instruments. The model incorporates risk-based factors that are designed to represent the

different risks inherent to CDS products. The factors are aggregated to determine the total

amount of margin required to protect a portfolio against exposures resulting from daily changes

in CDS spreads. For both total and minimum margin calculations, CME evaluates each CDS

contract held within a portfolio. These positions are distinguished by the single name of the

underlying entity, the CDS tenor, the notional amount of the position, and the fixed spread or

---

[3]   The Commission has modified the text of the summaries prepared by CME.

coupon rate. For consistency, margins for CDS indices in a portfolio are handled based on the required margin for each of the underlying components of the index.

CME proposes to make an adjustment to one particular component of its current CDS margin model, the liquidity risk factor. This CDS margin model component is designed to capture the risk that concentrated positions may be difficult or costly to unwind following the default of a CDS clearing member.

The Liquidity Risk Factor in CME's Current CDS Margin Model

The current liquidity/concentration factor ("Liquidity Factor") of CME's margin methodology for a portfolio of CDS indices is the product of (1) the gross notional amount for each family (i.e., CDX IG or CDX HY) of CDS positions in a portfolio (2) the current bid/ask of the 5 year tenor of the "on the run" (OTR) contract (3) the Duration/Series/Tenor ("DST") factor and (4) a concentration factor based upon the gross notional for each of the CDX IG and CDX HY contracts ("Gross Notional Function"). The associated margin for a CDS portfolio attributed to the Liquidity Factor is the sum of the Liquidity Factor calculations for each family of CDS positions in the portfolio.

The calculation of the Liquidity Factor is based on the premise that the 5-year OTR index is the most liquid CDS index product. As such, the methodology is designed to evaluate the liquidity exposure of each position in a CDS portfolio relative to the 5-year OTR index.

For each index family (i.e., CDX IG and CDX HY), a DST matrix is calculated based on the historical bid-ask averages of each cleared position relative to the OTR 5-year historical bid-ask averages. Then, the maximum DST values are used as the DST factors. Such maximum DST factors are then applied to the product of 5-year OTR bid-ask spread (adjusted for duration for CDX IG only) and the Gross Notional of all positions within each index family. The

resulting products are further scaled by concentration factors in order to account for oversized (as measured by Gross Notional) portfolios. The concentration factors are based on exponential functions of the Gross Notional of each index family in a given portfolio.

Proposed Changes to the Liquidity Risk Factor

As liquidation costs are dependent on the risk in a portfolio, CME is proposing to use an index portfolio's market risk rather than its gross notional as the basis for determining the margins associated with the Liquidity Factor. The proposed changes would calculate the Liquidity Factor as the sum of two components:

(1)   A concentration charge for market exposure as a function of absolute Spread DV01 (a portfolio sensitivity to 1% par spread shock); and

(2)   A concentration charge for portfolio basis exposure as a function of Residual Spread DV01 (which is the difference between the Gross Spread DV01 and the Net Spread DV01 of the portfolio).

CME expects that these proposed changes would not generally impact smaller portfolios whose liquidation costs are driven by the market bid/ask spread rather than by the cost of hedging, and are therefore adequately captured by the existing Liquidity Factor methodology. To account for the risks associated with such smaller portfolios, CME also proposes to establish a floor component to the Liquidity Factor using the current Gross Notional Function described above with the following modifications: (1) the concentration scalar would be removed as concentration risk would already be accounted for by the concentration charge component outlined above; and (2) the maximum DST would be replaced by series-tenor specific DST values based on the series and tenor of the relevant HY and IG positions, as applicable. CME

4

expects that large (by notional amount) portfolios will be impacted by the proposed changes more than smaller portfolios.

The proposed liquidity risk factor model adjustments do not require any changes to rule text in the CME rulebook and do not necessitate any changes to CME's CDS Manual of Operations. The change will be announced to CDS market participants in an advisory notice that will be issued prior to implementation.

CME believes the proposed rule changes are consistent with the requirements of the Exchange Act including Section 17A of the Exchange Act.[4] The enhancements to CME's current CDS margin methodology will facilitate the prompt and accurate settlement of security-based swaps and contribute to the safeguarding of securities and funds associated with security-based swap transactions. CME believes the proposed rule changes accomplish those objectives because the changes are designed to incorporate how the liquidity risk factor is affected by not only portfolio concentration based on gross notional, but also the composition of the portfolio based on an underlying strategy. CME believes the proposed rule changes would also better align CME's margin methodology with the liquidity profile of the actual instruments in the portfolio.

B.   Self-Regulatory Organization's Statement on Burden on Competition

CME does not believe that the proposed rule change will have any impact, or impose any burden, on competition.

C.   Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

CME has not solicited comments regarding this proposed rule change. CME has not received any unsolicited written comments from interested parties.

---

[4]   15 U.S.C. 78q-1.

III.   Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within

such longer period up to 90 days (i) as the Commission may designate if it finds such longer

period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-

regulatory organization consents, the Commission will:

(A) by order approve or disapprove the proposed rule change or

(B) institute proceedings to determine whether the proposed rule change should be

disapproved.

IV.   Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the

foregoing, including whether the proposed rule change is consistent with the Act. Comments

may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or

- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-CME-2012-
  34 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and
  Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-CME-2012-34. This file number should be

included on the subject line if e-mail is used. To help the Commission process and review your

comments more efficiently, please use only one method. The Commission will post all

comments on the Commission's Internet website (http://www.sec.gov/rules/sro.shtml). Copies

of the submission, all subsequent amendments, all written statements with respect to the

proposed rule change that are filed with the Commission, and all written communications

relating to the proposed rule change between the Commission and any person, other than those

that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be

available for website viewing and printing in the Commission's Public Reference Room, 100 F

Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m.

and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the

principal office of CME and on CME's website at

http://www.cmegroup.com/market-regulation/files/SEC_19B-4_12-34.pdf.

All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-CME-2012-34 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[5]

Kevin M. O'Neill
Deputy Secretary

[FR Doc. 2012-31241 Filed 12/28/2012 at 8:45 am; Publication Date: 12/31/2012]

---

[5]   17 CFR 200.30-3(a)(12).