Statement of
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Executive Chairman of CME Group Inc.
Before the
United States House of Representatives

Committee on Agriculture

February 3, 2009

I am Terrence Duffy, Executive Chairman of Chicago Mercantile Exchange Group Inc. ("CME Group" or "CME"). Thank you Chairman Peterson and Ranking Member Lucas for this opportunity to present our views.

CME GROUP EXCHANGES

CME Group was formed by the 2007 merger of Chicago Mercantile Exchange Holdings Inc. and CBOT Holdings Inc. CME Group is now the parent of CME Inc., The Board of Trade of the City of Chicago Inc., NYMEX and COMEX (the "CME Group Exchanges"). The CME Group Exchanges are neutral market places. They serve the global risk management needs of our customers and producers and processors who rely on price discovery provided by our competitive markets to make important economic decisions. We do not profit from higher or lower commodity prices. Our Congressionally mandated role is to operate fair markets that foster price discovery and the hedging of economic risks in a transparent, efficient, self-regulated environment, overseen by the CFTC.

The CME Group Exchanges offer a comprehensive selection of benchmark products in all major asset classes, including futures and options based on interest rates, equity indexes, foreign exchange, agricultural commodities, energy, and alternative investment products such as weather and real estate. We are in the process of joining with market users to operate a green exchange to provide trading and clearing services that will serve cap and trade programs respecting emissions and allowances.

We are joint venturers with Citadel to provide trading and clearing platforms for credit default swaps. Our risk analytics and financial safeguards have been thoroughly vetted by the CFTC, the Federal Reserve and the SEC. Our efforts to open our doors have been complicated by jurisdictional issues, but we are very close to a launch of the service.

We also offer order routing, execution and clearing services to other exchanges as well as clearing services for certain contracts traded off-exchange. CME Group is traded on NASDAQ under the symbol "CME."

EXECUTIVE SUMMARY

The draft bill that was recently circulated is proposed as an amendment "to the Commodity Exchange Act to bring greater transparency and accountability to commodity markets." We support that statement of the bill's purpose. We unequivocally support enhancing the enforcement capabilities and machinery of the CFTC, but it is essential that care be taken to avoid constraints on U.S. markets that will further weaken the already fragile US economy; damage the competitiveness

of U.S. markets; hurt U.S. consumers and produce less transparency and deprive the Commission of vital information.

We understand that there may be some markets in which "excessive speculation," as defined in the CEA, may cause price distortion; we set hard limits in those markets or enforce CFTC limits. We do not agree that hard position limits play a constructive role with respect to commodities that are not physically delivered and commodities whose trading does not affect any physical delivery market. We do not agree that the CFTC should be the front-line regulator setting hard limits. We disagree with the creation of "advisory" committees for setting hard limits in agriculture and energy products. The proposed committees are dominated by long and short hedgers, who are not constrained by any standards and who do not operate subject to a defined process. We are concerned that these committees will inordinately influence the setting of limits and will adversely affect the ability of our markets to efficiently perform their price discovery function. We believe that the bill's direction to the Commission to define a bona fide hedging transaction is overly restrictive both with respect to direct hedgers and its constraints on the ability of dealers, funds and others who have assumed risks in the over the counter market, which are consistent with their legitimate businesses.

We are strong proponents of the benefits of central counter party clearing as an effective means to collect and provide timely information to prudential and supervisory regulators and to greatly reduce systemic risk imposed on the financial system by unregulated bilateral OTC transactions. We would be a major beneficiary of Section 13 of the draft bill, but we are not confident that it is practicable. If the OTC dealers do not embrace clearing, they can easily transact in another jurisdiction, avoid the obligations imposed by the draft bill and cause significant damage to a valuable domestic industry. We urge the Committee to shape its bill in recognition of the reality of markets that operate in a global economy. Trading systems are electronic, banking is international, and every important trader has easy access to markets that are not regulated by the CFTC and not constrained by this bill. Prohibitions or costly impediments to legitimate business activities in the U.S. will simply divert business to jurisdictions that adopt rational measures to deal with the causes and protection against future financial meltdowns. We are eager to work with the Committee and the industry to shape incentives that will encourage clearing in appropriate cases and bring us quickly to the end position envisioned by the bill.

