WRITTEN TESTIMONY
OF
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BEFORE THE
HOUSE COMMITTEE ON AGRICULTURE HEARING ON
"OVERSIGHT OF THE SWAPS AND FUTURES MARKETS: RECENT EVENTS AND IMPENDING REGULATORY REFORMS"
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Chairman Lucas, Ranking Member Peterson, Members of the Committee, thank you for the opportunity to testify regarding the industry's efforts to deter, detect and prevent the misuse of customer funds. We, at CME Group, are appalled by the theft by Mr. Wasendorf of Peregrine Financial Group ("PFG") of customer segregated funds. This fraud, following MF Global Inc. ("MFG"), has shaken the very core of our industry.

Any breach of trust relating to customer funds is absolutely unacceptable, period – whether at PFG or MFG, or any firm. Since the failure of MFG, CME Group and others in our industry have been committed to strengthening the protections that guard customer property. The industry has recently implemented new regulatory measures, one of which was the new electronic confirm tool that uncovered Mr. Wasendorf's misreporting, forgery and theft. But more needs to be done.

In addition to the pressing issues raised by these recent deplorable actions, the Committee is examining at this hearing issues relating to the ongoing regulatory implementation of Dodd-Frank which I will also address at the end of my written testimony. Our concerns regarding the implementation of the statute center on ensuring that the rules do not needlessly hamper the strength, competitiveness and efficiency of the U.S. derivatives markest.

Industry Proposals to Protect Customers in the wake of MFG's Failure

On March 12th, a special committee composed of representatives from the futures industry's regulatory organizations, including CME (the "SRO Committee"), offered four recommendations to strengthen current safeguards for customer segregated funds held at the firm level. The first three have been implemented, and the fourth will be made effective in coordination with the National Futures Association (" NFA") in September:

- Requiring all Futures Commission Merchants (FCM) to file daily segregation reports.

- Requiring all FCMs to file bi-monthly Segregation Investment Detail Reports **(**"**SIDR**"**)**, reflecting how customer segregated funds are invested and where those funds are held.[1]

- Performing more frequent periodic spot checks to monitor FCM compliance with segregation requirements since last December.

- In direct response to the MFG collapse, the "Corzine Rule" will be implemented on September 1st. The "Corzine Rule" requires the CEO or CFO of the FCM to pre-approve in writing any disbursement of customer segregated funds not made for the benefit of customers and that exceeds 25% of the firm's excess segregated funds. The CME (or other SROs) must be immediately notified of the pre-approval.

In addition, to enhance intra-regulator coordination, we have established routine communications with FINRA for all of our common firms – the firm coordinators/relationship managers will reach out to each other to have these communications.

The SRO Committee has also implemented, or is in the process of implementing, the following initiatives:

- Using Confirmation.com – an electronic method of receiving account statements or balances from a third party bank or depository to check information provided by FCMs to regulators. NFA's use of Confirmation.com uncovered the initial statement and reporting irregularities at PFG.

  The SRO Committee plans to use the Confirmation.com tool as follows:

  - In regulatory audits now and going forward;

  - To verify bi-monthly SIDRs (investment reports). CME started using the tool for this purposed in mid-July; and

  - To periodically review the accuracy of daily segregation statements.

- Also, the SRO Committee agreed to develop rules to require all FCMs to provide them with direct online access to their bank or depository accounts to confirm segregated funds balances.

The Futures Industry Association's internal controls recommendations will be presented to the FCM Advisory Committee in August. These include:

[1]Daily segregation reporting and bimonthly SIDRs were also recommended by the Futures Industry Association in its proposed initial recommendations made on February 29th. **http://www.futuresindustry.org/downloads/Initial_Recommendations_for_Customer_Funds_Protection.pdf**

- Requiring FCMs to assure the appropriate separation of duties among individuals working at FCMs who are responsible for compliance with the rules protecting customer funds;

- Requiring FCMs to document their policies and procedures in several critical areas, including the valuation of securities held in segregated accounts, the selection of banks, custodians and other depositories for customer funds, and the maintenance and withdrawal of "residual interest," which consists of the excess funds deposited by firms in the customer segregated accounts.

NFA's Website Access to FCM capital ratios and investment reports (SIDRs) will be presented to the NFA's Board of Directors in August.

