TESTIMONY
OF
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EXECUTIVE CHAIRMAN
CME GROUP INC.
BEFORE THE
HOUSE FINANCIAL SERVICES COMMITTEE

FEBRUARY 15, 2011

Chairman Bachus, Ranking Member Frank, members of the committee, thank you for the opportunity to testify respecting implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203, July 21, 2010) ("DFA"). I am Terry Duffy, Executive Chairman of CME Group, which is the world's largest and most diverse derivatives marketplace. CME Group includes four separate exchanges—Chicago Mercantile Exchange Inc. ("CME"), the Board of Trade of the City of Chicago, Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX") and the Commodity Exchange, Inc. ("COMEX") (together "CME Group Exchanges"). The CME Group Exchanges offer the widest range of benchmark products available across all major asset classes, including futures and options based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products. CME also includes CME Clearing, a derivatives clearing organization and one of the largest central counterparty clearing services in the world; it provides clearing and settlement services for exchange-traded contracts, as well as for over-the-counter ("OTC") derivatives transactions through CME Clearing and CME ClearPort®.

The CME Group Exchanges serve the hedging, risk management and trading needs of our global customer base by facilitating transactions through the CME Globex® electronic trading platform, our open outcry trading facilities in New York and Chicago, as well as through privately negotiated transactions. In addition, CME Group distributes real-time pricing and volume data through a global distribution network of approximately 500 directly connected vendor firms serving approximately 400,000 price display subscribers and hundreds of thousands of additional order entry system users. CME's proven high reliability, high

availability platform coupled with robust administrative systems represent vast expertise and performance in managing market center data offerings.
The financial crisis focused well-warranted attention on the lack of regulation of OTC financial markets. We learned a number of important lessons and Congress crafted legislation that, we hope, reduces the likelihood of a repetition of that near disaster. However, it is important to emphasize that regulated futures markets and futures clearing houses operated flawlessly. Futures markets performed all of their essential functions without interruption and, despite failures of significant financial firms, our clearing house experienced no default and no customers on the futures side lost their collateral or were unable to immediately transfer positions and continue managing risk.

We support the overarching goals of DFA to reduce systemic risk through central clearing and exchange trading of derivatives, to increase data transparency and price discovery, and to prevent fraud and market manipulation. Unfortunately, DFA left many important issues to be resolved by regulators with little or ambiguous direction and set unnecessarily tight deadlines on rulemakings by the agencies charged with implementation of the Act. In response to the urgent schedule imposed by DFA, the Commodity Futures Trading Commission ("CFTC" or "Commission") has proposed hundreds of pages of new or expanded regulations.

In our view, many of the proposals are inconsistent with DFA, not required by DFA, and/or impose burdens on the industry that require an increase in CFTC staff and expenditures that could never be justified if an adequate cost/benefit analysis had been performed. In the view of many experienced derivative industry professionals, the CFTC has been selectively reading DFA to implement a policy that is likely to defeat the real goals of DFA.

We realize that the Commission is under immense pressure to complete many rulemakings within a very short time period. Put simply, DFA set forth an unrealistic rulemaking schedule. And even more problematically, many of the rulemakings required by DFA are interrelated. That is, DFA requires many intertwined rulemakings with varying deadlines. Entities such as CME often cannot fully anticipate the meaning of a proposed rule when that proposed rule is reliant on another rule that is not yet in its final form. As a result, interested parties are unable to comment on the proposed rules in a meaningful way, because they cannot know the full effect of the proposed rules.

For example, rules addressing the definitions of “swap,” “security-based swap,” “swap dealer,” “security-based swap dealer,” “major swap participant,” “major security-based swap participant," and "eligible contract participant" and "security-based swap agreement" are absolutely fundamental to the Commission's regulatory scheme under DFA. As such, they must be established before interested parties can meaningfully address other proposed rules. Nonetheless, the Commission just proposed rules regarding these definitions on December 21, 2010, and the comment period for those proposed rules does not even close until February 22, 2011. *See* 75 Fed. Reg. 80174. Meanwhile, the Commission has proposed many other rules, and many comment periods have closed without commentators having the benefit of clarity on these essential definitions.

This Congress can mitigate some of the problems that have plagued the CFTC rulemaking process by extending the rulemaking schedule so that professionals, including exchanges, clearing houses, dealers, market makers, and end users can have their views heard and so that the CFTC will have a realistic opportunity to assess those views and measure the real costs imposed by its new regulations. Otherwise, the unintended adverse consequences of those ambiguities and the rush to regulation will impair effective exchange innovation and stifle the most important growth paths in our industry, including the clearing of OTC transactions. Indeed, the threat of such policies has already driven major customers to move business off U.S. markets.