Finally, we appreciate the proposed clarification that will enhance our ability to provide clearing services for credit default swap contracts in a manner that does not infringe on the SEC's regulatory responsibilities and that will permit competition in this important market across regulatory regimes. We are concerned, however, that the bill will foreclose trading of CDSs in the U.S.

DRAFTING AND TECHNICAL ISSUES

We welcome a dialogue with the committee's staff to resolve our technical and philosophical concerns with the draft. For convenience, we describe our most serious concerns below.

SEC. 3. SPECULATIVE LIMITS AND TRANSPARENCY OF OFFSHORE TRADING.

Subpart (a) directs the Commission to preclude direct access from the U.S.: "to the electronic trading and order matching system of the foreign board of trade with respect to an agreement, contract, or transaction that settles against any price (including the daily or final settlement price) of 1 or more contracts listed for trading on a registered entity," unless the foreign board of trade satisfies a broad set of conditions respecting position limits, information sharing, and the definition of bona fide hedging.

The draft bill is calibrated appropriately to focus only on a narrow range of contracts that might be traded on a foreign board of trade, although we wonder why it is restricted to financially

settled contracts and does not include substantially identical physically settled contracts. We are, nonetheless, concerned that this effort may provoke retaliatory behavior from foreign governments or regulatory agencies that could severely impair our business.

SEC. 4. DETAILED REPORTING AND DISAGGREGATION OF MARKET DATA.

Section 4 amends the CEA to require that the Commission issue a "rule defining and classifying index traders and swap dealers (as those terms are defined by the Commission) for purposes of data reporting requirements and setting routine detailed reporting requirements for any positions of such entities . . . ." The draft requires the Commission to impose "routine detailed reporting requirements" on such traders. It is unclear that a higher level of routine reporting for such traders is necessary or appropriate; the Commission is empowered to issue special calls for information without demonstrating any cause. Section 4 also requires swap dealers and index traders to report all positions on foreign boards of trade, without regard to whether those positions implicate any U.S. regulatory interests. It is not clear that this was intended; it is not necessary and imposes an unnecessary burden on the CFTC.

Section 4 also includes a reporting provision that we do not understand. The Commission is required to publish: "data on speculative positions relative to bona fide physical hedgers in those markets to the extent such information is available.'' The Commission does not have information on hedgers who do not exceed speculative limits: in consequence this number is likely to be highly misleading.

SEC. 5. TRANSPARENCY AND RECORDKEEPING AUTHORITIES.

Subpart (a) extends the reporting requirements for CFTC registrants beyond trading on any board of trade in the United States or elsewhere to include OTC "trading of transactions and positions traded pursuant to subsection (d), (g), (h)(1), or (h)(3) of section 2, or any exemption issued by the Commission by rule, regulation or order." We agree that these transactions should not escape CFTC scrutiny but question whether subsection (a) is necessary in light of the special call provisions in subpart (b).

SEC. 6. TRADING LIMITS TO PREVENT EXCESSIVE SPECULATION.

Section 6 requires the Commission to: "establish limits on the amount of positions, as appropriate, other than bona fide hedge positions, that may be held by any person . . ." The mandatory limits apply to all commodities traded on regulated markets, without regard to whether excess speculation has ever been an issue in the commodity or whether it is a foreseeable danger. The standard that the Commission must apply is:

> "(B) to the maximum extent practicable, in its discretion—
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> > (i) to diminish, eliminate, or prevent excessive speculation as described under this section;
> > (ii) to deter and prevent market manipulation, squeezes, and corners;
> > (iii) to ensure sufficient market liquidity for bona fide hedgers; and
> > (iv) to ensure that the price discovery function of the underlying market is not disrupted; and
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> (C) to the maximum extent practicable, in its discretion, take into account the total number of positions in fungible agreements, contracts, or transactions that a person can hold in other markets."

We are concerned that the bill imposes conflicting standards and offers no guidance to the Commission on how those conflicts are to be resolved other than that each is to be fulfilled to the maximum extent practicable. Position limits are a device to promote liquidation and orderly delivery

in physical contracts. If position limits are not being used for those purposes they artificially impose restrictions on access to markets and are more likely to prevent prices from reaching a true equilibrium than to serve a positive purpose.