CME Group Initiatives

Notwithstanding the fact that MFG's misconduct was the cause of the shortfall in customer segregated funds, CME Group's efforts in the wake of these events speak to the level of our commitment to ensuring our customers' confidence in our markets:

- Guarantee for SIPC Trustee. We made an unprecedented guarantee of $550 million to the SIPC Trustee in order to accelerate the distribution of funds to customers.

- CME Trust Pledge. CME Trust pledged virtually all of its capital - $50 million – to cover CME Group customer losses due to MFG's misuse of customer funds.

- CME Group Family Farmer and Rancher Protection Fund. On April 2, 2012, CME Group launched the CME Group Family Farmer and Rancher Protection Fund to protect family farmers, family ranchers and their cooperatives against losses of up to $25,000 per participant in the event of shortfalls in segregated funds. Farming and ranching cooperatives also will be eligible for up to $100,000 per cooperative.

  The Protection Fund is available to PFG customers that qualify under Program terms.

- Agreement with MFG Trustee. On June 14, 2012, the agreement between the SIPC Trustee for MFG and CME Group was filed in the Bankruptcy Court. It provides for the distribution of approximately $130 million of MFG proprietary assets, on which CME and its members held perfected security interests, to MFG customers. The agreement is currently under review by the Bankruptcy Court.

- Bankruptcy Code. The shortfall in customer segregated funds occurred only in regard to funds under MFG's control. The customers' funds held in segregation at the clearing level at CME and other U.S. clearinghouses were intact. However, the clearinghouses were not able to avoid market disruptions by immediately transferring those customer positions and any related collateral because of limitations under the Bankruptcy Code. We propose that Congress amend the Bankruptcy Code to permit clearinghouses that hold sufficient collateral to support customer positions of a failed clearing member promptly to transfer all customer positions with supporting collateral, except defaulting customer positions, to another stable clearing member.

More Can Be Done

However, CME Group believes that more can be done, especially in light of the recent fraud at PFG and its impact on public confidence. CME believes that the regulators and industry need to carefully weigh the costs and benefits of even the most far-reaching proposals that might enhance protection for the segregated funds of our customers.

Some have suggested creating an industry-funded insurance program covering fraud and failure losses, possibly supplemented by privately arranged insurance. Such a program would certainly boost confidence but needs to be balanced against known negatives. It is likely to be cost prohibitive and ineffective given the size and scope of the accounts in our business, and may encourage the "moral hazard risk" that comes into play when customers feel they don't need to worry about their choice or stability of their FCMs.

We need to develop procedures and systems that give regulators direct, real time access to customer segregated account balances, and, as stated above, the SRO Committee is working to do so.

And, while it will be controversial and perhaps have disruptive consequences, we should explore whether customer property not required as collateral at clearing houses should, nonetheless be held by clearing houses or other custodians (while returning interest earned on that money back to the FCMs) and whether safeguards should be put in place to limit the ability of FCMs to transfer such property except to authorized recipients. We believe a look at these proposals in conjunction with our other efforts is necessary to restore public confidence in the derivatives markets while preserving the operating model for the vast majority of firms who respect and comply with the rules.

Finally, while we expect that the misconduct of MFG and PFG will renew calls to eliminate the role of exchanges and clearing houses in auditing and enforcement of their members, we do not believe that a legitimate case can be made to transfer these responsibilities to a government agency. Our regulatory systems are resilient, adaptive to address the challenges and efficient. The next section of my testimony focuses on why it is more important than ever to not only retain, but strengthen the self-regulatory structure.

Current Regulatory Structure Should Not Be Abandoned

Some critics suggest that the current regulatory framework is somehow to blame for MFG's and PFG's misconduct. As further detailed in the discussion below, "self-regulation" in the context of futures markets regulation is a misnomer, because the regulatory structure of the modern U.S. futures industry is in fact a comprehensive network of regulatory organizations that work together to ensure the effective regulation of all industry participants.

The CEA establishes the federal statutory framework that regulates the trading and clearing of futures and futures options in the United States, and following the recent passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, its scope has been expanded to include the over-the-counter swaps market as well. The CEA is administered by the CFTC, which establishes regulations governing the conduct and responsibilities of market participants, exchanges and clearing houses.

