TESTIMONY
OF
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BEFORE THE
HOUSE COMMITTEE ON AGRICULTURE

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I am Terrence A. Duffy, executive chairman of CME Group Inc. Thank you Chairman Peterson and Ranking Member Lucas for inviting us to testify today. You asked us to discuss the Treasury's proposed **TITLE VII – IMPROVEMENTS TO REGULATION OF OVER-THE-COUNTER DERIVATIVES MARKETS**, which I am sure we all recognize is far broader than its title implies. We will also discuss the ongoing efforts of the Securities Exchange Commission ("SEC") and Commodity Futures Trading Commission ("CFTC" or "Commission") to harmonize their regulatory regimes, as was suggested by the Treasury White Paper.

CME Group is the world's largest and most diverse derivatives marketplace. We are the parent of four separate regulated exchanges, including Chicago Mercantile Exchange Inc. ("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"). The CME Group Exchanges offer the widest range of benchmark products available across all major asset classes, including futures and options on futures based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products.

CME Clearing, a division of CME, is one of the largest central counterparty clearing services in the world, which provides clearing and settlement services for exchange-traded contracts, as well as for over-the-counter derivatives contracts through CME ClearPort®. Using the CME ClearPort service, eligible participants can execute an OTC swap transaction, which is transformed into a futures or options contract that is subject to the full range of Commission and exchange-based regulation and reporting. The CME ClearPort service mitigates counterparty credit risks, provides transparency to OTC transactions and enables the use of the exchange's market surveillance monitoring tools.

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 CME ClearPort transactions.

I. INTRODUCTION

A. Title VII: The Department of Treasury released the Administration's legislative language as "TITLE VII – IMPROVEMENTS TO REGULATION OF OVER-THE-COUNTER DERIVATIVES MARKETS" (the "proposed legislation" or "Title VII"). The heading is not fully descriptive of the proposed legislation. Of particular interest to this Committee, Title VII: (i) proposes a major restructuring of the classes of regulated and exempt futures exchanges; (ii) grants the CFTC authority over new contracts and rules; (iii) eliminates exemptions and exclusions for certain OTC contracts; (iv) weakens the principles-based regulatory regime created by Commodity Futures Modernization Act ("CFMA"); grants the CFTC authority over foreign boards of trade; and (v) more comprehensively and proscriptively, regulates the operation of clearing houses by means of an expanded list of core principles.

The proposed legislation preserves the allocation of jurisdiction between the CFTC and SEC set forth in the Shad-Johnson Accord, and extends that allocation to credit default swaps ("CDS") and other OTC contracts. This is accomplished by dividing the OTC world into swaps, which include swaps on broad-based security indexes and exempt securities, which are regulated by the CFTC, and security-based swaps, which include swaps on securities and narrow-based indexes and are regulated by the SEC.

The Administration's stated goals are 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. We support these overarching goals. We are concerned, however, that certain well-intentioned provisions of Title VII could have severe, adverse, unintended consequences on U.S. futures exchanges and clearing houses, including the following:

- **Constraints on Current Business Models**. Under the proposed legislation, the Commission gains new, direct authority over margins, position limits, new rules and contracts. Enhanced authority over approval of new contracts unnecessarily decreases exchanges' ability to be competitive in the global marketplace. Additionally, taking control of margin setting away from clearing houses and exchanges and placing it in the hands of legislators prevents those in the best position to make decisions about risk management from doing so and will potentially drive business to more favorable regimes. Similar concerns arise out of the Commission's new authority respecting position limits. Further constraining existing business models is the proposed legislation's move away from the CFMA's principles-based regulation towards prescriptive regulation.

- **Shifting Business Overseas**. The efforts to drive OTC transactions onto electronic trading platforms and into regulated clearing houses may dampen OTC business in the U.S. in a manner that will deny U.S. exchanges and clearing houses the opportunity to serve that market. If the proposed legislation's constraints – including the scope of mandated trading and clearing and increased capital requirements – are unacceptable to the major OTC dealers and hedge funds, they may choose to shift their OTC business operations overseas, substantially reducing the size of the U.S. OTC market and jeopardizing U.S. futures markets that are complemented by OTC markets.
- **Engender Retaliatory Action from Overseas Regulators**. The provisions to close the "London Loophole" require foreign boards of trade ("FBOTs") to register with the CFTC if there is direct access from the U.S. to the electronic trading system of such FBOTs. The definition of "direct access" is broad enough to permit the CFTC to capture every FBOT that can be accessed from the U.S. The proposed legislation does not include a carve-out from the registration requirements for exchanges registered and regulated in high quality regulatory venues. While the CFTC has discretion to exempt FBOTs from registration if certain conditions are met, this extension of U.S. jurisdiction could incite retaliatory actions requiring U.S. futures exchanges to register and be regulated in numerous jurisdictions.

