TESTIMONY
OF
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EXECUTIVE CHAIRMAN
CME GROUP INC.
BEFORE THE

SENATE COMMITTEE ON
BANKING, HOUSING & URBAN AFFAIRS

APRIL 12, 2011

Chairman Johnson, Ranking Member Shelby, members of the committee, thank you for the opportunity to testify on the 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 ("CME Group" or "CME"), which is the world's largest and most diverse derivatives marketplace. CME Group includes four separate exchanges—Chicago Mercantile Exchange Inc. the Board of Trade of the City of Chicago, Inc., the New York Mercantile Exchange, Inc. and the Commodity Exchange, Inc. (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 executed in compliance with the applicable Exchange rules and cleared by CME's clearing

house. 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 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. Dodd-Frank was adopted to impose a new regulatory structure on a previously opaque and unregulated market – the OTC swaps market. It was not intended to re-regulate the robustly regulated futures markets.

For example, while Congress granted the Commission the authority to adopt rules respecting core principles, it did not direct it to eliminate principles-based regulation. Yet the Commission has proposed specific requirements for multiple Core Principles—almost all Core Principles in the case of designated contract markets ("DCMs")—and effectively eviscerate the principle-based regime that has fostered success in CFTC-regulated entities for the past decade.

The Commission's almost complete reversion to a prescriptive regulatory approach converts its role from an oversight agency, responsible for assuring self regulatory organizations comply with sound principles, to a front line decision maker that imposes its business judgments on the operational aspects of derivatives trading and clearing. This reinstitution of rule-based regulation will require a substantial increase in the Commission's staff and budget and impose indeterminable costs on the industry and the end users of derivatives. Yet there is no evidence that this will be beneficial to the public or to the functioning of the markets. In keeping with the President's Executive Order to reduce unnecessary regulatory cost, the CFTC should be required to reconsider each of its proposals with the goal of performing those functions that are mandated by DFA.

Further, 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. Without unnecessary, costly and burdensome regulatory review, U.S. futures exchanges have been 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. 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. The transition to an inflexible regime threatens to stifle growth and innovation in U.S. exchanges and thereby drive market participants overseas. As further discussed below, this will certainly impact the relevant job markets in the United States.

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 aggressive 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 Commission's 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. I will discuss below the Commission's failure to comply with the Congressionally mandated cost-benefit process, the need to sequence Dodd-Frank rulemaking appropriately, and the potential negative impact on U.S. markets of regulatory proposals.

A. Lack of Consideration of Costs of Regulatory Proposals

The Commission's rulemaking has been skewed by its failure to follow the plain language of Section 15 of the Commodity Exchange Act ("CEA"), as amended by DFA, which requires the Commission to consider the costs and benefits of its action before it promulgates a regulation. In addition to weighing the traditional direct costs and benefits, Section 15 directs the Commission to

include in its evaluation of the benefits of a proposed regulation the following intangibles: "protection of market participants and the public," "the efficiency, competitiveness, and financial integrity of futures markets," "price discovery," "considerations of sound risk management practices," and "other public interest considerations." The Commission has construed this grant of permission to consider intangibles as a license to ignore the real costs.

The explicit cost-benefit analysis included in the more than thirty rulemakings to date and the Commission's testimony in a number of congressional hearings indicate that those responsible for drafting the rule proposals are operating under the mistaken interpretation that Section 15(a) of the CEA excuses the Commission from performing any analysis of the direct, financial costs and benefits of the proposed regulation. Instead, the Commission contends that Congress permitted it to justify its rule making based entirely on speculation about unquantifiable benefits to some segment of the market. The drafters of the proposed rules have consistently ignored the Commission's obligation to fully analyze the costs imposed on third parties and on the agency by its regulations.

Commissioner Sommers forcefully called this failure to the Commission's attention at the CFTC's February 24, 2011, Meeting on the Thirteenth Series of Proposed Rulemakings under the Dodd-Frank Act.