Several Commissioners clearly recognize this issue and have been forthright in suggesting that the CFTC temper its ambitions. For example, in her recent statement opposing proposed rules in the area of position limits, Commissioner Sommers expressed concern regarding the lack of analysis performed before proposal of the rules. She specifically noted that she was troubled by the lack of analysis of swap markets and of whether the proposal would "cause price discovery in the commodity to shift to trading on foreign boards of trade," and that "driving business overseas remains a long standing concern." Further, Commissioner Sommers noted that, in any case, the Commission did not have the capacity to enforce the proposed rule.[1] Commissioner Dunn has echoed our

[1] In full, Commissioner Sommers stated:"I oppose the proposal before us today because I believe it is flawed in a number of respects. First, I believe we should conduct a complete analysis of the swap market data before we determine the appropriate formula to propose. We have not done that. Second, without data on swap market positions, the spot month limits we are proposing are not enforceable. I think it is bad policy to propose regulations that the agency does not have the capacity to enforce. Third, in Section 4a(a)(1) of the Commodity Exchange Act, Congress specifically authorized the Commission to consider different limits on different groups or classes of traders. This language was added in Section 737 of Dodd-Frank. The proposal before us today does not analyze, or in any way consider, whether different limits are appropriate for different groups or classes of traders. Finally, Section 737 of Dodd-Frank states that the Commission shall strive to ensure that position limits will not cause price discovery in the commodity to shift to trading on foreign boards of trade. This proposal does not contain any analysis of how the

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concerns regarding the lack of CFTC funding and the potential detrimental effects of a prescriptive, rather than principles-based, regime upon the markets. More specifically, he expressed concern that if the CFTC's "budget woes continue, [his] fear is that the CFTC may simply become a restrictive regulator. In essence, [it] will need to say "No" a lot more . . . No to anything [it does] not believe in good faith that [it has] the resources to manage" and that "such a restrictive regime may be detrimental to innovation and competition."[2] Commissioner O'Malia has likewise expressed concern regarding the effect of proposed regulations on the markets. More specifically, the Commissioner has expressed concern that new regulation could make it "too costly to clear." He noted that there are several "changes to [the] existing rules that will contribute to increased costs." Such cost increases have the effect of "reducing the incentive of futures commission merchants to appropriately identify and manage customer risk. In the spirit of the Executive Order, we must ask ourselves: Are we creating an environment that makes it too costly to clear and puts risk management out of reach?"[3]

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proposal attempts to accomplish this goal. In fact, the proposal does not even mention this goal. Driving business overseas is a long standing concern of mine, and that concern remains unaddressed."

Commissioner Jill E. Sommers, Opening Statement, Open Meeting on the Ninth Series of Proposed Rulemakings under the Dodd-Frank Act, (January 13, 2011) http://www.cftc.gov/PressRoom/SpeechesTestimony/sommersstatement011311.html

[2] Commissioner Dunn stated: "Lastly, I would like to speak briefly about the budget crisis the CFTC is facing. The CFTC is currently operating on a continuing resolution with funds insufficient to implement and enforce the Dodd-Frank Act. My fear at the beginning of this process was that due to our lack of funds the CFTC would be forced to move from a principles based regulatory regime to a more prescriptive regime. If our budget woes continue, my fear is that the CFTC may simply become a restrictive regulator. In essence, we will need to say "No" a lot more. No to new products. No to new applications. No to anything we do not believe in good faith that we have the resources to manage. Such a restrictive regime may be detrimental to innovation and competition, but it would allow us to fulfill our duties under the law, with the resources we have available." Commissioner Michael V. Dunn, Opening Statement, Public Meeting on Proposed Rules Under Dodd-Frank Act (January 13, 2011) http://www.cftc.gov/PressRoom/SpeechesTestimony/dunnstatement011311.html

[3] In Facing the Consequences: "Too Costly to Clear," Commissioner O'Malia stated: "I have serious concerns about the cost of clearing. I believe everyone recognizes that the Dodd-Frank Act mandates the clearing of swaps, and that as a result, we are concentrating market risk in clearinghouses to mitigate risk in other parts of the financial system. I said this back in October, and unfortunately, I have not been proven wrong yet. Our challenge in implementing these new clearing rules is in not making it 'too costly to clear.' Regardless of what the new market structures ultimately look like, hedging commercial risk and operating in general will become more expensive as costs increase across the board, from trading and clearing, to compliance and reporting."

"In the short time I have been involved in this rulemaking process, I have seen a distinct but consistent pattern. There seems to be a strong correlation between risk reduction and cash. Any time the clearing rulemaking team discusses increasing risk reduction, it is followed by a conversation regarding the cost of compliance and how much more cash is required."

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We are concerned that many of the Commission's rulemakings to date would unnecessarily convert the regulatory system for the futures markets from the highly successful principles-based regime that has permitted U.S. Futures markets to prosper as an engine of economic growth for this nation, to a restrictive, prescription-based regime that will stifle growth and innovation. This could have a detrimental affect on the competitiveness of U.S. exchanges as well as job creation and the U.S. economy as a whole. We are also concerned that many of the Commission's proposed rulemakings go beyond the specific mandates of DFA, and do not comply with the Administrative Procedure Act's requirements that rulemakings be legitimately grounded in evidence and strong economic theory. I will now address, in turn, several proposed rules issued by the Commission that illustrate these problems.