B. Additional Harmonization Issues: Integral to the Administration's efforts to reform regulation of the financial sector is its mandate to the CFTC and SEC to submit to it by September 30 a document detailing the differences in agencies' regulatory regimes and including an explanation as to why these differences could not be "harmonized," should that be the agencies' determination. As part of this "harmonization" effort, the CFTC and SEC held joint hearings on September 2 and 3 (the “harmonization hearings”) to discuss the myriad of issues presented by the harmonization process. During the harmonization hearings, CFTC Chairman Gensler stated that three issues should be addressed during the process of harmonization: (1) eliminating gaps in the current regulatory system to reduce risk, protect market integrity and promote market transparency by adopting comprehensive regulatory reform for OTC derivatives; (2) limiting overlapping regulation by the SEC and CFTC to only where it is beneficial, and eliminating opportunities for arbitrage or regulatory uncertainty; and (3) eliminating cases in which the SEC and CFTC regulate similar products, practices or markets in a different manner when those differences could stifle competition, increase costs or limit investor protection. SEC Chairman Schapiro was less specific as to the goal of the harmonization process, stating that the agencies needed harmonized regulation for similar financial products, unless it could be explained why differences between the two agencies’ regulations were necessary.

During the course of the harmonization hearings, Chairman Gensler also listed 12 areas that he believes the two agencies should examine in their efforts to meet the harmonization goal, and then mentioned two more at the end of the meetings. These areas include: the process for approving new products; the process for approving new exchange and clearinghouse rules; the methods for setting margin in customer accounts (portfolio margining); market structure (fungibility and competition among exchanges); differences in manipulation standards; insider trading rules; customer suitability standards; the application of fiduciary standards to intermediaries; international mutual recognition; a review of the CFTC’s principles-based approach to regulation versus the SEC’s rules-based approach; differences in the two agencies’ approaches to regulating investment funds; and differences in the various definitions of sophisticated investors embedded in SEC and CFTC regulations.

In addition to the harmonization hearings, the SEC and CFTC are meeting at the Commissioner and staff levels to further the harmonization process. We believe that a number of issues have surfaced to date in the harmonization process that pose potential risks to the U.S. futures industry.

As we testified during the harmonization hearings, in our view, “harmonization” should be defined by its goal, and that goal should be to assure that the regulatory regimes for derivatives, securities and security options avoid costly duplication, work together to produce a net welfare gain through efficiently operating markets and clearing houses and eliminate regulatory gaps. One concern we have, which was shared by almost every one of the thirty witnesses who testified at the harmonization hearings, is that the real goal of "harmonization" will be lost and we will be driven toward a merger of the existing regulatory structures into a single set of one-size-fits-all rules administered by separate agencies or a super agency, a result that would undermine the integrity of both the securities and the futures markets and add nothing in the way of reducing systemic risk.

We are also concerned that the harmonization process will invite each agency to attempt to expand its jurisdiction without warrant, although the public message is that the agencies will work together in a manner that serves the best interest of public customers, financial service industry intermediaries and other professionals and the market as a whole.

II. FUNDAMENTAL DISTINCTIONS BETWEEN SECURITIES AND FUTURES MARKETS

Among other critical distinctions, futures markets and securities markets serve different purposes and different classes of customers.

Futures markets provide price discovery and an efficient means to hedge or shift economic risk for sophisticated market participants. Information is disclosed to the market through the trading of market participants and not through a disclosure regime.

In contrast, securities markets support capital formation by providing a secondary market for trading plain vanilla securities. Because the most relevant information is company specific, regulation focuses on creating a level playing field where insiders are precluded from taking unfair advantage of uninformed investors.

Treatment of customer funds is another critical difference between futures and securities markets. The CFTC's customer segregation rules and the consequent portability of customer positions in the event of an intermediary's bankruptcy are essential for the class of customers and type of contracts traded on futures exchanges. SIPA would not provide protection for derivatives participants because of payment limits and because it does not focus on portability or customer positions in the event of an intermediary's failure.