> "Before I address the specific proposals, I would like to talk about an issue that has become an increasing concern of mine – that is, our failure to conduct a thorough and meaningful cost-benefit analysis when we issue a proposed rule. The proposals we are voting on today, and the proposals we have voted on over the last several months, contain very short, boilerplate "Cost-Benefit Analysis" sections. The "Cost-Benefit Analysis" section of each proposal states that we have not attempted to quantify the cost of the proposal because Section 15(a) of the Commodity Exchange Act does not require the Commission to quantify the cost. Moreover, the "Cost Benefit Analysis" section of each proposal points out that all the Commission must do is "consider" the costs and benefits, and that we need not determine whether the benefits outweigh the costs."

Commissioner Sommers reiterated her concern with the lack of cost-benefit analysis performed by the Commission in her March, 30, 2011 testimony before the Subcommittee on Oversight and Investigations of the House Committee on

Financial Services. Commissioner Sommers noted that "the Commission typically does not perform a robust cost-benefit analysis at either the proposed rule stage or the final rule stage" and noted that "while we do ask for comment from the public on the costs and benefits at the proposal stage, we rarely, if ever, attempt to quantify the costs before finalizing a rule."

B. Sequencing of Rulemakings under Dodd-Frank

Chairman Gensler has recently disclosed his plan for the sequencing of final rulemakings under DFA. He has divided the rulemakings into three categories: early, middle and late. We agree that sequencing of the rules is critical to meaningful public comment and effective implementation of the rules to implement DFA. Many of the rulemakings required by DFA are interrelated. That is, DFA requires many intertwined rulemakings with varying deadlines. Market participants, including CME cannot fully understand the implications or costs 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.

We agree with many, but not all aspects of the Chairman's proposed sequencing agenda and have recently proposed an alternative sequencing agenda to the Commissioners. We recommend that in Phase 1 (early), the Commission focus on rules that are necessary to bring the previously unregulated swaps market into the sound regulatory framework that exists for futures markets. This set of major rulemakings represents the largest amount of change for the industry and cannot be satisfactorily addressed in a timely manner if key elements of the regulatory framework for swaps clearing are not determined until the middle or late stages of the rulemaking process. Further, the regulatory framework for reducing systemic risk in OTC derivatives was the central focus of DFA and therefore should have the highest priority.

We suggest that Phase II (middle) deal with exchange-trading requirements for swaps, including the definition of and requirements for swap trading facilities, business conduct standards for swap dealers and requirements for swap data repositories. While we support efforts to increase transparency in swaps markets, we believe these rulemakings are less critical in time priority than the clearing mandate and related clearing rules that will reduce systemic risk.

Finally, we recommend that the Commission leave those rulemakings that deal with DCMs and position limits for Phase III (late). As I mention throughout my testimony, the exchange-traded derivatives market operated flawlessly during the financial crisis, and the proposed rules affecting DCMs and position limits, which as discussed below, often represent an overstepping of the Commission's authority under DFA, represent incremental changes to an already robust regulatory scheme.

With respect to the phasing in of the mandatory clearing rules for swaps, some have suggested that the clearing requirement first be applied to dealer-to-dealer swaps and then later applied to dealer-to-customer swaps. CME Group strongly disagrees with this approach insofar as it may limit clearing competition and customer choice and because, more importantly, it will disadvantage customers who are preparing for central counterparty clearing of swaps but are unable to complete their preparations due to the uncertainty associated with the lack of final rules. Sell-side and buy-side participants may elect to support or prefer different clearing solutions depending on how they are owned and operated, the membership requirements associated with each clearing house, and the risk management and default management features associated with each clearing solution. Different clearing houses have already adopted differing approaches to these features, enhancing competition and the proliferation of different business models. Sequencing dealer-to-dealer clearing prior to dealer-to-customer clearing lacks any rational justification and simply limits the availability of competing clearing models, potentially limiting competition, which Congress expressly provided for in DFA.