1. Proposed Rulemaking on Position Limits[4]

One example of this is the Commission's proposal to impose broad, fixed position limits for all physically delivered commodities. The Commission's proposed position limit regulations ignore the clear Congressional directives, which DFA added to section 4a of the Commodity Exchange Act, to set position limits "as the Commission finds are necessary to diminish, eliminate, or prevent" "sudden or unreasonable fluctuations or unwarranted changes in the price of" a commodity.[5] Without any basis to make this finding, the Commission instead justified its position limit proposal as follows:

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"For example, there are several changes to our existing rules that will contribute to increased costs, including more stringent standards for those clearinghouses deemed to be systemically significant. The Commission staff has also recommended establishing a new margining regime for the swaps market that is different from the futures market model because it requires individual segregation of customer collateral. I am told this will increase costs to the customer and create moral hazard by reducing the incentive of futures commission merchants to appropriately identify and manage customer risk. In the spirit of the Executive Order, we must ask ourselves: Are we creating an environment that makes it too costly to clear and puts risk management out of reach?" Commissioner Scott D. O'Malia, *Derivatives Reform: Preparing for Change, Title VII of the Dodd-Frank Act: 732 Pages and Counting*, Keynote Address (January 25, 2011) http://www.cftc.gov/PressRoom/SpeechesTestimony/opaomalia-3.html

[4] 76 Fed. Reg. 4752 (proposed Jan. 26, 2011) (to be codified at 17 C.F.R. pts. 1, 150-51)

[5] My December 15, 2010, testimony before the Subcommittee On General Farm Commodities and Risk Management of the House Committee on Agriculture includes a more complete legal analysis of the DFA requirements.

> The Commission is not required to find that an undue burden on interstate commerce resulting from excessive speculation exists or is likely to occur in the future in order to impose position limits. Nor is the Commission required to make an affirmative finding that position limits are necessary to prevent sudden or unreasonable fluctuations or unwarranted changes in prices or otherwise necessary for market protection. Rather, the Commission may impose position limits prophylactically, based on its reasonable judgment that such limits are necessary for the purpose of "diminishing, eliminating, or preventing" such burdens on interstate commerce that the Congress has found result from excessive speculation. 76 Federal Register 4752 at 4754 (January 26, 2011), Position Limits for Derivatives.

At the December 15, 2010, hearing of the General Farm Commodities and Risk Management Subcommittee of the House Agriculture Committee on the subject of the implementation of DFA's provisions respecting position limits, there was strong bipartisan agreement among the subcommittee members with the sentiments expressed by Representative Moran:

> Despite what some believe is a mandate for the commission to set position limits within a definite period of time, the Dodd-Frank legislation actually qualifies CFTC's position-limit authority. Section 737 of the Dodd-Frank act amends the Commodity Exchange Act so that Section 4A-A2A states, "The commission shall, by rule, establish limits on the amount of positions as appropriate." The act then states, "In subparagraph B, for exempt commodities, the limit required under subparagraph A shall be established within 180 days after the date of enactment of this paragraph." When subparagraphs A and B are read in conjunction, the act states that when position limits are required under subparagraph A, the commission shall set the limits within 180 days under paragraph B. Subparagraph A says the position-limit rule should be only prescribed when appropriate.
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> Therefore, the 180-day timetable is only triggered if position limits are appropriate. In regard to the word "appropriate," the commission has three distinct problems. First, the commission has never made an affirmative finding that position limits are appropriate to curtail excessive speculation. In fact, to date, the only reports issued by the commission or its staff failed to identify a connection between market trends and excessive speculation. This is not to say that there is no

connection, but it does say the commission does not have enough information to draw an affirmative conclusion.

"The second and third issues relating to the appropriateness of position limits are regulated to adequacy of information about OTC markets. On December 8, 2010, the commission published a proposed rule on swap data recordkeeping and reporting requirements. This proposed rule is open to comment until February 7, 2011, and the rule is not expected to be final and effective until summer at the earliest. Furthermore, the commission has yet to issue a proposed rulemaking about swap data repositories. Until a swap data repository is set up and running, it is difficult to see how it would be appropriate for the commission to set position limits." CME group is not opposed to position limits and other means to prevent market congestion; we employ limits in most of our physically delivered contracts. However, we use limits and accountability levels, as contemplated by the Congressionally-approved Core Principles for Designated Contract Markets ("DCMs"), to mitigate potential congestion during delivery periods and to help us identify and respond in advance of any threat to manipulate our markets. CME Group believes that the core purpose that should govern Federal and exchange-set position limits, to the extent such limits are necessary and appropriate should be to reduce the threat of price manipulation and other disruptions to the integrity of prices. We agree that such activity destroys public confidence in the integrity of our markets and harms the acknowledged public interest in legitimate price discovery and we have the greatest incentive and best information to prevent such misconduct.

We don't want to lose sight of the real economic cost of imposing position limits that are unwarranted. For the last 150 years, modern day futures markets have served as the most efficient and transparent means to discover prices and manage exposure to price fluctuations. Regulated futures exchanges operate centralized, transparent markets to facilitate price discovery by permitting the best informed and most interested parties to express their opinions by buying and selling for future delivery. Such markets are a vital part of a smooth functioning economy. Futures exchanges allow producers, processors and agribusiness to transfer and reduce risks through bona fide hedging and risk management strategies. This risk transfer means producers can plant more crops. Commercial participants can ship more goods. Risk transfer only works because speculators are prepared to provide liquidity and to accept the price risk that others do not. Futures exchanges and speculators have been a force to reduce price volatility and mitigate risk. Overly inclusive position limits adversely impact legitimate trading and impair the ability of producers to hedge. Worse, the drive certain classes of speculators into physical markets and distort the physical supply chain and prices.

