# TESTIMONY
# OF
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## BEFORE THE
## HOUSE COMMITTEE ON AGRICULTURE
***Hearing on Dodd-Frank Turns Five: Assessing the Progress of Global Derivatives Reforms***

Good morning Chairman Conaway, Ranking Member Peterson. I am Terry Duffy, Executive Chairman and President of CME Group.[1] Thank you for the opportunity to offer our perspective on the G20 commitments and whether U.S. and global regulators are meeting them.

As we know, the G20 Leaders agreed in 2009 to strengthen the financial system through reforms that increase transparency and reduce systemic risk in the over-the-counter (OTC) derivatives market. To achieve these commitments, the G20 agreed to implement reforms requiring:

- **Reporting**: All OTC derivatives should be reported;

- **Trading and Clearing**: All standardized OTC derivatives should be traded on exchanges or electronic trading platforms, and cleared through central counterparties; and

- **Margin and Capital**: Uncleared OTC derivatives should be subject to higher capital requirements and minimum margin requirements should be developed.

Since Congress passed the Dodd-Frank Act in 2009, the U.S. has made tremendous progress towards fulfilling its G20 Commitments. A clearing mandate has been implemented for certain rates and credit default swaps, swaps are trading on execution venues, and swaps are reported to trade repositories.

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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.

There is more work to be done. A core tenet of the G20 Commitments was to develop a global framework for the regulation of OTC derivatives. The lack of consistency in both substance and timing of regulatory reforms between the US and other G20 nations that have yet to implement many OTC regulatory reforms has led to uncertainty and the potential for harm to the efficient functioning of the U.S. and global derivatives markets. We and the other G20 nations must move carefully to avoid undermining this objective.

Here are a few examples where policymakers and regulators must work to better align national and international policies governing the regulation of OTC derivatives markets.

**EU Equivalency Standards**

Among the most critical issues facing the CFTC today is the potential for the United States to be denied status as a country whose regulations are equivalent to Europe's. CME operates futures exchanges, clearinghouses and reporting facilities in the U.S. and United Kingdom, and our U.S. futures products reach over 150 jurisdictions across the globe. Cross-border access is a core part of our global business strategy. CME has long been a strong supporter of mutual recognition regimes that (i) eliminate legal uncertainty, (ii) allow cross-border markets to continue operating without actual or threatened disruption, (iii) afford U.S.-based and foreign-based markets and market participants equal flexibility, and (iv) promote a level playing field.

Historically, both the U.S. and EU have mutually recognized each other's regulatory regimes to promote cross-border access. Recently, however, the European Commission has taken a different approach. Under European law, U.S. clearinghouses and exchanges – like CME – must first be recognized by European regulators in order to be treated the same as EU clearinghouses and exchanges. The European Commission is conditioning its recognition of U.S. derivatives laws as equivalent to European law on demands for harmful regulatory changes by the U.S. that would impose competitive burdens on U.S., but not EU, clearinghouses and exchanges, and would harm both U.S. and EU market participants. This refusal to recognize U.S. derivatives laws as equivalent is already having a negative impact on liquidity in our markets by creating trading disincentives and barriers to entry. As a result, diminished liquidity leads to higher hedging costs for commercial end-users in the U.S. and ultimately higher commodity prices paid by U.S. consumers.

After more than two years of negotiation and delay, the EU still has refused to grant U.S. equivalence. Since his arrival at the CFTC, Chairman Massad has been a tremendous leader in working toward a solution that avoids market disruption and affords U.S. and foreign-based markets equal flexibility. Yet, the EU continues to hold up the U.S. equivalence determination over the single issue of differing initial margining standards for clearinghouses. The specific

U.S. margin standards in question are an important component, but not the only component, of a robust regulatory structure under the CFTC's oversight. And even considering just this component of the margin standards, the U.S. rules generally require equal, if not more, margin to be posted with clearinghouses to offset exposures than is the case under the EU rules. We applaud Chairman Massad's effective testimony on this issue before the European Parliament last May. Nonetheless, the European Commission has thus far insisted that the U.S. accept EU margin requirements. As Chairman Massad recently stated, "[The CFTC has] offered a substituted compliance framework for clearinghouse regulation which was [the European Commission's] principal concern. I believe there is ample basis for [the European Commission] to make a determination of equivalence and I hope that they will do so soon."

By contrast, the European Commission recently granted "equivalent" status to several jurisdictions in Asia, including Singapore, which has the same margin regime as the U.S. Treating the U.S. as not equivalent when the European Commission has deemed the same margin requirements equivalent in Singapore illustrates clearly the hypocritical and inconsistent position the European Commission is taking.