The theory behind phasing in dealer-to-dealer swaps first is that dealers will be prepared to begin clearing swaps before buy-side participants are likewise prepared. This rationale, however, is not based in fact. An overwhelming number of buy-side participants are already clearing or ready to clear or will be ready to clear in the near future. Ten buy-side firms are already clearing at CME Group. Another 30 are testing with us and have informed us that they are planning to be prepared to clear no later than July 15. Another 80 buy-side firms are in the pipeline to clear with us and would like to be ready to clear voluntarily approximately 3-6 months before mandated to do so. Also, UBS recently conducted a comprehensive study (March 10, 2011) of OTC derivatives market participants to gauge the readiness on the buy-side for this transition. Their study found that buy-side firms are increasingly prepared to clear OTC derivatives, reporting that 73% of firms are already clearing or preparing to clear, 71% expect

to begin clearing within 12 months, and 82% expect that the majority of their OTC businesses will be cleared within two years. Claims that buy-side participants are not ready to clear are simply false and will disadvantage buy-side firms that wish to reduce bilateral clearing risks by adopting central counterparty clearing as soon as possible.

We believe that the most efficient way to implement the clearing mandate is to phase in the mandate on a product-class by product-class basis. Once the CFTC defines "class," it can mandate that large classes of instruments, such as 10-year interest rate swaps, be cleared regardless of the counterparties to the trade. This approach will (i) preserve customer choice in clearing, (ii) bring the largest volume of swaps into clearing houses as soon as possible, and (iii) allocate the Commission's limited resources in an efficient manner. CME Group's letter to Chairman Gensler, which discusses our position on both sequencing of rulemaking and sequencing of implementation of the clearing mandate in greater detail, is attached for your reference as Exhibit A.

The Commission should avoid creating an un-level playing field among large swap market participants - both in terms of freedom to choose among competing clearing offerings and in terms of their ability to reduce bilateral credit risks in a timely fashion. Congress wisely recognized that major swap participants that are not swap dealers can also pose systemic risks to the marketplace; hence the Commission should sequence rules applying to swap dealers and major swap participants at the same time.

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 the innovative, effective risk management that regulated exchanges have provided through the recent financial crisis and stifle the intended effects of financial reform, including the clearing of OTC transactions.

C. Impact of Regulatory Proposals on U.S. Markets

Several Commissioners clearly recognize the potential unintended consequences and the potential detrimental effects of a prescriptive, rather than principles-based, regime upon the markets. Commissioner Dunn, for example, 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."[1] 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?" [2]

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[1] 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

[2] 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."

"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

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Additionally, concern has been expressed regarding unduly stringent regulation driving major customers overseas; indeed, we have already seen this beginning to happen with only the threat of regulation. For example, Commissioner Sommers has 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."

The CFTC's apparent decision to impose a multitude of prescriptive rules on both DCMs"" and swap execution facilities ("SEFs") may have a detrimental effect on employment in the United States. The principles-based regulation of futures markets had a transformative effect on U.S. futures markets over the past decade. Since the Commodity Futures Modernization Act of 2000 ("CFMA"), which converted the CEA from a rules-based to principles-based regime, the futures markets have experienced unparalleled growth and innovation and have been able to regain and maintain a competitive position in the global market. The principles-based regime has allowed U.S. futures exchanges to keep pace with rapidly changing technology and market needs by introducing new products, processes, and methods of compliance and avoiding stifling regulatory review. The adoption by the CFTC of a prescriptive regime will stifle this innovation, make U.S. futures markets less attractive to traders, and in the end can only result in the loss of jobs as the markets lose their ability to compete.