Similarly troubling is the fact that the CFTC's proposed rules in this and other areas affecting market participants are not in harmony with international regulators. That is, international regulators, such as the EU, are far from adopting an approach as prescriptive of the CFTC's proposal in this and other areas. This creates an incentive for market participants to move their business to international exchanges where they may be subject to less prescriptive regimes, negatively impacting the global leadership of the U.S. financial market. The Commission should be careful not to adopt restrictions that tilt the competitive playing field in favor of overseas markets. Such a tilt threatens to export the price discovery process to overseas exchanges, resulting in both a loss of jobs in the U.S. and less cost-efficient hedging for persons in business in the U.S. As an example, consider the two major price discovery indexes in crude oil: West Texas Intermediate, which trades on NYMEX, and Brent Oil, which trades overseas. If the Commission places heavy restrictions in areas such as position limits on traders in the U.S., traders in crude oil, and with them the price discovery process, is likely to move to overseas markets.

2. Proposed Rulemaking on Mandatory Swaps Clearing Review Process[6]

Another example of a rule proposal that raises concerns and could produce consequences counter to the fundamental purposes of DFA is the Commission's proposed rule relating to the process for review of swaps for mandatory clearing. The proposed regulation treats an application by a derivatives clearing organization ("DCO") to list a particular swap for clearing as obliging that DCO to perform due diligence and analysis for the Commission respecting a broad swath of swaps, as to which the DCO has no information and no interest in clearing. In effect, a DCO that wishes to list a new swap would be saddled with the obligation to collect and analyze massive amounts of information to enable the Commission to determine whether the swap that is the subject of the application and any other swap that is within the same "group, category, type, or class" should be subject to the mandatory clearing requirement.

This proposed regulation is one among several proposals that impose costs and obligations whose effect and impact are contrary to the purposes of Title VII of

[6] 75 Fed. Reg. 667277 (proposed Nov. 2, 2010) (to be codified at 17 C.F.R. pts. 1, 150, 151)

DFA. The costs in terms of time and effort to secure and present the information required by the proposed regulation would be a massive disincentive to DCOs to voluntarily undertake to clear a "new" swap. The Commission lacks authority to transfer the obligations that the statute imposes on it to a DCO. The proposed regulation eliminates the possibility of a simple, speedy decision on whether a particular swap transaction can be cleared—a decision that the DFA surely intended should be made quickly in the interests of customers who seek the benefits of clearing—and forces a DCO to participate in an unwieldy, unstructured and endless process to determine whether mandatory clearing is required. Regulation section 39.5(b)(5) starkly illustrates this outcome. Every simple request to clear a swap is converted into a marathon that is likely to kill the runner before Athens is in sight. No application is deemed complete until all of the information that the Commission needs to make the mandatory clearing decision has been received. The Commission is the sole judge of completion and the only test is its unfettered discretion. Only then does the 90 day period begin to run. This turns DFA on its head.

3. Conversion from Principles-Based to Rules-Based Regulation[7]

Some of the CFTC's rule proposals are explained by the ambiguities created during the rush to push DFA to a final vote. For example, Congress preserved and expanded the scheme of principles-based regulation by expanding the list of core principles and granting self regulatory organizations "reasonable discretion in establishing the manner in which the [self regulatory organization] complies with the core principles." Congress granted the Commission the authority to adopt rules respecting core principles, but did not direct it to eliminate principles-based regulation.

The agency's prescriptive regulatory approach would convert its role from an oversight agency, whose role is to assure compliance with sound principles, to a front line decision maker that imposes its business judgments on every operational aspect of derivatives trading and clearing. This role reversal will require doubling of the Commission's staff and budget and impose astronomical costs on the industry and the end users of derivatives. Yet there is no evidence that this interpretation of Congressional intent behind DFA is necessary or will be beneficial to the public or to the functioning of the markets. This approach will also unnecessarily deplete the agency's limited resources. In keeping with the

[7] *See*, 75 Fed. Reg. 80747 (proposed Dec. 22, 2010) (to be codified at 17 C.F.R. pts. 1, 16, 38)

President's Executive Order to reduce unnecessary regulatory cost, the CFTC should be required to reconsider each of its proposals with an eye toward performing those functions that are clearly mandated by DFA.

Prior to DFA, the Commodity Exchange Act ("CEA"), as amended by the Commodity Futures Modernization Act of 2000 ("CFMA"), prohibited the CFTC from mandating exclusive means of compliance with the Core Principles applicable to regulated entities. *See* CEA 5c(a)(2). The CFTC set forth "[g]uidance on, and Acceptable Practices in, Compliance with Core Principles," but these statements operated only as guidance or as a safe harbor for compliance—not as requirements.