The competitive environments in which futures and securities markets operate are distinct. Derivative markets face global competition. Inappropriate levels of regulation in the U.S. invites major market participants to migrate business to their off shore offices and off shore markets. On the contrary, competition among securities markets is local. Securities markets are inherently domestic. The only issue posed by overregulation of securities markets is whether the regulator creates a distorted playing field among its regulated entities; there is no threat that our securities markets will shift to jurisdictions with more rational regulatory regimes.

These important distinctions between securities and futures markets are directly pertinent to the question of whether law or regulation ought to be directed at bringing the two regulatory regimes closer together, and are discussed in more detail in the testimony of CME Group's CEO Craig Donohue, submitted in conjunction with the harmonization hearings.

III. TITLE VII – IMPACT ON DESIGNATED CONTRACT MARKETS AND CLEARING ORGANIZATIONS

Although Title VII proposes changes that impact all aspects of and participants in the derivatives market, our testimony focuses on the provisions of Title VII that most directly impact designated contract markets ("DCMs") and derivatives clearing organizations ("DCOs"). Title VII grants extraordinary levels of discretionary authority to the CFTC and mandates that the CFTC and SEC jointly develop the regulatory regime applicable to trading and clearing OTC derivatives. This wholesale transfer of law making authority to the agencies makes it impossible to assess the consequences to the industry if Title VII were enacted.

A. Clearing of Swaps (Section 713; Section 3B)

Title VII divides OTC swaps into two categories – swaps and security-based swaps. It allocates jurisdiction of swaps to the CFTC and security-based swaps to the SEC. Although appealing on paper, we agree with the Futures Industry Association ("FIA") that the proposed legislation will require some revisions to avoid being unworkable. Specifically, Title VII calls for dual registration with both the SEC and CFTC by clearing houses, trading platforms, swap dealers, major swap participants, alternative swap execution facilities ("ASEF") and mixed swaps and permits each agency to fully and simultaneously regulate. Imposing duplicative and costly regulatory regimes on market participants without purpose, such as this, completely contradicts the purpose and intent of harmonization and is contrary to every reasonable principle of efficient regulation.   Moreover, if this dual-regulatory structure remains in the final piece of legislation, we believe that it will perpetuate the continuing jurisdictional conflicts between the SEC and CFTC.

As we have previously testified, we are proponents of eliminating jurisdictional wrangling over the undistributed middle between the Securities Acts and the Commodity

Exchange Act ("CEA"). Rather than imposing unduly and unnecessary burdens on the markets, however, we believe that the correct approach to resolving this issue is to grant primacy to the regulator that has primary regulatory authority over other aspects of the regulated entity's operations. The CFTC has effectively used its exemptive power to achieve such a result. Had the SEC granted a similar accommodation in respect of CME's efforts to create an effective clearing solution for credit default swaps it would have facilitated the process of bringing our offering to market. The arguments usually advanced against this option – that there will be a race to the lowest regulatory standard – should not be a concern where both regulators are agencies of the same government and are enforcing identical, effective regulatory regimes, as the CFTC and SEC would be under Title VII.

We believe that only minor revisions are necessary to correct the unworkable situation presented by the dual-regulatory regime embedded in Title VII. Indeed, the language of Title VII suggests that Treasury identified an effective means to accomplish the goals of harmonization, while permitting clearing houses to operate without costly, duplicative two-headed regulation. Specifically, Title VII requires the SEC and the CFTC to "jointly adopt uniform rules governing persons that are registered as derivatives clearing organizations for swaps under this subsection and persons that are registered as clearing agencies for security-based swaps under the Securities Exchange Act of 1934 (15 U.S.C. 78a, et seq.).[1] Title VII also creates a uniform set of core principles under which both forms of clearing house must operate. With this framework, regulatory arbitrage and regulatory gaps are completely eliminated, and both CFTC-regulated and SEC-regulated clearing houses are permitted to clear both swaps (province of the CFTC) and security-based swaps (province of the SEC). Thus, legislators need only add a provision to Title VII that permits the regulator with the most existing contacts with the regulated entity to have primary regulatory jurisdiction over the regulated entity. Such a change will, among other things, reduce legal uncertainty, minimize regulatory inefficiencies and speed bringing new products to the markets.

