Clearing and Execution Requirements: Product Migrations and the Futures Commission Merchant in the United States

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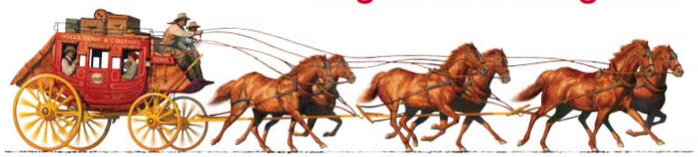
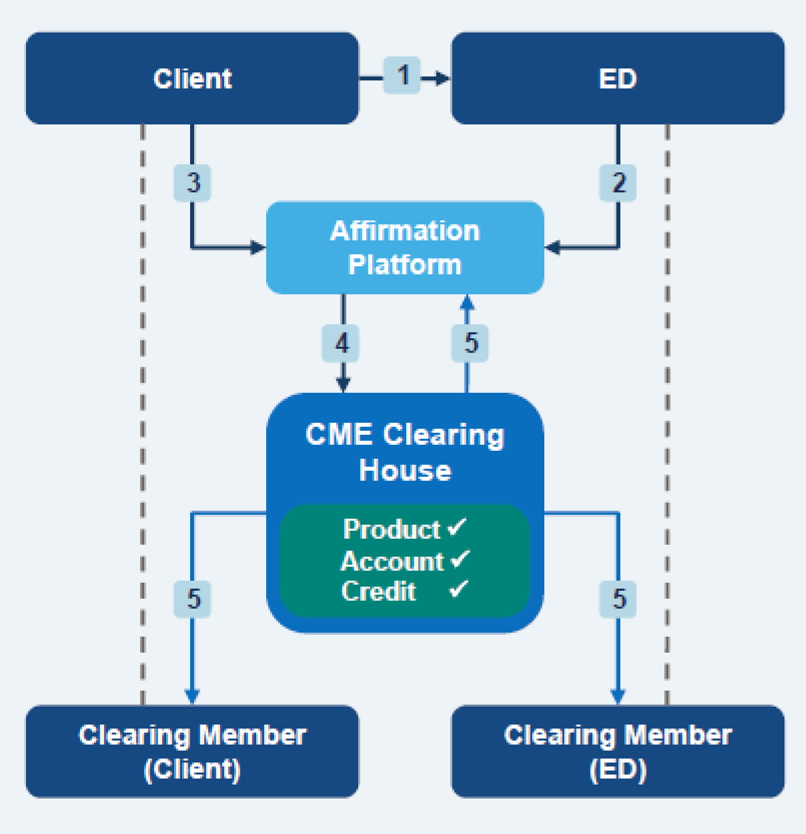
Together we'll go far



- "Clearing" is the process of taking a contract between two parties and replacing it with two contracts, one between the clearinghouse and the first party and the other between the clearinghouse and the second party.

- Swaps new class of contracts under regulations
- Eligible products – available on DCO and approved, gradual phase in
- Various DCOs – different risk management/valuation methodologies
- Potential Downside: New DCOs too big to fail, supervisory challenges
- Margin for "must clear" swap dealers and MSPs vs. end-users, expense for dealers
- Distinguish between G14 and G20 Supervisory Commitment letters and regulatory mandate
- DCO Settlement Risk – different currency deliveries; will DCOs settle via CLS?
- Netting opinions re: margin or settlement at DCO

Cleared OTC IRS: Trade Workflow Mechanics



Validations, notifications and confirmations are real-time and allow Straight Through Processing

1 – Client executes swap with Executing Broker (ED)

2 – ED alleges swap to Client

3 – Client selects Clearing Member and affirms swap

4 – Affirmation Platform sends matched trade to CME for Clearing

5 – After validating product, account and applying credit limits set by Clearing member(s), CME accepts swap for clearing

5 – CME sends "*Cleared*" notification to Affirmation Platform which displays trade status to principals

5 – CME sends a Clearing Confirmation to Clearing Member(s)

Source: CME Group

- **I. Full Physical Segregation** - Each customer's collateral maintained in separate accounts at every level: FCM, DCO and each custodian.
- **II. Legal Segregation with Commingling** - Collateral of all FCMs customers held in omnibus account separate from FCM but allowing commingling of customer collateral. Collateral is attributed to each customer for purposes of DCO margin requirements. FCM posts collateral to DCO on portfolio basis for all customers. If FCM defaults, DCO debits and credits each customer account. Non-defaulting customer collateral not available to support defaulting FCM obligations. CFTC has indicated this as preferred model.
- **III. Moving Customers to the Back of the Waterfall** – Same as Legal Segregation with Commingling structure but funds of non-defaulting customers of defaulting FCM could only be used after all other funds applied including DCO's capital and other clearing member default funds. CFTC still considering this model.
- **IV. Baseline** – Current collateral structure for exchange-traded futures. Customer funds held by FCM in an account separate from FCM funds but combined with other customer collateral. DCO has recourse to all funds in FCM omnibus clearing account, including non-defaulting customers, in the event of an FCM default. Customer funds utilized to satisfy FCM default obligations even before DCO contribution or other clearing members.
- **V. Optional Approach** – Allow each DCO to choose among models.