WRITTEN TESTIMONY
OF
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BEFORE THE
SENATE COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY
REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION
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Good afternoon Chairwoman Stabenow, Ranking Member Cochran, and Members of the Committee. Thank you for the opportunity to testify today regarding the CFTC's reauthorization. I am Terry Duffy, Executive Chairman and President of CME Group[1,2]

As the Committee considers reauthorization of the Agency, implementation of the Dodd-Frank Act continues to be central to the Committee's oversight. Dodd-Frank authorized the CFTC to create a regulatory structure for what had been unregulated swaps. Congress' goals were laudable: to reduce systemic risk through central clearing, to increase transparency and price discovery through exchange trading, to give government officials a window into swap dealings through transaction reporting, and to prevent fraud and market manipulation. Congress gave the CFTC a daunting task to write the regulations implementing this complex and far-reaching mandate, and the agency and staff are to be commended for their efforts to fix the swap market. Yet, despite these diligent efforts to establish swap regulations, the Commission often went far beyond Congress' intent, and in some instances adopted rules without providing needed guidance and clarification, relying upon last-minute no-action or exemptive relief to respond to confusion in the marketplace. Our industry would have ground to a standstill without last minute relief.

For example, the CFTC finalized its product definition rulemaking in the summer of 2012, with an effective date of October 12, 2012. This effective date triggered compliance obligations

[1] CME Group Inc. is the holding company for four exchanges, 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") (collectively, the "CME Group Exchanges"). The CME Group Exchanges offer a wide range of benchmark products across all major asset classes, including derivatives based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products. The CME Group Exchanges serve the hedging, risk management, and trading needs of our global customer base by facilitating transactions through the CME Group Globex electronic trading platform, our open outcry trading facilities in New York and Chicago, and through privately negotiated transactions subject to exchange rules.

[2] My testimony supplements CME Group's letter dated May 1, 2013 to the Committee regarding CFTC's reauthorization.

relating to products defined as “swaps” under many different rulemakings previously finalized by the CFTC. However, market participants were confused about their responsibilities under these rulemakings because the CFTC had not yet completed critical rulemakings that would clarify whether certain types of contracts used in the energy markets were “swaps.” Ultimately, and at the last minute before the compliance deadline, the CFTC issued an order delaying the implementation of these compliance obligations to allow the swaps and futures markets to continue operating without disruption until year end.

A few months later, lack of clarity in swap reporting rulemaking again led to confusion in the energy markets. When the swap data reporting obligations became effective, it was not clear to market participants whether they were required to provide historical trade data relating to certain energy contracts that have been listed and regulated as futures for over a decade. Notwithstanding the fact that this same trade data was already being reported to the CFTC under the existing futures rules, it was not clear, and remains unclear, whether this data was also subject to swap data reporting requirements. CME Group has submitted to the CFTC two requests for guidance, consistent with the CFTC’s explicit indication in their proposed rulemaking that they would provide such guidance.[3] To date, energy market participants still have not received clarity from the CFTC regarding their recordkeeping or reporting obligations under the new swap rules, many of which are today in effect.

Furthermore, the Commission has used its swap mandate as a pretext to impose needless rules on the robustly regulated futures markets. Congress did not intend in Dodd-Frank to rewrite rules for this well-functioning, highly regulated marketplace, or to discourage market participants around the world from using U.S. markets. As the CFTC completes its remaining work to implement Dodd-Frank, we encourage the Committee to ensure that these rules remain within the Congressional mandate and do not undermine the ability of businesses in the U.S. and worldwide to continue to manage risk.

Margin Rules and Misplaced claims about “Futurization”

Futures markets have a long history of strong oversight and regulation. That history rebuts those that claim the “Futurization” of swap markets is a way to secure weaker regulation and more favorable margin treatment. Market participants trade futures because they understand the well-established rules for futures. Dodd-Frank makes clear that futures and swaps are different product classes and should receive similar, but not identical, regulation.

For example, margin is one of the areas of greatest concern to those decrying "Futurization." Margin requirements permit the clearing house that is clearing a contract to mitigate the risk attendant to that specific contract. CFTC rules set a floor for the amount of initial margin that clearinghouses must collect. At the CME's clearing house, margin is determined by risk management policies and procedures designed to account for the actual risk profile of the

[3] In the rule proposal relating to historical data reporting requirements, the Commission stated that it "expects to provide interpretive guidance concerning the determination of the reporting counterparty in situations where a historical swap was executed and submitted for clearing via a platform on which the counterparties to the swap do not know each other's identity." 77 Fed. Reg. 35200, 35211, n.43 (June 12, 2012).

product -- its underlying volatility and liquidation risk -- not its label as a swap or a future. In fact, many of our futures products require initial margin based on a two-day volatility measure, in excess of the CFTC's regulatory minimum for futures.