## Harmonized Global Framework

For the G20 Commitments to succeed globally, each member nation needs to have a workable cross-border regulatory framework. Chairman Massad has been a leader in working with his counterparts among the G20 member nations to achieve that. An effective cross-border regulatory framework does not require each nation's law to be identical; this is unrealistic and unnecessary. Instead, the goal is to adopt frameworks that lead to consistent regulatory outcomes and allow for appropriate substituted compliance.

Unfortunately, recognition for U.S. clearinghouses will not end the cross-border regulatory debate between the US and EU. Some of the key policy issues that will have to be resolved among the G20 nations in the next few years include:

- **Benchmark administrators –** Equivalence provisions for benchmark administrators are being debated in the European benchmark process. Benchmarks integrity is necessary for market confidence, and therefore should be regulated so that they are not readily susceptible to manipulation. However, I agree with Chairman Massad that direct government involvement, as employed by the EU, is not the solution.

- **Trading venues –**Although much of the cross-border equivalence discussions have focused on new execution venues for swaps, the existing licenses for non-

European futures exchanges, including CME Group exchanges, will also be reviewed against new European rules for trading venues under MiFID II.

- **Position Limits –** I have previously testified about the importance of the CFTC's position limits policy to risk management for end users and commodity prices. Getting this policy right extends beyond U.S. borders. This necessarily requires global coordination between the CFTC and other G20 nations. If the CFTC adopts an overly prescriptive position limits rule when other G20 nations have not, price discovery and risk management for U.S. commodities will likely move abroad. For end users that stay in U.S. markets, their cost to hedge will be significantly higher due to potential lack of liquidity and wider spreads.

  Commercial end users are critical to the development and success of physical commodity markets nationally and internationally. As with other regulatory policies adopted by regulators, it is necessary for us to ensure that final position limit rules do not unduly restrict commercial hedging activity or unnecessarily increase costs. In this regard, it is critical that global policy makers ensure that hedge exemptions are not too narrow or overly cumbersome to obtain. Moreover, global policy makers must ensure that position limits policy does not undermine the integrity of commodity derivatives benchmarks. In particular, global position limits policies must not incent price discovery to move from physical delivery markets to linked cash-settled markets, where there is no index or other independent means for assuring that the cash-settled products are not readily susceptible to manipulation.

## Supplemental Leverage Ratio

In addition to harmonizing global frameworks, international regulators must also ensure that global regulations further G20 policy objectives and commitments rather than work against them. A key example of global regulations frustrating G20 commitments is the impact of the Basel III Supplemental Leverage Ratio and its potential to undermine the use of central clearing to mitigate systemic risk.

The Federal Reserve, in consultation with the Basel Committee on Banking Supervision, last year adopted the Supplemental Leverage Ratio rule intended to limit the amount of leverage that the largest banking organizations can hold on their balance sheets. By keeping balance sheet leverage low, regulators seek to further mitigate systemic risk in the event of a default, including for a bank that is a clearing member of a central clearing counterparty such as CME Group.

The rule as adopted will increase costs for end-users by up to five times to clear trades due to clearing members having to pass along the cost of the additional capital they must hold to meet the rule's requirements. In fact, under the current leverage ratio framework, capital costs for agricultural products are two times more expensive than for credit default swaps. These excess capital costs have already contributed to the decision by some clearing members to exit the market altogether, thus concentrating risk among a smaller pool of central counterparties. Higher clearing costs and fewer clearing members will only exacerbate, not mitigate, the risks central clearing is intended to address.

The Supplemental Leverage Ratio's main flaw is that it overstates clearing member leverage exposures because it does not allow clearing members to net segregated margin held for a cleared trade against the clearing member's exposure on the trade. It is directly at odds with the requirements of the Commodity Exchange Act that (1) client margin be strictly segregated from clearing member and clearing house own funds at all times and (2) investment of client margin is subject to significant restrictions (including that it must always be segregated, and only limited investments are permitted). In fact, not only are clearing members significantly restricted in their treatment of customer margin, but the majority of customer margin actually gets passed on to the clearing house, which results in the margin being completely outside of the clearing member control.

Despite these clear regulatory restrictions, the Supplemental Leverage Ratio rule does not permit banks or bank- affiliated clearing members to offset their cleared derivatives exposures on behalf of their customers with the segregated margin posted by those customers, based on the Basel Committee's mistaken rationale that banks and bank affiliates have the ability to use customer margin for purposes other than to offset the cleared derivatives exposure of those customers.

CME Group appreciates the steps this Committee and CFTC Chairman Massad have taken in recent months to address this issue with prudential regulators in the U.S., and we are hopeful that the Basel Committee and prudential regulators will consider proposed solutions that we and others in the industry have been discussing with them since the rule was adopted.

**Conclusion**

CME Group is concerned that as more time passes without consensus on developing a global framework, regulation will artificially influence liquidity, price discovery and risk management. We also are concerned that continued uncertainty in these areas will competitively disadvantage U.S. markets – far beyond just clearinghouses – in an increasingly competitive global marketplace.