Moreover, position limits are not appropriate for all commodity contracts. Where the final price of the futures contract is determined by reference to an externally calculated index that is not impacted by the futures market, for example rainfall during a fixed period, position limits cannot be justified. Most financial futures traded on CME Group are not settled by delivery of an underlying commodity and therefore are not readily susceptible to market manipulation. In such a case, accountability levels are more appropriate than position limits.

Mandating position limits in non-spot month physical delivery contracts is unnecessary because those contracts do not have a close, direct impact on the price discovery function for the cash market of the underlying commodity. Accountability levels are sufficient to deter and prevent market manipulation in non-spot months.

CME Group has numerous surveillance tools, which are used routinely to ensure fair and orderly trading on our markets. Monitoring the positions of large traders in our market is a critical component of our market surveillance program. Large trader data is reviewed daily to monitor reportable positions in the market. On a daily basis, we collect the identities of all participants who maintain open positions that exceed set reporting levels as of the close of business the prior day. Generally, we identify in excess of 85% of all open positions through this process. This data, among other things, are used to identify position concentrations requiring further review and focus by Exchange staff. Any questionable market activity results in an inquiry or formal investigation.

Section 6 also requires that the Commission establish advisory committees with respect to agriculture based futures and energy based futures to advise the Commission on speculative position limits. These advisory committees are, by law, dominated by enterprises that have a direct interest in the markets on which they are advising. In addition to this inherent conflict, the bill offers no standard to direct the deliberations of these advisory committees. Instead, it puts 19 or 20 people, with diverging financial interests, in a room and tells them to make a decision. We strongly oppose this process, which empowers market participants whose objectives differ materially from the CEA's purpose in establishing position limits.

Regulated futures markets and the CFTC have the means and the will to limit speculation that might distort prices or distort the movement of commodities in interstate commerce. Former CFTC Acting Chairman Lukken's testimony before the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce United States House of Representatives (December 12, 2007) offers a clear description of these powers and how they are used:

> All agricultural and natural resource futures and options contracts are subject to either Commission or exchange spot month speculative position limits – and many financial futures and options are as well. With respect to such exchange spot month speculative position limits, the Commission's guidance specifies that DCMs should adopt a spot month limit of no more than one-fourth of the estimated spot month deliverable supply, calculated separately for each contract month. For cash settled contracts, the spot month limit should be no greater than necessary to minimize the potential for manipulation or distortion of the contract's or underlying commodity's price. For the primary agricultural contracts (corn, wheat, oats, soybeans, soybean meal, and soybean oil), speculative limits are established in

the Commodity Exchange Act and changes must be approved via a petition and public rulemaking process.
http://www.cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/opalukken-32.pdf

Subsection (2) directs the Commission to define a bona fide hedge, which permits traders to exceed the hard speculative limits. Proposed subpart (A) pertains to hedgers acting for their own accounts. Subpart (B) governs swap dealers and others who are hedging risks assumed in the OTC market. We believe that subpart (A) has unintended and highly detrimental consequences respecting the ability of regulated futures exchanges to provide hedging opportunities for important business enterprises. The bill provides that a futures position does not qualify as a bona fide hedge unless it: ''(A)(i) represents a substitute for transactions made or to be made or positions taken or to be taken at a later time in a physical marketing channel . . . ." This interpretation is compelled by the linking of clauses (i), (ii) and (iii) by the conjunctive "and," which requires that all three conditions be satisfied.[1] As a result, the provisions in (ii) and (iii), which currently operate as independent grounds for a hedge exemption, are nullified. This works perfectly for a grain elevator or farmer who shorts his inventory or expected crop. Futures markets, however, are also used for more sophisticated hedging.

Obviously, this limitation precludes electric utilities from hedging capacity risks associated with weather events by use of degree day unit futures contracts. That hedge involves no substitute for a transaction in a physical marketing channel. Insurance companies may not hedge hurricane or other weather risks. Enterprises that consume a commodity that is not used in a "physical marketing channel" such as airlines that use fuel, generating facilities that use gas and produce electricity, freight companies whose loads depend on geographic pricing differentials and hundreds of other important examples that readily present themselves, will not be entitled to a hedge exemption from mandatory speculative limits. Even if "or" were substituted, a significant number of clearly legitimate hedging transactions are precluded.