Changes to the CEA made by DFA gave the Commission discretion to, where necessary, step back from this principles-based regime. That is, they changed the language of the CEA to state that boards of trade "shall have reasonable discretion in establishing the manner in which they comply with the core principles, unless otherwise determined by the Commission by rule or regulation. *See, e.g.*, DFA § 735(b), amending Section 5(d)(1)(B) of the CEA. To begin, this language assumes that the principles-based regime will remain in effect and that, as such, regulated entities will have reasonable discretion as to the manner with which they comply with the Core Principles except in limited circumstances in which more specific rules addressing compliance with a core principle are necessary. The Commission has used this change in language, however, to propose specific requirements for multiple Core Principles—almost all Core Principles in the case of DCMs—and effectively eviscerate the principle-based regime that has fostered success in CFTC-regulated entities for the past decade.

The principles-based regime of the CFMA has facilitated tremendous innovation and allowed U.S. exchanges to compete effectively on a global playing field. Principles-based regulation of futures exchanges and clearing houses permitted U.S. exchanges to regain their competitive position in the global market. U.S. futures exchanges are able to keep pace with rapidly changing technology and market needs by introducing new products, new processes and new methods by certifying compliance with the CEA and thereby avoiding stifling regulatory review. Indeed, U.S. futures exchanges have operated more efficiently, more economically and with fewer complaints under this system than at any time in their history.

(a) Proposed Rulemaking under Core Principle 9 for DCMs

One example of the Commission's unnecessary and problematic departure from the principles-based regime is its proposed rule under Core Principle 9 for DCMs – Execution of Transactions, which states that a DCM "shall provide a competitive, open and efficient market and mechanism for executing transactions that protects the price discovery process of trading in the centralized market" but that "the rules of a board of trade may authorize . . . (i) transfer trades or office trades; (ii) an exchange of (I) futures in connection with a cash commodity transaction; (II) futures for cash commodities; or (III) futures for swaps; or (iii) a futures commission merchant, acting as principle or agent, to enter into or confirm the execution of a contract for the purchase or sale of a commodity for future delivery if that contract is reported, recorded, or cleared in accordance with the rules of the contract market or [DCO]."

Proposed rule 38.502(a) would require that 85% or greater of the total volume of any contract listed on a DCM be traded on the DCM's centralized market, as calculated over a 12 month period. The Commission asserts that this is necessary because "the price discovery function of trading in the centralized market" must be protected. 75 Fed. Reg. at 80588. However, Congress gave no indication in DFA that it considered setting an arbitrary limit as an appropriate means to regulate under the Core Principles. Indeed, in other portions of DFA, where Congress thought that a numerical limit could be necessary, it stated so. For example, in Section 726 addressing rulemaking on Conflicts of Interest, Congress specifically stated that rules "may include numerical limits on the control of, or the voting rights" of certain specified entities in DCOs, DCMs or Swap Execution Facilities ("SEFs").

Congress did not sanction arbitrary proscriptions by the Commission, and the 85% exchange trading requirement is completely arbitrary. That is, the Commission justifies the requirement only with its observations as to percentages of various contracts traded on various exchanges—it provides no support for a position that the 85% requirement provides or is necessary to provide a "competitive, open, and efficient market and mechanism for executing transactions that protects the price discovery process of trading in the centralized market of the board of trade," as is required under Core Principle 9. Further, Core Principle 9, as noted above, expressly permits DCMs to authorize off-exchange transactions including for exchanges to related positions pursuant to their rules.

The Commission does not assert in its proposal that the 85% exchange trading requirement has any regulatory benefit for either it or market participants. Indeed, there is no such benefit. The Commission does not receive any additional information regarding the market through the proposed 85% requirement. That is, if an instrument is not traded on an exchange, it will in many cases simply be traded on an SEF or in the OTC market as a swap. Following DFA, the swap and OTC markets, like the futures market, is regulated by the Commission. Thus, the Commission will receive the same information for use in regulation regardless of whether the instrument is traded in the centralized market or not.

Moreover, imposition of the proposed 85% exchange trading requirement will have extremely negative effects on the industry. The 85% requirement would significantly deter the development of new products by exchanges like CME. This is because new products generally initially gain trading momentum in off-exchange transactions. Indeed, it takes years for new products to reach the 85% exchange trading requirement proposed by the Commission. For example, one now popular and very liquid foreign exchange product developed and offered by CME would not have met the 85% requirement for four years after it was initially offered. The product's on-exchange trading continued to increase over ten years, and it now trades only 2% off exchange. Under the proposed rule, CME would have had to delist this product.[8]

Imposition of an 85% exchange trading requirement would also have adverse effects on market participants. If instruments that are most often traded off-exchange are forced onto the centralized market, customers will lose cross-margin efficiencies that they currently enjoy and will be forced to post additional cash or assets as margin. For example, customers who currently hold open positions on CME Clearport® will be required to post a total of approximately $3.9 billion in margin (at the clearing firm level, across all clearing firms).