[1] Notably absent from Title VII , however, is any explanation as to how regulatory principles that should/would be applicable to security-based swaps will work with respect to swaps that are not security-based, making it difficult to understand how a harmonization of rules for these two regimes will succeed. (Section 713(h), Subtitle A.)

Finally, whether a drafting error or intentional, the CFTC is made the junior partner in this two-headed regulatory scheme. Specifically, Title VII authorizes the CFTC to defer to the SEC and exempt an SEC-registered clearing agency from registration with the CFTC. However, no comparable exemption authority is given to the SEC in Title VII. This uneven construct undoubtedly will steer clearing houses to "choose" the SEC as their regulator and seek an exemption from the CFTC, to avoid being dually regulated. Our preferred solution is to allocate responsibility to the primary regulator of the enterprise, as discussed above.

B. Position Limits (Section 723)

The CEA currently grants the CFTC sufficient authority to set limits for DCMs. Section 4a(a) of the CEA directs the Commission to fix position limits for a commodity traded on a DCM if it first finds that such action is "necessary to diminish, eliminate, or prevent" "sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity." However, the Commission's direct use of the authority conferred in Section 4a(a) is neither required nor justified if the relevant designated contract market has acted effectively to avoid "excessive speculation." Indeed, as the Commission has previously noted, the exchanges have the expertise and are in the best position to set position limits for their contracts. In fact, this determination led the Commission to delegate to the exchanges authority to set position limits in non-enumerated commodities, in the first instances, almost 30 years ago.

Since that time, the regulatory structure for speculative position limits has been administered under a two-pronged framework with enforcement of speculative position limits being shared by both the Commission and the DCMs. Under the first prong, the Commission establishes and enforces speculative position limits for futures contracts on a limited group of agricultural commodities. Under the second prong, for all other commodities, individual DCMs, in fulfillment of their obligations under the CEA's core principles, establish and enforce their own speculative position limits or position accountability provisions (including exemption and aggregation rules), subject to Commission oversight.

Title VII permits DCMs and ASEF to continue to set position limits or position accountability levels, where appropriate. The core principles differentiate between the lead month and back months. (Section 719.) However, no guidance is provided as to how such limits or accountability levels should be calculated. (Section 723(a)(1).) We believe that each DCM and ASEF should be required to set its own position limits based on and in proportion to its liquidity, volume, open interest and other factors respecting trading for which it is directly responsible.

The proposed legislation also grants the CFTC authority to impose aggregate limits on contracts listed by boards of trade and on swaps that perform a significant price discovery function with respect to regulated markets; however, it does not provide clear guidance as to how aggregate limits will be calculated. (Section 723(a)(2).)

We support the provisions of Title VII that expand the CFTC's authority to impose and enforce position limits on positions taken in excluded commodities and other OTC transactions. We also agree with the elimination of the protected ECM category.

We urge, however, that the CFTC's power to set position limits be subject to explicit guidance comparable to the existing regime in that it should only act if the relevant regulated market has failed to act and only act for the purpose of avoiding "sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity." It is critical that position limits do not become a political issue that are imposed in the hope of controlling the underlying prices in the cash market. First, it will not work. Second, it will have a devastating impact on the U.S. futures industry and participants that rely on these markets to manage risk.

The United States has been the center of global futures trading because of its first mover advantage and its rational regulatory regime which has provided efficient and fair markets while encouraging innovation. If speculative traders and accumulators like swap dealers and index funds are restricted from trading global commodities such as oil and metals on U.S. exchanges and on the U.S. OTC market, their alternative is clear. They will turn to their foreign affiliates and the market will move offshore. For example, although Natural Gas delivered at Henry Hub is a natural U.S. product and it is not likely that that specific contract will move offshore, natural gas is a global product and it is certain that a new global benchmark contract will emerge on a foreign exchange if trading on U.S. markets is constricted by inappropriate limits. The likely chain of effects is predictable and unacceptable; liquidity of U.S. markets will be impaired, causing damage to the domestic natural gas industry and its customers.

Even if Congress or the Commission could find a legitimate basis to restrict or impede U.S. firms from participating in offshore markets, the only consequence will be to disadvantage U.S. firms and U.S. markets. World prices would be set without U.S. participation. Thus, precisely calibrated and properly administered position limits on energy contracts, along with a carefully managed exemption process, are critically important to the preservation of properly functioning markets.