With respect to MF Global, CME was the designated self-regulatory organization ("DSRO"). As MFG's DSRO, CME was responsible for conducting periodic audits of MFG's FCM-arm and worked

with the other regulatory bodies of which the firm is a member. Some critics have suggested that the failure of MFG demonstrates that the current system of front line auditing and regulation by clearing houses and exchanges is deficient because of conflicts of interest. However, there is no conflict of interest between the CME Group's duties as a DRSO and its duties to its shareholders – both require that it diligently keep its markets fair and open by vigorously regulating all market participants.

Federal law mandates an organizational structure that eliminates conflicts of interest. In addition, we have very compelling incentives to ensure that our regulatory programs operate effectively. We have established a robust set of safeguards designed to ensure these functions operate free from conflicts of interest or inappropriate influence. The CFTC conducts its own surveillance of the markets and market participants and actively enforces compliance with the CEA and Commission regulations. In addition to the CFTC's oversight of the markets, exchanges separately establish and enforce rules governing the activity of all market participants in their markets. Further, the NFA, the registered futures association for the industry, establishes rules and has regulatory authority with respect to every firm and individual who conducts futures trading business with public customers. The CFTC, in turn, oversees the effectiveness of the exchanges, clearing houses and the NFA in fulfilling their respective regulatory responsibilities.

In summary, the futures industry is a very highly-regulated industry with several layers of oversight. The industry's current 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 further oversight by the NFA and CFTC.

CME Group is committed to working with Congress, CFTC, NFA, FIA and market participants to re-evaluate the current system to find solutions to further protect customer funds at the FCM level, and to restoring confidence in derivatives markets. Finding solutions continues to be or highest priority. We are prepared to lead.

Dodd-Frank

Turning to Dodd-Frank, as the CFTC and other regulators finalize the rules implementing the statute, CME Group continues to work with the CFTC to ensure that these rules promote the fundamental principles of Dodd-Frank without compromising the growth and strength of the robust and globally competitive U.S. derivatives markets. For example, statutory Core Principle 9 was written by Congress to apply flexibly, allowing all DCMs to develop their means to achieve a "competitive, open and efficient market and mechanism" for trading. The CFTC's current rule proposal to implement Core Principle 9 would impose a rigid rule that will require an arbitrary percentage of transactions (now set at 85%) to take place on the central order book of an exchange regardless of the underlying products, the market characteristics or the bona fide needs of customers. At the CFTC's recent roundtable on this proposal, every market participant opposed the rule as proposed and expressed strong concerns about the proposal's implications. The rule would make it impossible for U.S. futures exchanges to develop new products, force futures exchanges to delist hundreds of successful products, and force trading into unregulated, less regulated or foreign markets with less transparency. Moreover, the proposal would exponentially increase the trading costs, market risk and adverse regulatory and tax consequences for market users, which costs ultimately will be reflected in commodity prices. We urge the Commission to consider this consensus assessment, and avoid adopting any rule under Core Principle 9 that would have the adverse effects stated above.

With respect to the reporting of cleared swaps data, the Commission should allow for implementation of a clearing regime that permits clearing houses to choose the Swap Data Repository to which it must report, including their own affiliated SDR. Doing this will make it possible for SDRs to be up and running for cleared swaps almost immediately, which would be in the greatest interest of not only the regulators seeking to implement the statute, but also the marketplace seeking the most efficient and cost-effective mechanism with which to comply. The CFTC-adopted regulatory reporting regime does not appropriately utilize the existing infrastructure available in derivatives clearing organizations ("DCOs") as far as cleared trades are concerned. Any system that requires a DCO that clears a swap trade to make reports to an external non-DCO data warehouse is inefficient, costly and unnecessary. A much better approach is to build reporting requirements that ensure that the DCO that clears a swap trade houses the complete set of non-public swap information. This is the lowest cost and least burdensome method for implementing regulatory reporting requirements and it can be implemented quickly. It is also the best way to ensure regulators have access to the most accurate swap information including the ability to view the true positions of market participants.

Thank you for the opportunity to testify before the Committee today and for the Committee's continued strong oversight of the implementation of this seminal statute.