Most notably, the newly prescriptive regime, as well as other rules proposed by the Commission, are not in harmony with international regulators. This creates an incentive for market participants to move their business to international exchanges where they may be subject to less prescriptive regimes, threatening negative consequences for U.S. exchanges. While the Commission has been working to induce international regulators to be equally prescriptive, that effort seems to be failing as other jurisdictions are alert to the value of snapping up the business that the Commission will drive off shore. The threat of prescriptive position limits and restrictions on hedging in the U.S. are already driving business overseas or into unregulated markets. Additionally, broad, undefined prohibitions

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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

on so-called "disruptive" trading practices and trading strategies will drive liquidity providers from the U.S. markets and impair hedging and price discovery. The CFTC should be careful not to adopt restrictions that tilt the competitive playing field in favor of overseas markets. Such a tilt will result in both a loss of jobs in the U.S. and less cost-efficient hedging for persons in business in the U.S.

Conclusion

Attached to my testimony are just a few examples where the Commission has proposed rules inconsistent with DFA or that impose unjustified costs and burdens on both the industry and the Commission. As previously noted, CME Group has great concern about the number of unnecessary and overly burdensome rule proposals aimed at the regulated futures markets. The goal of Dodd-Frank was to bring transparency, safety and soundness to the over-the-counter market, not re-regulate those markets which have operated transparently and without default. However, given the CFTC has determined to issue numerous rules above and beyond what is statutorily required by DFA, 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. To this end, we urge the Congress to ensure that the Commission performs a proper cost-benefit analysis, taking into account real financial costs to market participants, before the proposal or implementation of rules promulgated under DFA. The imposition of unnecessary costs and restrictions on market participants can only result in the stifling of growth of the U.S. futures industry, send market participants to overseas exchanges, and in the end, result in harm to the U.S. economy and loss of American jobs. 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.

Appendix

Concerns Regarding Specific Rulemakings

We are concerned that many of the Commission's proposed rulemakings go beyond the specific mandates of DFA, and are not legitimately grounded in evidence and economic theory. I will now address, in turn, several proposed rules issued by the Commission that illustrate these problems.

1. Advance Notice of Proposed Rulemaking on Protection of Cleared Swaps Customers Before and After Commodities Broker Bankruptcies[3]

In its Advanced Notice of Proposed Rulemaking ("ANPR") regarding segregation of customer funds, the Commission notes that it is considering imposing an "individual segregation" model for customer funds belonging to swaps customers. Such a model would impose unnecessary costs on derivatives clearing organizations ("DCOs") and customers alike. As noted in the ANPR, DCOs have long followed a model (the "baseline model") for segregation of collateral posted by customers to secure contracts cleared by a DCO whereby the collateral of multiple futures customers of a futures commission merchant ("FCM") is held together in an omnibus account. If the FCM defaults to the DCO because of the failure of a customer to meet its obligations to the FCM, the DCO is permitted (but not required), in accordance with the DCO's rules and CFTC regulations, to use the collateral of the FCM's other futures customers in the omnibus account to satisfy the FCM's net customer futures obligation to the DCO. Under the baseline model, customer collateral is kept separate from the property of FCMs and may be used exclusively to "purchase, margin, guarantee, secure, transfer, adjust or settle trades, contracts or commodity option transactions of commodity or option customers."[4] A DCO may not use customer collateral to satisfy obligations coming out of an FCM's proprietary account.

In its ANPR, the Commission suggests the possibility of applying a different customer segregation model to collateral posted by swaps customers, proposing three separate models, each of which requires some form of "individual segregation" for customer cleared-swap accounts. Each of these models would severely limit the availability of other customer funds to a DCO to cure a default

[3] 75 Fed. Reg. 75162 (proposed Dec. 2, 2010) (to be codified at 17 C.F.R. pt. 190)

[4] *See* Reg. 1.20(a).

by an FCM based on the failure of a customer to meet its obligations to the DCO. The imposition of any of these alternative models first, is outside of the Commission's authority under DFA and second, will result in massive and unnecessary costs to DCOs as well as to customers – the very individuals such models are allegedly proposed to protect.