Subpart (B) offers swap dealers a very narrow window within which to qualify for a hedge exemption. The position being hedged must reduce: "risks attendant to a position resulting from a transaction that— . . . was executed opposite a counterparty for which the transaction would qualify as a bona fide hedging transaction . . . ." On a practical basis, swap dealers use the futures market to reduce their overall risk; we do not believe that particular futures positions can be linked to identified OTC transactions. Thus, the utility of futures markets as a risk transfer venue will be seriously impaired. We are happy to work with the staff to devise language that will eliminate the use of OTC intermediaries as a mask for trading that would otherwise violate position limits.

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[1] (2) For the purposes of contracts of sale for future delivery and options on such contracts or commodities, the Commission shall define what constitutes a bona fide hedging transaction or position as a transaction or position that—

(A)(i) represents a substitute for transactions made or to be made or positions taken or to be taken at a later time in a physical marketing channel;
(ii) is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise; and
(iii) arises from the potential change in the value of—
(I) assets that a person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising;
(II) liabilities that a person owns or anticipates incurring; or
(III) services that a person provides, purchases, or anticipates providing or purchasing;

We believe that the bill's direction to the Commission to define a bona fide hedging transaction set out in Section 6 (2) is overly restrictive with respect to its constraints on the ability of dealers, funds and others who have assumed risks in the over the counter market, which are consistent with their legitimate businesses, to transfer the net risk of their OTC positions to the futures markets. CME Group is concerned that this limitation on hedge exemptions for swap dealers will limit the ability of commercial enterprises to execute strategies in the OTC market to meet their hedging needs. For example, commercial participants often need customized OTC deals that can reflect their basis risk for particular shipments or deliveries. In addition, not all commercial participants have the skill set necessary to participate directly in active futures markets trading. Swap dealers assume that risk and lay it off in the futures market.

This restriction contravenes the otherwise clear intent of the draft bill to limit systemic risk by driving OTC generated risk into a central counter party clearing context. The consequences of this constraint are magnified by the simultaneous imposition of hard position limits on financial futures that are settled by reference to prices that are not susceptible to manipulation, such as Eurodollars or currencies.

SEC. 8. REVIEW OF PRIOR ACTIONS.

Section 8 of the proposed bill imposes a burden on the Commission that is not justified and that will divert it from the important responsibilities assigned to it in Section 7. It requires the Commission to:

> "review, as appropriate, all regulations, rules, exemptions, exclusions, guidance, no action letters, orders, other actions taken by or on behalf of the Commission, and any action taken pursuant to the Commodity Exchange Act by an exchange, self-regulatory organization, or any other registered entity, that are currently in effect, to ensure that such prior actions are in compliance with the provisions of this Act."

No guidance is offered as to what is appropriate, and we are unaware of any action that the Commission has taken, including those with which we have disagreed, that could be found to be "not in compliance with the "provisions of this Act." The review of the rules of the rules of registered entities and the NFA will be a massive undertaking, given the size and complexity of the rule books, interpretations and notices that govern the business of the registered entities and the NFA and the lack of direction. We are not aware of any significant dissatisfaction with the Commission's actions or the actions of the registered entities and the SRO's that would compel so wide-reaching a review.

SEC. 11. OVER-THE-COUNTER AUTHORITY.

Section 11 authorizes the Commission to impose position limits on transactions exempted or excluded from the CEA by "subsections (d), (g), (h)(1), and (h)(3) of section 2," if it first finds that such contracts are: "fungible (as defined by the Commission) with agreements, contracts, or trans actions traded on or subject to the rules of any board of trade or electronic trading facility with respect to a significant price discovery contract . . . ." We are surprised by the use of the term "fungible," which is generally limited to contracts that may be offset. We assume that this power should apply when the contracts are close economic substitutes. Secondly, the reference to the defined term "board of trade" rather than the phrase "designated contract markets and derivatives transaction execution facilities" or "registered entity" (as is ordinarily used in the bill) is bound to be afforded some significance, which escapes us. While we are generally in agreement with the purposes of this Section, we expect that representatives of the participants in the OTC market are best positioned to discuss the impact of this provision and any other technical drafting issues.