The example provided by the Lehman bankruptcy is informative. From the time CME decided to liquidate Lehman's house accounts' futures positions cleared by CME to the time of complete liquidation, six hours elapsed. This was a complex portfolio, across all of CME major product categories, with the margin required on the portfolio approaching $2 billion. We used a variety of market participants to liquidate, and did so with without needing to access assets beyond the margin that was appropriately posted according to CME's rules. Based on the Lehman experience, we can expect it will require more resources and industry coordination to liquidate complex swaps portfolios.

This example illustrates that whether a swap and a future share an economic profile is not the determinative factor to a clearing house in setting margins. The determinative factor is the overall risk profile of the product. And the liquidity and transparency afforded by that product's market infrastructure is a critical element of the product's risk profile.

It is consistent with the risk mitigation objectives of Dodd-Frank to ensure that margin requirements be tailored to address the risk characteristics of different contracts. Market participants will continue to use both customizable swaps and standardized futures products. Innovation, competition and customer choice among well-regulated markets for swaps and futures is not only a positive development for customers and the public as a whole, but is entirely consistent with the goals of Dodd-Frank. Congress should welcome this as an accomplishment of the Act.

Cross-Border Interpretative Guidance

The Agency's initial proposal to impose its rules across international borders without regard to local rules or regulators had threatened to expose the industry to conflicting duties and set the stage for retaliation from foreign regulators. We welcome the recent agreement between the CFTC and European Commission on a "Common Path Forward." We are hopeful that this positive development will lead to the US and EU regulators achieving workable mutual recognition of derivatives trading and clearing regulation.

In this regard, the joint statement of the CFTC and the European Commission noted the difference in treatment between the EU and US of initial margin coverage. While the minimum standards, such as initial margin, that apply to CCPs in the US and the EU may differ, they are both narrowly tailored to the relevant marketplaces in those jurisdictions, and accordingly, we would suggest, achieve the same risk mitigation outcome. Initial margin is just one of many risk mitigation techniques employed by CCPs (e.g. concentration charges, variation margin/mark to market). Due to CME's twice daily mark-to-market rules, CME's minimum margin period of risk of one day effectively covers twice the potential exposure of a portfolio in a given day. This approach to initial margin levels has been validated repeatedly during periods of market stress, including during the liquidation of house and customer portfolios where necessary. ESMA (the European Securities and Markets Authority) has imposed a 2-day minimum initial margin

coverage. We believe that the application of a 2-day minimum for the US futures markets is both inappropriate based on market characteristics and unnecessarily costly to end users, including small agricultural producers who use the markets as a necessary hedge to their business risks.

Position Limits

The CFTC's over-reaching has extended to its physical commodity position limit rule. We have imposed position limits in the spot months for many of our own markets and an early warning system of accountability levels for all other trading months. The CFTC, however, tried to impose hard cap limits for all months, including the non-spot months, based on its view that in Dodd-Frank Congress had mandated those limits even if they were not found to be necessary.

Last year, a U.S. District Court Judge found the CFTC improperly concluded that it had a mandate post-Dodd-Frank to impose limits under any circumstances. The CFTC is appealing that decision. CME recently joined other market participants asking the court to direct the CFTC to determine that position limits are necessary and appropriate before imposing them.

Simultaneously with the appeal, the CFTC is also re-writing its position limits rule. To ensure that the CFTC relies upon accurate and current market data in its analysis, CME recently submitted updated deliverable supply data for physical commodities – energies, metals and agriculture products. The Commission should rely on these updated data if it undertakes to propose a new position limit rule.

Customer Protection

Industry Safeguards

I have previously testified about the rules CME Group, together with the National Futures Association ("NFA") and other U.S. futures exchanges have implemented to strengthen the protection of customer property (and its investment) at Futures Commission Merchants ("FCMs") through strict and regular reporting and daily feeds of cash and securities balances of all customer accounts at banks. They improve our work to mitigate the risk of, and early detection of, the improper transfer of customer funds and the improper reporting of customer asset balances, and improve our ability to check compliance with CFTC requirements for the investment of customer funds. Our efforts to enhance our monitoring continue today through the use of an account balance aggregation tool. Timely, including daily, access to this additional information is enabling us to better direct our regulatory resources at risk-based reviews of customer balances at clearing members and FCMs and their activity with respect to those balances.