CME Group recognizes that effective protection of customer funds is, without a doubt, critical to participation in the futures and swaps markets. This fact does not, however, call for a new segregation regime. The baseline model has performed this function admirably over the years, with no futures customers suffering a loss as a result of an FCM's bankruptcy or default. There is no reason to believe it will not operate as well in the swaps market. DFA did nothing to change this segregation regime as applied to futures, and a focus of Dodd-Frank is to bring the OTC swaps market into a regulatory scheme similar to that which allowed the futures markets to function flawlessly throughout the financial crisis. To this end, it is nonsensical that Congress would intend to require a different scheme of segregation of customer funds and as a result, a different margining and default model than that currently used in the futures markets. Imposing such a conflicting model would complicate the function of DCOs intending to clear both futures and swaps. Indeed, the statutory language adopted in Section 724 of DFA does nothing to compel such a result.

The imposition of a different customer segregation system could undermine the intent behind DFA by imposing significantly higher costs on customers, clearing members, and DCOs intending to clear swaps and injecting moral hazard into a system at the customer and FCM levels. A change from the baseline model would interfere with marketplace and capital efficiency as DCOs may be required to increase security deposits from clearing members. That is, depending on the exact methodology employed, DCOs may be forced to ask for more capital from clearing members. Based on CME Group's initial assessments, these increases in capital requirements would be substantial. For example, CME Group's guarantee fund would need to double in size. Aside from these monetary costs, adoption of a segregation model would create moral hazard concerns at the FCM level. That is, the use of the new proposed models could create a disincentive for an FCM to offer the highest level of risk managements to its customers if the oversight and management of individual customer risk was shifted to the clearing house and continue to carry the amount of excess capital they do today.

Imposition of the suggested systems could increase costs and decrease participation in the CFTC-regulated cleared-swaps market because customers may be unable or unwilling to satisfy resultant substantially increased margin requirements. FCMs would face a variety of increased indirect costs, such as staffing costs, new systems and compliance and legal costs and direct costs such as banking and custodial fees. FCMs would likely, in turn, pass these costs on to customers. Additionally, smaller FCMs may be forced out of business, larger FCMs may not have incentive to stay in business, and firms otherwise qualified to act as FCMs may be unwilling to do so due to the risk and cost imposed upon the FCM model by individualized segregation. This could lead to a larger concentration of customer exposures at fewer FCMs, further increases to margin and guarantee fund requirements, and further increased costs to customers. All of these consequences would lead to decreased participation in U.S. futures and swaps exchanges and result in loss of jobs in the United States.

2. Proposed Rulemaking on Position Limits[5]

A prime example of a refusal to regulate in strict conformance with DFA, 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 CEA, 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.[6] Without any basis to make this finding, the Commission instead justified its position limit proposal as follows:

> 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

[5] 76 Fed. Reg. 4752 (proposed Jan. 26, 2011) (to be codified at 17 C.F.R. pts. 1, 150-51)

[6] 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.

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. (emphasis supplied)

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.

"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 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 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.

It is important not to lose sight of the real economic cost of imposing unnecessary and unwarranted position limits. 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 restrictive position limits adversely impact legitimate trading and impair the ability of producers to hedge. They may also drive certain classes of speculators into physical markets and consequently 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. International regulators, such as the EU, are far from adopting such a prescriptive approach with respect to position limits. Ultimately, this could create

an incentive for market participants to move their business to international exchanges negatively impacting the global leadership of the U.S. financial market. Furthermore, exporting the price discovery process to overseas exchanges will likely result 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, are likely to move to overseas markets.

3. Proposed Rulemaking on Mandatory Swaps Clearing Review Process[7]

Another example of a rule proposal that 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 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 DFA. The costs in terms of time and effort to secure and present the information required by the proposed regulation would be a significant 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 time-consuming process to determine whether mandatory

[7] 75 Fed. Reg. 667277 (proposed Nov. 2, 2010) (to be codified at 17 C.F.R. pts. 1, 150, 151)

clearing is required. Regulation Section 39.5(b)(5) starkly illustrates this outcome. No application is deemed complete until all of the information that the Commission needs to make the mandatory clearing decision has been received. Completion is determined in the sole discretion of the Commission. Only then does the 90 day period begin to run. This process to enable an exchange to list a swap for clearing is clearly contrary to the purposes of DFA.