(b) Proposed Comparable Fee Structures under Core Principle 2 for DCMs

In the case of certain proposed fee restrictions to be placed on DCMs, the Commission not only retreats needlessly from principles-based regulation but also greatly exceeds its authority under DFA. DCM Core Principle 2, which appears in DFA Section 735, states, in part, that a DCM "shall establish, monitor, and enforce compliance with rules of the contract market including . . . access requirements." Under this Core Principle, the Commission has proposed rule 38.151, which states that a DCM "must provide its members, market participants and independent

[8] More specifically, the product traded 32% off-exchange when it was first offered in 2000, 31% off exchange in 2001, 25 % in 2002, 20% in 2003, finally within the 85% requirement at 13% off-exchange in 2004, 10% in 2005, 7% in 2006, 5% in 2007, 3% in 2008, and 2% in 2009 and 2010.

software vendors with impartial access to its market and services including . . . comparable fee structures for members, market participants and independent software vendors receiving equal access to, or services from, the [DCM].”

The CFTC's attempt to regulate DCM member, market participant and independent software vendor fees is unsupportable. The CFTC is expressly authorized by statute to charge reasonable fees to recoup the costs of services it provides. 7 U.S.C. 16a(c). The Commission may not bootstrap that authority to set or limit the fees charged by DCMs or to impose an industry-wide fee cap that has the effect of a tax. *See Federal Power Commission v. New England Power Co.*, 415 U.S. 345, 349 (1974) ("[W]hole industries are not in the category of those who may be assessed [regulatory service fees], the thrust of the Act reaching only specific charges for specific services to specific individuals or companies."). In any event, the CFTC's overreaching is not supported by DFA. Nowhere in the CEA is the CFTC authorized to set or limit fees a DCM may charge. To the extent the CFTC believes its authority to oversee impartial access to trading platforms may provide a basis for its assertion of authority, that attempt to read new and significant powers into the CEA should be rejected.

3. Provisions Common to Registered Entities[9]

The CFMA streamlined the procedures for listing new products and amending rules that did not impact the economic interests of persons holding open contracts. These changes recognized that the previous system required massive, worthless paper pushing efforts by exchanges and by the CFTC's staff. It slowed innovation and offered no demonstrable public benefit. Our ability to compete on a global scale, which had been progressively eroded by the disparity between the U.S. process and the rules under which foreign competitors operated, was restored.

Under current rules, before a product is self-certified or a new rule or rule amendment is proposed, DCMs and DCOs conduct a due diligence review to support their conclusion that the product or rule complies with the Act and Core Principles. The point of the self-certification process that Congress retained in DFA is that registered entities that list new products have a self-interest in making sure that the new products meet applicable legal standards. Breach of this certification requirement potentially subjects the DCM or DCO to regulatory liability. In addition, in some circumstances, a DCM or DCO may be subject to litigation or other commercial remedies for listing a new product, and the

[9] 75 Fed. Reg. 67282 (proposed Nov. 2, 2010) (to be codified at 17 C.F.R. pt. 40)

avoidance of these costs and burdens is sufficient incentive for DCMs and DCOs to remain compliant with the Act.

Nothing in the last decade of self-certification suggests that this concept is flawed or that registered entities have employed this power recklessly or abusively. During 2010, CME launched 438 new products and submitted 342 rules or rule amendments to the Commission. There was no legitimate complaint respecting the self-certification process during this time. Put simply, the existing process has worked, and there is no reason for the Commission to impose additional burdens, which are not required by DFA, to impair that process.

Section 745 of DFA merely states, in relevant part, that "a registered entity may elect to list for trading or accept for clearing any new contract, or other instrument, or may elect to approve or implement any new rule or rule amendment, by providing to the Commission a written certification that the new contract or instrument or clearing of the new contract or instrument, new rule, or rule amendment complies with this Act (including regulations under this Act)." To be sure, DFA in no way directs the Commission to require the submission of all documents supporting such a certification nor to require a review of the legal implications of the product or rule with regard to laws other than DFA. Essentially, it requires exactly what was required prior to the passage of DFA—a certification that the product, rule or rule amendment complies with the CEA. Nonetheless, the Commission has taken it upon itself to impose these additional and burdensome submission requirements upon registered entities.

The new requirements are likely to significantly impair the speed and value of innovation by U.S. exchanges and clearing houses, which will be required to watch their innovations, brought to market by foreign competitors while the U.S. agency checks boxes to insure that filings are complete. Moreover, given the volume of filings required by the Notice of proposed rulemaking, the Commission will require significant increases in staffing and other resources. The Commission's resources should be better aligned with the implementation of the goals of DFA rather than "correcting" a well-functioning and efficient process.

The proposed rules greatly and unnecessarily increase the documentation burden associated with this submission process, and it seems inevitable that they will greatly slow the process of new rule and product introduction. First, a registered entity must submit "all documentation" relied upon to determine whether a new product, rule or rule amendment complies with applicable Core Principles. This requirement is, to begin with, vague, and thus is likely to result in the submission of unnecessary and non-useful information. More importantly, this requirement imposes an additional burden on both registered entities, which must compile and produce all such documentation, and the Commission, which must review it. The benefits, if any, to be gathered by this requirement are significantly outweighed by the costs imposed both on the marketplace and the Commission.

