TESTIMONY
OF
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EXECUTIVE CHAIRMAN & PRESIDENT
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BEFORE THE
HOUSE COMMITTEE ON AGRICULTURE
HEARING ON THE FUTURE OF THE CFTC: MARKET PERSPECTIVES
May 21, 2013

Good morning Chairman Lucas and Ranking Member Peterson. Thank you for the opportunity to offer market perspectives on the future of the CFTC as the Committee considers reauthorization of the Agency. I am Terry Duffy, Executive Chairman and President of CME Group[1]. Four critical issues to the future of the Agency include Agency funding, rulemaking, market structure and customer protection.

Agency Funding

We support adequate funding for the CFTC, but 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. For some market makers, this tax could represent a 100% cost increase. Market-making is an essential source of market liquidity. Imposing this new tax would increase the cost of business for all customers 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

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[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.

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 market participants choose lower cost alternative jurisdictions and markets.

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

Rulemaking

We have been strong advocates for the primary driver behind the Dodd-Frank Act: bringing transparency and clearing to the opaque over-the-counter swaps market. However, the Commission has misused the DFA to expand its role, as primarily evidenced by its unnecessary departure from the principles-based regulatory regime which has operated so successfully. Regulated futures markets performed flawlessly throughout the financial crisis. The Commission's efforts to impose unnecessary new regulations on futures markets and clearing houses are inefficient, hamper innovation, and ultimately increase consumers' costs. Consequently, the use of regulated markets and clearing as risk management tools is becoming less appealing to market participants – increasing overall risk in complete contravention of the intention of DFA

The Commission implemented DFA with an uncoordinated and often inflexible set of rules resulting in conflicting rules, confusion and over inclusion. Our industry would have ground to a standstill without the issuance of dozens of no-action letters, most of which were issued as deadlines approached. A look at some rulemakings affecting the U.S. energy markets in recent months illustrates these problems.[2]

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 relating to products defined as "swaps" under many different rulemakings previously finalized by the CFTC. However, because the CFTC had not yet completed critical rulemakings that would clarify whether certain types of contracts used in the energy markets were "swaps.", market participants, understandably, were unclear as to their responsibilities. 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 the 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

[2] I highlighted similar problems in my testimony before the Committee on February 10, 2011, and its subcommittee on General Farm Commodities and Risk Management on April 13, 2011, respectively.

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, which for many of them will go into effect on May 29.

We ask the Committee to direct the Agency to re-examine its DFA rulemaking with genuine attention to a cost-benefit criteria and commitment to return to principles-based regulation.

Market Structure

As previously indicated, one of the fundamental purposes of the DFA was to respond to the financial crisis by bringing regulatory oversight to the previously unregulated and opaque swaps market. The DFA accomplished this through two primary changes to the swaps market: (1) centralized clearing, to reduce systemic risk; and (2) reporting and trading on regulated platforms, to provide transparency. These policies mirror, in many ways, the regulatory structure under which the U.S. futures markets have operated for many decades.

The DFA makes clear that futures and swaps are different product classes and should receive similar, but not identical, regulation. Claims that "Futurization" is an improper effort to secure more favorable margin treatment or other regulatory benefits are misplaced. 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 a well-run and regulated clearing house, like ours, margin is determined by risk management policies and procedures designed to account for the actual risk profile of the product -- its underlying volatility and liquidation risk of the contract -- 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 floor.

The example provided by the Lehman bankruptcy is informative. From the time CME decided to liquidate Lehman's futures house positions cleared by CME to complete liquidation, 6 hours elapsed. This was a complex portfolio, across all of CME major product categories, with a margin required on the portfolio approaching $2 billion. We used a variety of market participants to liquidate, and did so within margin cover. In contrast, Lehman's cleared swaps portfolio – which consisted of "vanilla" swaps – was so complex that it took the clearinghouse that liquidated them over three weeks to fully liquidate the portfolio.

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

[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).

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 DFA 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 is not only a positive development for customers and the public as a whole, but is entirely consistent with the goals of DFA.

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 the FCM through strict and regular reporting and on-line access to customers' balances at banks and other depositories. 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 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. As we explained in our comment letter, 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 construed in the near future the 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 complimentary 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.

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 to narrower revisions that would enhance a clearinghouse's ability to promptly transfer positions of non-defaulting customers. While amending the Bankruptcy Code is a significant undertaking, CME Group believes that modification to the bankruptcy regime in light of recent experience would benefit customers and the market as a whole.

Insurance for Futures 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.

Conclusion

As Congress considers reauthorization of the CFTC, we urge the Committee to continue its strong oversight of the CFTC to ensure that rulemaking is efficient and consistent with the DFA; regulation enhances the safety and soundness of futures and derivatives markets by a principles-based regulatory regime; and the U.S. competitive stance in the global financial marketplace is preserved. We look forward to working with the Committee during this process.

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