4. Conversion from Principles-Based to Rules-Based Regulation[8]

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 the principles-based regulation, which was the foundation of the CFMA. In accordance with CFMA, the CFTC set forth "[g]uidance on, and Acceptable Practices in, Compliance with Core Principles" that operated as safe harbors for compliance. This approach has proven effective and efficient in terms of appropriately allocating responsibilities between regulated DCMs and DCOs and the CFTC.

We recognize that the changes instituted by DFA give the Commission discretion, where necessary, to step back from this principles-based regime. Congress amended 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. But the language clearly assumes that the principles-based regime will remain in effect 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.

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

The Commission's almost complete reversion to a prescriptive regulatory approach converts its role from an oversight agency, responsible for assuring self regulatory organizations comply with sound principles, to a front line decision maker that imposes its business judgments on the operational aspects of derivatives trading and clearing. This reinstitution of rule-based regulation will require a substantial increase in the Commission's staff and budget and impose indeterminable costs on the industry and the end users of derivatives. Yet there is no evidence that this will be beneficial to the public or to the functioning of the markets. In keeping with the President's Executive Order to reduce unnecessary regulatory cost, the CFTC should be required to reconsider each of its proposals with the goal of performing those functions that are mandated by DFA.

Further, 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. Without unnecessary, costly and burdensome regulatory review, U.S. futures exchanges have been 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. 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. The transition to an inflexible regime threatens to stifle growth and innovation in U.S. exchanges and thereby drive market participants overseas. This, I noted earlier, will certainly impact the relevant job markets in the United States.

(a) Proposed Rulemaking under Core Principle 9 for DCMs

A specific 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 principal 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 SEFs.

The Commission justifies the 85% requirement only with its observations as to percentages of various contracts traded on various exchanges. It provides no support evidencing that the requirement will provide 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 imposition of the proposed 85% exchange trading requirement will have extremely negative effects on the industry. It 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 suite of very popular and very liquid foreign exchange products developed and offered by CME would not have met the 85% requirement for four years after it was initially offered. The suite of products' 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 suite of products.[9]

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 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

[9] 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.

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.

5. Provisions Common to Registered Entities[10]

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 the generation of substantial unnecessary paperwork by exchanges and by the CFTC's staff. It slowed innovation without a demonstrable public benefit.

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 underlying rationale for the self-certification process which has been 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 avoidance of these costs and burdens is sufficient incentive for DCMs and DCOs to remain compliant with the Act.

Self-certification has been in effect for ten years and nothing has occurred to suggest 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.

[10] 75 Fed. Reg. 67282 (proposed Nov. 2, 2010) (to be codified at 17 C.F.R. pt. 40)

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)." DFA does not direct the Commission to require the submission of all documents supporting the 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 proposed by the CFTC will require exchanges to prematurely disclose new product innovations and consequently enable foreign competitors to introduce those innovations while the exchange awaits CFTC approval. This, again, inhibits the ability of U.S. exchanges to compete, drives market participants overseas and impairs job growth in the United States. Moreover, given the volume of filings required by the Notice of proposed rulemaking, the Commission will require significant increases in staffing and other resources. Alternatively, the result will be that these filings will not be reviewed in a timely manner, further disadvantaging U.S. exchanges. Again, we would suggest that the Commission's limited resources should be better aligned with the implementation of the goals of DFA rather than "correcting" a well-functioning and efficient process.