SEC. 12. EXPEDITED PROCESS.

Section 12 grants the Commission authority to act in an expedited manner "to carry out this Act if, in its discretion, it deems it necessary to do so." The Commission currently has comprehensive authority to respond to an emergency. This provision eliminates the salutary requirement that there be an emergency before the Commission is empowered to act precipitously and we do not agree that it is either necessary or appropriate to grant such powers.

SEC. 13. CERTAIN EXCLUSIONS AND EXEMPTIONS AVAILABLE ONLY FOR CERTAIN TRANSACTIONS SETTLED AND CLEARED THROUGH REGISTERED DERIVATIVES CLEARING ORGANIZATIONS.

Section 13 is intended to force certain transactions that were exempted from the exchange trading requirement and most other Commission regulations by 2(d)(1)(C), 2(d)(2)(D), 2(g)(4), 2(h)(1)(C), or 2(h)(3)(C) of the Act either onto a regulated trading platform or to be cleared by a CFTC Designated Clearing Organization or a comparable clearing house. While this section appears to favor our organization and advances our goals, we are concerned that it will fail to produce the desired result and negatively impact the U.S. derivatives industry. We discussed this point in the introductory portion of this testimony.

SEC. 14. TREATMENT OF EMISSION ALLOWANCES AND OFFSET CREDITS.

Section 14 authorizes the trading of: "any allowance authorized under law to emit a greenhouse gas, and any credit authorized under law toward the reduction in greenhouse gas emissions or an increase in carbon sequestration.'' The CEA was already sufficiently broadly worded to permit such contracts to be traded on futures exchanges subject to the Commission's exclusive jurisdiction. We are concerned that the specific description may, in the future, be read as a limitation on the authority to create futures contracts relating to the greening of America and we believe that the Committee needs to generalize the language to avoid that implication.

SEC. 16. LIMITATION ON ELIGIBILITY TO PURCHASE A CREDIT DEFAULT SWAP.

Section 16, which makes it: "unlawful for any person to enter into a credit default swap unless the person would experience financial loss if an event that is the subject of the credit default swap occurs'' is worded in a manner that prohibits the use of credit default swaps for any purpose. The language requires both the buyer and seller of credit protection to suffer a loss if the event were to occur and there was no credit default swap in place. Obviously, only the buyer of credit protection qualifies.

However, even if the language were corrected, we are opposed to this provision as an unwarranted restriction on functioning of free markets. This provision punishes the instrument and legitimate users of the instrument for the excesses of the management of AIG. The instrument was innocent as were the vast bulk of the users of the instrument and the markets in which the instruments were transacted. We do not purport to be the appropriate spokesperson for the industry, but we can assure you that all of our plans to clear CDSs will come to naught if this provision is adopted.

Credit default contracts serve an important economic purpose in an unfortunately imperfect manner. At the ideal level, credit default contracts permit investors to hedge specific risk that a particular enterprise will fail or that the rate of failure of a defined group of firms will exceed expectations. However, because credit default contracts are not insurance, investors who are not subject to any specific risk can assume default risk to enhance yield or buy protection against a default to speculate on the fate of a company or the economy generally. Credit default contracts are also an excellent device to short corporate bonds, which otherwise could not be shorted.

If such contracts are executed in a transparent environment, if the regulators responsible for controlling systemic risk can easily keep track of the obligations of the banks, brokers and other participants in the market and if a well regulated clearing house acts as the central counterparty for such contracts, we believe that they can serve an important role in our economy without imposing undue systemic risks.

CONCLUSION:

Futures markets perform two essential functions—they create a venue for price discovery and they permit low cost hedging of risk. Futures markets depend on short and long term speculators to make markets and provide liquidity for hedgers. Futures markets could not operate effectively without speculators and speculators will not use futures markets if artificial barriers or tolls impede their access. CFTC-regulated futures markets have demonstrated their importance to the economy, the nation's competitive strength and America's international financial leadership. We have the means and the power to protect our markets against speculative excesses and are committed to doing so.