Moreover, the CFTC has recently proposed additional rules on customer protection that include provisions codifying these initiatives, which we strongly support. However, this rulemaking also seeks to fundamentally change the way in which the futures marketplace operates. If a proposed "protective" measure is so expensive or its impact on market structure is so severe that

customers cannot effectively use futures markets to mitigate risk or discover prices, the reason to implement that measure needs to be re-examined. Among the proposed rules to reevaluate is the rule that would require *at all times* an FCM's residual interest (its own funds) in segregated accounts to exceed the margin deficiencies of its customers. It does not appear that any system currently exists or could be constructed in the near future that will permit FCMs to accurately calculate customer margin deficiencies, continuously in real-time. Without access to this data, FCMs will be required to maintain substantial residual interest in segregated accounts or require customers to significantly over-collateralize their accounts. We believe this will be a significant and unnecessary drain on liquidity that will make trading significantly more expensive for customers to hedge. We believe this rule and others could have a very significant impact on certain sectors in the marketplace, particularly smaller FCMs that serve the agricultural community. The industry is conducting an impact analysis of these rules. We have urged the CFTC to allow the industry to complete this impact analysis before proceeding further with the rulemaking process.

Further, CME Group believes that proposed changes to Rule 1.52 threaten the viability of the current regulatory structure. This rule governs the manner in which self-regulatory organizations ("SROs"), such as CME and NFA, conduct their risk-based reviews of FCMs. Among other things, the proposed rule improperly conflates the roles played by an FCM's outside auditor and its regulatory examiners (designated SROs or DSROs), in essence requiring SROs and DSROs to replicate the role of an external auditor. SROs and DSROs are not staffed to play such a role, nor should they be. One of the primary strengths of the current regulatory scheme is that SROs and DSROs play a role distinct from, yet complementary to, that played by an outside auditor. Rather than simply replicating the work performed by outside auditors, the SROs and DSROs perform limited reviews that focus on particular areas of regulatory concern, including the segregation of customer funds and net capital requirements. This proposal would serve little regulatory purpose while imposing significant costs.

SRO Structure is Critical to Continued Customer Protection

Some critics suggest that self-regulation is a contributing factor to any failure or fraud in the financial services business. The self-regulation that is being criticized no longer exists. Yes, before exchanges demutualized and became public companies they were owned by their members and were responsible for regulating and disciplining their owners. That was self-regulation. Self-regulation in the context of modern futures markets regulation, though, is a misnomer.

The regulatory structure of the modern U.S. futures industry involves a comprehensive network of regulatory organizations that work together to ensure the effective regulation of all industry participants. The Commodity Exchange Act establishes the federal statutory framework that regulates the trading and clearing of futures and futures options in the United States, as well as swaps other than security-based swaps (which fall under the regulatory purview of the Securities Exchange Commission), pursuant to Dodd-Frank. The CEA is administered by the CFTC, which establishes regulations governing the conduct and responsibilities of market participants, exchanges and clearing houses. Thus, the industry's SRO-based regulatory structure is not that of a single entity governed by its members regulating its members, but rather a structure in which exchanges, most of which are public companies, regulate the activity of all participants in their

markets - members as well as non-members - complemented with corollary oversight by the NFA and CFTC.

In the wake of certain high profile failures at FCMs, some have suggested that the SRO model should be discarded. This is a misguided suggestion that ignores the clear and significant benefits of the SRO model. Direct regulation by the exchange offers our regulators unique proximity to the markets, market participants and the broader resources of the exchange in ways that foster the development of expertise that not only helps to make our regulatory staff more effective, but also assists federal regulators in our common objective of preserving the integrity of the markets. Exchange sponsored regulation also allows for more expedient identification of potential issues given our knowledge of and proximity to the markets, as well as the ability to react more quickly and flexibly to potential market and regulatory issues. Finally, it should not be forgotten that SROs have very compelling incentives to ensure that the regulatory programs operate effectively, and devote considerable resources to regulating FCMs. CME, for example, spends more than $40 million each year on its regulatory function, and employs more than 200 financial and regulatory surveillance professionals, market regulation professionals and regulatory IT professionals.