Second, the proposed rules require registered entities to examine potential legal issues associated with the listing of products and include representations related to these issues in their submissions. Specifically, a registered entity must provide a certification that it has undertaken a due diligence review of the legal conditions, including conditions that relate to contractual and intellectual property rights. The imposition of such a legal due diligence standard is clearly outside the scope of DFA and is unnecessarily vague and impractical, if not impossible, to comply with in any meaningful manner. An entity, such as CME, involved in product creation and design is always cognizant of material intellectual property issues that might arise. This amorphous and potentially vast legal diligence requirement could require that registered entities expand what could reasonably be considered to be a material or colorable intellectual property analysis and undertake extensive intellectual property analysis, including patent, copyright and trademark searches in order to satisfy the regulatory mandates. This would greatly increase the cost and timing of listing products without providing any true corresponding benefit to the marketplace. Indeed, the Commission itself admits in its NOPR that these proposed rules will increase the overall information collection burden on registered entities *by approximately 8,300 hours per year*. 75 Fed. Reg. at 67290.

Further, these rules steer the Commission closer to the product and rule approval process currently employed by the SEC, about which those regulated by the SEC complained at the CFTC-SEC harmonization hearings. Indeed, William J. Brodsky of the Chicago Board of Options Exchange testified that the SEC's approval process "inhibits innovation in the securities markets" and urged the adoption of the CFTC's certification process.

4. Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding Mitigation of Conflicts of Interest[10]

The Commission's proposed rules regarding the mitigation of conflicts of interest in DCOs, DCMs and SEFs ("Regulated Entities") also exceed its rulemaking authority under DFA and impose constraints on governance that are unrelated to

[10] 75 Fed. Reg. 63732 (proposed October 18, 2010) (to be codified at 17 C.F.R. pts. 1, 37, 38, 39, 40)

the purposes of DFA or the CEA. The Commission purports to act pursuant to Section 726 of DFA but ignores the clear boundaries of its authority under that section, which it cites to justify taking control of every aspect of the governance of those Regulated Entities. Section 726 conditions the Commission's right to adopt rules mitigating conflicts of interest to circumstances where the Commission has made a finding that the rule is "necessary and appropriate" to "improve the governance of, or to mitigate systemic risk, promote competition, or mitigate conflicts of interest *in connection with a swap dealer or major swap participant's conduct of business with*, a [Regulated Entity] that clears or posts swaps or makes swaps available for trading and in which such swap dealer or major swap participant has a material debt or equity investment." (emphasis added) The "necessary and appropriate" requirement constrains the Commission to enact rules that are no more intrusive than necessary to fulfill the stated Congressional intent—in other words, the regulations must be narrowly-tailored to minimize their burden on the industry. The Commission failed to make the required determination that the proposed regulations were "necessary and proper" and, unsurprisingly, the proposed rules are not narrowly-tailored but rather overbroad, outside of the authority granted to it by DFA and extraordinarily burdensome.

The Commission proposed governance rules and ownership limitations that affect all Regulated Entities, including those in which no swap dealer has a material debt or equity investment and those that do not even trade or clear swaps. Moreover, the governance rules proposed have nothing to do with conflicts of interest, as that term is understood in the context of corporate governance. Instead, the Commission has created a concept of "structural conflicts," which has no recognized meaning outside of the Commission's own declarations and is unrelated to "conflict of interest" as used in the CEA. The Commission proposed rules to regulate the ownership of voting interests in Regulated Entities by any member of those Regulated Entities, including members whose interests are unrelated or even contrary to the interests of the defined "enumerated entities." In addition, the Commission is attempting to impose membership condition requirements for a broad range of committees that are unrelated to the decision making to which Section 726 was directed.

The Commission's proposed rules are most notably overbroad and burdensome in that they address not only ownership issues but the internal structure of public corporations governed by state law and listing requirements of SEC regulated national securities exchanges. More specifically, the proposed regulations set requirements for the composition of corporate boards, require Regulated Entities to have certain internal committees of specified compositions and even propose a new definition for a "public director." Such rules in no way relate to the conflict of interest Congress sought to address through Section 726. Moreover, these proposed rules improperly intrude into an area of traditional state sovereignty. It is well-established that matters of internal corporate governance are regulated by the states, specifically the state of incorporation. Regulators may not enact rules that intrude into traditional areas of state sovereignty unless federal law compels such an intrusion. Here, Section 726 provides no such authorization.

Perhaps most importantly, the proposed structural governance requirements cannot be "necessary and appropriate," as required by DFA, because applicable state law renders them completely unnecessary. State law imposes fiduciary duties on directors of corporations that mandate that they act in the best interests of the corporation and its shareholders—not in their own best interests or the best interests of other entities with whom they may have a relationship. As such, regardless of how a board or committee is composed, the members must act in the best interest of the exchange or clearinghouse. The Commission's concerns—that members, enumerated entities, or other individuals not meeting its definition of "public director" will act in their own interests—and its proposed structural requirements are wholly unnecessary and impose additional costs on the industry—not to mention additional enforcement costs—completely needlessly.

5. Prohibition on Market Manipulation[11]

The Commission's proposed rules on Market Manipulation, although not representing as clear an overstepping of its boundaries under DFA, are also problematic because they are extremely vague. The Commission has proposed two rules related to market manipulation: Rule 180.1, modeled after SEC Rule 10b-5 and intended as a broad, catch-all provision for fraudulent conduct; and Rule 180.2, which mirrors new CEA Section 6(c)(3) and is aimed at prohibiting price manipulation. *See* 75 Fed. Reg. at 67658. Clearly, there is a shared interest among market participants, exchanges and regulators in having market and regulatory infrastructures that promote fair, transparent and efficient markets and that mitigate exposure to risks that threaten the integrity and stability of the market. In that context, however, market participants also desire clarity with respect to the rules and fairness and consistency with regard to their enforcement.