First, the proposed rules require a registered entity to submit "all documentation" relied upon to determine whether a new product, rule or rule amendment complies with applicable Core Principles. This requirement is so vague as to create uncertainty as to what is actually required to be filed. 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. It is clear that the benefits, if any, of 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 that material intellectual property issues may arise. This requirement would force registered entities to undertake extensive intellectual property analysis, including patent, copyright and trademark searches in order to satisfy the regulatory mandates, with no assurances that any intellectual property claim is discoverable through that process at a particular point in time. Again, this would greatly increase the cost and timing of listing products without providing any 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*.[11]

Further, these rules steer the Commission closer to the product and rule approval process currently employed by the SEC, which is routinely criticized and 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.

6. Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding Mitigation of Conflicts of Interest[12]

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 the purposes of DFA or the CEA. The Commission purports to act

[11] 75 Fed. Reg. at 67290

[12] 75 Fed. Reg. 63732 (proposed October 18, 2010) (to be codified at 17 C.F.R. pts. 1, 37, 38, 39, 40)

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 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.

7. Prohibition on Market Manipulation[13]

The Commission's proposed rules on Market Manipulation, although arguably within the authority granted by 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.

[13] 75 Fed.Reg. 67657-62 (proposed Nov. 3, 2010) (to be codified at 17 C.F.R. pt. 180)

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 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, we believe 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. These potential market participants will either use a different method to manage risk or go to overseas exchanges, stifling the growth of U.S. futures markets and affecting related job markets.

8. Antidisruptive Practices Authority Contained in DFA[14]

[14] 75 Fed. Reg. 67301 (proposed November 2, 2010) (to be codified at 17 C.F.R. pt. 1)

Rules regarding Disruptive Trade Practices (DFA Section 747) run the risk of being similarly vague and resulting in chilling market participation. The CFTC has recently issued a Proposed Interpretive Order which provides guidance regarding the three statutory disruptive practices set for in DFA Section 747.[15] CME Group applauds the Commission's decision to clarify the standards for liability under the enumerated disruptive practices and supports the Commission's decision to refrain from setting forth any additional "disruptive practices" beyond those listed in the statute. We believe, however, that in several respects, the proposed interpretations still do not give market participants enough notice as to what practices are illegal and also may interfere with their ability to trade effectively.

For example, the Commission interprets section 4c(a)(5)(A), Violating Bids and Offers, "as prohibiting any person from buying a contract at a price that is higher than the lowest available offer price and/or selling a contract at a price that is lower than the highest available bid price" regardless of intent.[16] However, certain existing platforms allow trading based on considerations other than price. Without an intent requirement, these platforms do not "fit" under the regulations, and presumably will be driven out of business. Similarly, market participants desiring to legitimately trade on bases other than price will presumably be driven to overseas markets.

Further, the Commission states that section 4c(a)(5)(B), Orderly Execution of Transactions During the Closing Period, applies only where a participant "demonstrates intentional or reckless disregard for the orderly execution of transactions during the closing period." However, the Commission goes on to state that "market participants should assess market conditions and consider how their trading practices and conduct affect the orderly execution of transactions during the closing period." In so stating, the Commission seems to impose an affirmative obligation on market participants to consider these factors before executing any trade. This, first, directly conflicts with the scienter requirements also set forth by the Commission and thus interferes with the ability of market participants to determine exactly what conduct may give rise to liability. Second, such an affirmative obligation will interfere with the ability of market participants to make advantageous trades, especially in the context of a fast-moving, electronic trading

[15] 76 Fed.Reg. 14943 (proposed March 18, 2011)

[16] 76 Fed.Reg. 14946 (proposed March 18, 2011)

platform. The end result of both these issues is that, if the Interpretive Order goes into effect as written, market participation will be chilled, participants will move to overseas markets and jobs will be lost in the U.S. futures industry.

Section 747 of DFA, which authorizes the Commission to promulgate additional rules if they are reasonably necessary to 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. If the Interpretive Order does not clearly define "disruptive trade practices," it will discourage legitimate 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.

9. Effects on OTC Swap Contracts

DFA's overhaul of the regulatory framework for swaps creates uncertainty about the status and validity of existing and new swap contracts. 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.