The lesson from the failure of certain FCMs is not to tear down the SRO regulatory structure, but rather to build it even stronger to ensure direct and robust regulation by SROs. To that end, our focus has been, as it should be, on how our systems and processes can continue to evolve and improve so that we can best perform our role as an SRO. Over the last 18 months, the futures SRO model has been buttressed by new requirements the industry has put in place to deter another firm from misusing customer funds:

- Increased surprise reviews of customer segregated funds
- Daily segregation reporting by all FCMs
- Bi-monthly reporting on investment of segregated funds
- Periodic electronic confirmation of customer segregation balances from firms via e-confirm system
- New rules providing for daily feeds of cash and securities balances for all customer accounts at banks
- CEO/CFO signoffs of customer segregated fund distributions (Corzine rule)

These new rules, which, as noted above, have also been proposed by the CFTC in regulations to enhance protections afforded customers and customer funds, have strengthened SRO regulatory protection for all participants in the derivatives markets.

Bankruptcy Code Improvements

We believe that Congress could further enhance customer protections through amendments to the Bankruptcy Code. Potential amendments range from fundamental changes that would facilitate individual segregation of customer property, as an option should an FCM choose to offer it, to narrower revisions that would enhance a clearing house’s ability to promptly transfer positions of non-defaulting customers. While amending the Bankruptcy Code is a significant undertaking, CME Group believes in light of recent experience that modification to the bankruptcy regime would benefit customers and the market as a whole.

Insurance for Future Study

In the wake of MF Global and Peregrine Financial, some have advocated establishing an insurance scheme to protect futures customers. Any such proposal must be analyzed in light of the costs and potentially limited efficacy of such an approach due the extraordinarily large amount of funds held in U.S. segregation.

The futures industry, led by the Futures Industry Association[4], is researching various insurance mechanisms in order to provide a quantitative, data-based analysis that will enable policymakers and market participants to determine whether insurance for futures would be viable.

Agency Funding and Proposals to Merge the CFTC and SEC

Finally, I want to briefly address the issues of agency funding and proposals to merge the CFTC and SEC.

It is essential to customer protection and healthy U.S. derivatives markets that the agency that oversees us be adequately funded. But we strongly oppose the Administration's proposal to fund the entire amount with a "user fee,'' which is just another name for a transaction tax. The Administration's FY-2014 Budget proposes to increase the CFTC's budget by $109 million to $315 million and to fund the entire amount with a "user fee" levied on futures and derivatives trades. Such a "user fee" will impose a $315 million per year transaction tax on market making, which is an essential source of market liquidity. Imposing this new tax would also increase the cost of business for all customers, even those the Administration wants to exempt, because it would reduce liquidity, increase volatility, and impair the efficient use of U.S. futures markets. It will make it more difficult and expensive for farmers, ranchers, and other end users to hedge commodity price risk in the market. This will force farmers and other market participants to pass along these higher costs to consumers in the form of higher food prices.

Moreover, the tax will change the competitive balance in favor of foreign and OTC markets with lower transaction costs where, in an electronic trading environment, market users can and will shift their business; lessen the value of the information provided to farmers and the financial services industry by means of the price discovery that takes place in liquid, transparent futures markets with low transaction costs; increase the cost to the government resulting from less liquid government securities markets; and fail to actually collect the funds anticipated when volume drops and market participants choose lower cost alternative jurisdictions and markets. Last week, regulators in India saw derivatives volume drop by more than a third immediately following implementation of a one percent transaction tax.

For all of these reasons, Congress should reject a transaction tax to fund the CFTC.

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[4] CME Group, the Institute for Financial Markets ("IFM") and the NFA are also sponsors of the study.

With respect to proposals to merge the CFTC and SEC, we continue to believe that such a merger is unwarranted and would hamper, rather than increase, the effectiveness of each of these critical agencies. Derivatives and equities markets differ greatly in market structure, market purpose, and regulatory structure. Equities markets are fragmented, with multiple pools of liquidity both on and off exchange. The purposes of equities markets include investment and capital formation, while those of derivatives markets are primarily to hedge risk and discover macro-economic prices. And while the regulation of equities markets has traditionally been through a strict rules-based regime, the Commodity Exchange Act, which governs derivatives markets, has a principles-based structure.

While there are instances in which the two agencies must and should coordinate on rulemakings for these differing markets, this does not support the wholesale elimination of the regulatory structures that have evolved to address the unique needs and purposes of these markets, and we urge the Committee to oppose efforts to do so. Derivatives markets are critical to the systemic integrity of financial markets in the U.S. and around the world. Both derivatives and equities markets play a vital role in the domestic and international economy. Each should have its own regulator and regulatory structure that focuses on the unique challenges of each marketplace.

Conclusion

These are just a few of the many issues that have been submitted to the Committee in connection with your consideration of CFTC reauthorization. We stand ready to be a resource to the Committee on these and other critical issues to the futures and derivatives marketplace.