As to its proposed rule 180.1, the Commission relies on SEC precedent to provide further clarity with respect to its interpretation and notes that it intends to

[11] 75 Fed.Reg. 67657-62 (proposed Nov. 3, 2010) (to be codified at 17 C.F.R. pt. 180)

implement the rule to reflect its "distinct regulatory mission." However, the Commission fails to explain how the rule and precedent will be adapted to reflect the differences between futures and securities markets. *See* 75 Fed. Reg. at 67658-60. For example, the Commission does not provide clarity as to if and to what extent it intends to apply insider trading precedent to futures markets. Making this concept applicable to futures markets would fundamentally change the nature of the market, not to mention all but halting participation by hedgers, yet the Commission does not even address this issue. Rule 180.1 is further unclear as to what standard of scienter the Commission intends to adopt for liability under the rule. Rule 180.2 is comparably vague, providing, for example, no guidance as to what sort of behavior is "intended to interfere with the legitimate forces of supply and demand" and how the Commission intends to determine whether a price has been affected by illegitimate factors.

These proposed rules, like many others, have clearly been proposed in haste and fail to provide market participants with sufficient notice of whether contemplated trading practices run afoul of them. Indeed, the proposed rules are so unclear as to be subject to constitutional challenge. That is, due process precludes the government from penalizing a private party for violating a rule without first providing adequate notice that conduct is forbidden by the rule. In the area of market manipulation especially, impermissible conduct must be clearly defined lest the rules chill legitimate market participation and undermine the hedging and price discovery functions of the market by threatening sanctions for what otherwise would be considered completely legal activity. That is, if market participants do not know the rules of the road in advance and lack confidence that the disciplinary regime will operate fairly and rationally, market participation will be chilled because there is a significant risk that legitimate trading practices will be arbitrarily construed, post-hoc, as unlawful.

6. Antidisruptive Practices Authority Contained in DFA[12]

Rules regarding Disruptive Trade Practices (DFA Section 747) run the risk of being similarly vague and resulting in chilling of market participation. At this juncture, the Commission has issued only an Advance notice of proposed rulemaking ("ANPR") on this issue, and the ANPR demonstrates the Commission's understanding that it must provide clarity beyond that provided by DFA. Still, it is worthy of note that Section 747 of DFA, which authorizes the Commission to promulgate additional rules if they are reasonably necessary to

[12] 75 Fed. Reg. 67301 (proposed November 2, 2010) (to be codified at 17 C.F.R. pt. 1)

prohibit trading practices that are "disruptive of fair and equitable trading," is exceedingly vague as written and does not provide market participants with adequate notice as to whether contemplated conduct is forbidden. Hasty rulemaking resulting in vague rules in the area of disruptive trade practices will have the same effect as such rulemaking in the area of market manipulation—participation in the market and the hedging and price discovery functions of the market will be chilled due to uncertainty among participants as to whether their contemplated conduct is acceptable.

7. Effects on Existing Derivatives Contracts

DFA's overhaul of the regulatory framework for swaps creates uncertainty about the status and validity of existing swap contracts, and the Commission's failure thus far to address, in particular, the definition of "swap" or other provisions for dealing with currently effective swaps will serve to exacerbate the effects of this uncertainty. Today, under provisions enacted in 2000, swaps are excluded or exempt from the CEA under Sections 2(d), 2(g) and 2(h) of the CEA. These provisions allow parties to enter into swap transactions without worrying about whether the swaps are illegal futures contracts under CEA section 4(a). DFA repeals those exclusions and exemptions effective July 16, 2011. At this time, it is unclear what if any action the CFTC plans to take or legally could take to allow both swaps entered into on or before July 16 and those swaps entered into after July 16 from being challenged as illegal futures contracts. To address this concern, Congress and the CFTC should consider some combination of deferral of the effective dates of the repeal of sections 2(d), 2(g) and 2(h), exercise of CFTC exemptive power under section 4(c) or other appropriate action. Otherwise swap markets may be hit by a wave of legal uncertainty which the statutory exclusions and exemptions were designed in 2000 to prevent. This uncertainty may, again, chill participation in the swap market and impair the ability of market participants, including hedgers, to manage their risks.

The above are merely a few examples of instances in which CME believes the Commission has proposed rules inconsistent with DFA or that impose unjustified costs and burdens on both the industry and the Commission. We ask this Congress to extend the rulemaking schedule under DFA to allow time for industry professionals of various viewpoints to fully express their views and concerns to the Commission and for the Commission to have a realistic opportunity to assess and respond to those views and to realistically assess the costs and burdens imposed by the new regulations. We urge the Congress to ensure that implementation of DFA is consistent with the Congressional directives in the Act and does not unnecessarily harm hedging and risk transfer markets that U.S. companies depend upon to reduce business risks and increase economic growth.