CME Group
A CME/Chicago Board of Trade Company

KEYNOTE ADDRESS
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BEFORE THE
U.S. SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION
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As CEO of CME Group, I am pleased to have this opportunity to share my view of the benefits the U.S. derivatives industry has achieved under the principles-based regulatory regime created by the Commodity Futures Modernization Act of 2000. I hope that the overwhelmingly positive results that have flowed from the modernization of the regulatory framework for derivatives markets can serve as a model for modernizing the regulatory structure of the U.S. securities industry.

Like the U.S. securities industry today, U.S. futures and options markets in the 1990s faced a plethora of competitive threats. To name a few:

- Exempt OTC markets were outpacing our growth. OTC dealers brought innovative new products to market as quickly as they felt demand was in place, whereas we filed applications demonstrating that our new product innovations served a bona-fide economic purpose and waited for CFTC consideration.

- The U.K. and Germany had deregulated and adopted principles-based regimes for regulating exchange markets, creating a badly tilted playing field for U.S. exchanges competing with European exchanges in the same or highly correlated products.

- The CFTC crafted a no-action policy that permitted the major foreign exchanges to offer U.S. customers direct electronic access to foreign futures and options products.

- Electronic trading, direct market access and the development of global distribution networks were greatly accelerating cross-border investment flows.

- Wall Street investment banks and for-profit companies were coalescing to offer competing platforms that threatened to siphon business away from traditional incumbent exchanges.

CFMA of 2000

To their great credit, our committees of jurisdiction and the House and Senate as a whole recognized the need for action and passed sweeping legislation that has greatly benefited the global derivatives industry. The Commodity Futures Modernization Act (CFMA) came about because all the elements of the industry were at risk under the existing regulatory regime. The pain was severe enough to force consensus on a regime change that offered something for everyone. Years of conflict between the listed and OTC elements of the derivatives industry produced a common understanding of the need to replace the prescriptive rules-oriented approach that had been in place for decades with a principles-based approach designed to foster innovation and encourage competition between domestic and foreign exchanges as well as between listed and OTC markets.

Since the adoption of CFMA, U.S. futures markets have been spurred to unparalleled growth and innovation. Five of the eight legislative purposes articulated by Congress in the preamble of the CFMA are highly relevant to today's discussion. Congress called on the CFTC to transform its role, to streamline and eliminate unnecessary regulation, to promote innovation, to allow futures clearing houses to compete for OTC business, and to focus on enhancing the competitive position of U.S. financial institutions and financial markets.

First and foremost, as a result of CFMA, the CFTC does not dictate precisely how derivatives exchanges must organize and operate. Rather, CFMA empowers exchanges and clearing organizations to operate within the ambit of broad core principles. This change has had a profound impact on our ability to innovate, compete and let market forces determine the value of our efforts. The CFTC's staff stopped operating under the assumption that it had responsibility for assuring that exchanges were making the "best" decisions. As a result, futures markets are now able to operate as highly competitive commercial businesses. Under CFMA, regulatory oversight really means oversight. The best part is that the system works. Customer complaints are down and exchange related misconduct has been minimized.

Additionally, CFMA created a tiered regulatory structure that allowed flexibility in designing exchanges and trading platforms that meet unique needs of market participants trading widely different instruments with similar counterparties, and with non-traditional market structures, trading conventions or clearing mechanisms.

Importantly, CFMA reflected the recognition that the degree of regulation depends on the type of products being traded, the sophistication of the customers and the type of trading system employed. For example, CME Group was able to launch Swapstream as an "exempt board of trade" under CFMA. Swapstream offers sophisticated customers an exchange-like trading and clearing system for interest rate swaps with a regulatory structure that is more consistent with the exempt OTC market. Similarly, we created FXMarketSpace, our joint venture with Reuters, which is the first electronic, anonymous and centrally-cleared platform for trading OTC foreign exchange products.

In addition to the change from prescriptive to principles-based regulation, and the flexible tiered regulatory approach, two other factors were important to the continued vitality of our industry.

First, CFTC adopted the principle that functionally comparable foreign regulation should serve as an informal passport for cross border trading. Not only did this pave the way for foreign exchanges to expand their presence in the U.S., it created an opportunity for U.S. exchanges like CME Group to efficiently distribute its products in foreign jurisdictions without the burden of meeting different, but not necessarily better, regulatory requirements in each of the dozens of jurisdictions where we do business around the globe. I view this principle of mutual recognition of comparable regulatory frameworks – despite technical differences – as a cornerstone of ensuring our competitiveness in global markets. With the continued emergence and success of major economies and market infrastructure in emerging markets like China, India, Brazil and elsewhere, and the corresponding increases in cross-border capital flows, the U.S. can no longer insist that our form of regulation is best. Simply put, it is no longer the case that capital formation or risk transfer activities are best accomplished in U.S. regulated markets.

To be fair, there are some very real differences between securities and futures markets. Regulation of equity and bond markets is based on disclosure standards set by the SEC. Historically, the SEC has determined that U.S. customers, trading by means of a U.S. located

account, are entitled to similar information when trading foreign equity securities. Futures market regulators have never been concerned about disclosure as a regulatory principle. Instead, their view is that the highest purpose of a futures market is to create a forum for fair discovery of prices. Their view is also that price discovery markets can be organized with different rules and structures so long as they provide for effective price discovery and prevent against fraud and manipulation. In this regard, the CFTC is more concerned with the *what* than the *how* of how exchanges accomplish these goals.

This difference in philosophy has created a gulf between the globalization of derivative and securities markets. Two obvious classes of impacts should be of immediate interest to the treasury, the GAO, the Committee on Capital Markets Regulation and the congressional Committees of Jurisdiction now conducting studies of competitiveness in securities markets. First, foreign securities markets cannot offer easy, direct access to U.S. customers and, consequently, those U.S. customers must jump through hoops and incur substantial costs to access those markets. Second, to the extent that the U.S. regulatory regime is perceived as imposing excessive costs and risks on issuers, and capital is readily available offshore, U.S. markets and investors will have fewer choices and U.S. markets will be at a significant competitive disadvantage.

We are all acutely aware of the importance of the ongoing effort to test claims that U.S. securities markets have been disadvantaged in meeting international competition by an overly-prescriptive, costly system of regulation and enforcement. It is clear to us that prescriptive regulation constrains innovation, creating a costly lag between idea and implementation. A strong case is being made for reform. The SEC is obviously struggling to resolve the needs of the industry within the constraints of its statutory mandate. It appears to be making progress. However, without meaning to sound dismissive, the intellectual fire power and time that have been invested in the problem seem slightly excessive to those steeped in futures regulation. Securities markets seem to function quite adequately throughout Western Europe. I would be surprised if the level of fraud and dishonesty per $1 billion of securities bought and sold significantly exceeds the level of misconduct that occurs in the U.S. I don't imagine that we need to discuss recent examples of fraud in U.S. securities markets. If U.S. customers are adequately warned that the disclosure standards are not identical to U.S. standards, it is fair to ask why try to maintain a barrier at the border.

First, anyone can avoid the barrier if willing to bear the cost. Either establish an offshore account or invest here in ETFS or mutual funds. Of course, both of those choices mean that the investor is deprived of valuable options and made to pay an intermediary with whom he might not chose to do business in a more open environment. It is obvious that the investor has no better information about the underlying security when he buys an Asian index ETF than when he buys the underlying securities, but that does not seem to be a problem if the issuer of the ETF is registered and information about the issuer is available.

Second, it is plain offensive to European regulators to insist that their systems and issuers meet U.S. standards or that they move in that direction before U.S. investors are permitted easy access to their markets. The U.K. and Germany have each allowed investors in their jurisdictions to directly and efficiently access trading opportunities in U.S. listed securities. The converse is not true.

Third, there is no legitimate interest in insulating regulators from competition by precluding exchanges that are open to U.S. customers from operating in an offshore jurisdiction that facilitates their business and that is attractive to issuers.

In contrast to the barriers that exist in the U.S. securities markets, U.S. investors can directly and electronically trade foreign futures and options contracts from the U.S. Correspondingly, European and Asian investors can directly and electronically trade products listed by CME and other U.S. futures and options exchanges. Moreover, foreign boards of trade can efficiently offer U.S. customers access to products also traded on U.S. exchanges, thereby increasing global competition in these markets.

Starting in 1998 and for nearly a decade now, foreign derivatives exchanges have been able to distribute their products electronically to U.S. investors with direct market access. As a result, there are now 17 foreign exchanges operating in the United States pursuant to CFTC no-action relief, offering dozens of foreign products to U.S.-based investors. Correspondingly, CME Group offers direct market access in more than 85 countries, with telecommunications hubs installed or planned in Europe, Asia and South America. Most global derivatives exchanges doing business this way now estimate off-shore volumes to account for 15% - 20% of total business flows. Perhaps this explains, at least in small part, the marked difference between compounded annual growth rates for the last four years of 4% in cash equity markets versus nearly 28% in global futures and options markets.

One very strong reason to hope that the SEC will get to the same place is the policy leadership being provided by Chairman Cox who has made it clear that he understands that the interconnectedness between securities markets requires that U.S. securities regulators work cooperatively with their foreign counterparts. Earlier this year, the SEC issued a concept release and proposed rule that would allow foreign issuers to prepare their financial statements in accordance with International Financial Reporting Standards (IFRS).

By any measure, CFMA is a credible candidate for a highly successful piece of financial sector reform legislation. It has led to record breaking volume on U.S. futures exchanges from domestic and international customers; lower costs of trading; enhanced efficiency for customers; enormous innovation in products and trading; and unprecedented competition both within the futures industry and between the futures industry and other market sectors.

One reason the CFMA was so successful is that it carefully reflected the needs and idiosyncrasies of the futures industry. I harbor no false hopes that you can simply apply CFMA to the securities industry wholesale. But taking advantage of the valuable lessons learned from the CFMA experience, and drawing on other modern securities industry systems such as that in the U.K and Germany, I would think that if the political courage exists there is no reason a workable and productive principles based system cannot be fashioned for the U.S. securities industry.

Merger of CFTC and SEC

It is tempting to use this forum to respond to the calls from the options exchanges to merge the SEC and the CFTC. I am going to resist that temptation except to note that we recognize in capital markets that most mergers don't work. Approximately 70% of all such transactions destroy value notwithstanding the best intentions of management to achieve synergies that should create value for customers and shareholders. A merger of two very different agencies with very different purposes and philosophies or cultures is no different and should be treated with equal skepticism. Recent testimony and op eds from the options exchanges is revelatory. They believe that the prescriptive regulation is crippling but are unwilling to demand reform. Instead, they call for a level playing field that would be created by

making CFTC regulation more onerous. This lowest common denominator approach is, to say the least, a perverse solution to the problem.

There have been occasional jurisdictional conflicts between the CFTC and SEC with respect to new products such as security futures and credit derivatives. These "border disputes" are unfortunate, but they present modest costs and consequences relative to ensuring the continued ability of U.S. futures exchanges to compete globally under the modern regulatory framework created by CFMA – versus the outdated and ill-fitting securities industry regulatory framework. The proper and pro-competitive resolution in these few "overlap" areas is the course that the CFTC pioneered, *i.e.,* finding a solution that permits the new products to trade under both regimes and then standing back and allowing the market to choose.

The inadequacies of securities market regulation cited by critics need to be resolved by reform of that regulatory regime, not by subjecting derivative markets to a system that is not credible in a globally competitive economy.

Conclusion

There are significant differences between our industries. Some are a matter of custom and history, such as segregation of customer funds versus SIPC, and customer suitability versus "know your customer" obligations. Other differences, such as disclosure obligations, are almost religious in importance and character. Certain barriers between our businesses need to be lowered to reduce customer costs and expenses, for example portfolio margining between futures and securities. I believe, however, we share certain core principles about how a business – including an exchange business – ought to be allowed to be operated. We believe that a customer-focused business – disciplined by its performance in the public market for its shares and by essential government oversight – will create the greatest value for customers, intermediaries and shareholders.

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