C. Treatment of Foreign Boards of Trade (Section 725)

Title VII imposes a number of registration and compliance requirements on an FBOT that grants U.S. users "direct access"[2] to its systems for trading. Section 725(b)(1) provides, "The Commission may adopt rules and regulations requiring registration with the Commission for a foreign board of trade that provides the members of the foreign board of trade or other participants located in the United States direct access to the electronic trading and order matching system of the foreign board of trade, including rules and regulations prescribing procedures and requirements applicable to the registration of such foreign boards of trade." The proposed legislation, however, fails to define any criteria for determining whether or not to require registration. If the CFTC does require such registration, FBOTs must meet all requirements of the CEA.

Even if registration is not required, Section 725(b)(2) makes it unlawful for an FBOT to provide a member or other participant located in the U.S. with direct access to its trading and order-matching system with respect to an agreement, contract or transaction that settles against any price (including the daily or final settlement price) of one or more contracts listed for trading on a registered entity unless the FBOT complies with, among other things, information reporting requirements and positions limits requirements, which mirror those imposed on U.S. contract markets. There is substantial risk that if enacted as currently drafted, foreign countries in which U.S. DCMs and DCOs that have customers and physical facilities, may enact similar requirements that could subject U.S. DCMs and DCOs to registration and regulation in such countries.

D. Principles-Based Regulation, Self-Certification Process (Sections 721, 724 and 725)

Despite Treasury's recommendation last year that the SEC move towards the CFTC's principles-based regime, and the repeated testimony at the harmonization hearings by market participants and industry experts that this regime presents the appropriate framework for

[2] "Direct access" is defined as an explicit grant of authority by an FBOT to an identified member or other participant located in the United States to enter trades directly into the trade matching system of the FBOT. (Section 725(b)(1), Subtitle A.)

regulating futures exchanges, Title VII of the Treasury's proposal would grant the CFTC administrative authority to eradicate the advantages of the CFMA's principles-based regime. Specifically, whereas the CEA currently prohibits the CFTC from providing that its "Guidance On, and Acceptable Practices In, Compliance with Core Principles" (Appendix B to Part 38 of CFTC's Regulations) is the exclusive means to comply with core principles (CEA §5c(a)(2)), Title VII expressly grants the CFTC the authority to state that an interpretation may provide the *only* means for compliance with core principles.[3] By eliminating this option, Title VII substantially inhibits the ability of U.S. futures exchanges to develop innovative and potentially more effective ways of complying with the core principles.

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. U.S. futures exchanges are 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 and thereby avoiding stifling regulatory review. U.S. futures exchanges operate more efficiently, more economically and with fewer complaints under this system than at any time in their history.

Unfortunately, instead of pursuing this successful regime, the reaction against excesses in other segments of the financial services industry appears to have generated pressure to force a retreat from the principles-based regulatory regime adopted by CFMA. The myriad of problems resulting in the financial services meltdown did not originate in futures markets and the exchanges performed impeccably throughout the crisis and should not be penalized by a return to a prescriptive regulatory regime. Moreover, this is exactly the regime that impaired the competitiveness of the U.S. futures industry pre-CFMA.

The benefits of CFMA's principles-based regulatory regime are easily overlooked in the turmoil following the collapse of the housing market and major investment banks. We have said it before, but it bears repeating: derivative transactions conducted on CFTC-regulated futures

[3] Section 5c(a)(2) is amended by striking "shall not" and inserting "may." All of the new core principles included in Title VII are modified by language similar to the following: "Except where the Commission determines otherwise by rule or regulation, a derivatives clearing organization shall have reasonable discretion in establishing the manner in which it complies with the core principles."

exchanges and cleared by CFTC-regulated clearing houses did not contribute to the current financial crisis. Moreover, it was not unintentional gaps in the regulatory jurisdiction of the SEC and the CFTC that caused the meltdown. To the extent that regulatory gaps contributed to the problem, those gaps existed because Congress exempted broad classes of instruments and financial enterprises from regulation by either agency.

Another aspect of Title VII that adversely impacts innovation and puts regulators in the position of making business judgments for market participants is the proposed amendments to Section 5c(c)(1) of the CEA, which will require a time consuming justification process for every significant new contract and new rule. This proposed amendment steers the CFTC closer to the product and rule approval process currently employed by the SEC, the very process about which those regulated by the SEC complained at the 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 current certification process.

E. Margin (Section 722, Subtitle A)

Title VII includes explicit standards respecting the setting of collateral requirements, which are in accord with CME's processes and procedures. However, Section 722 of Title VII would amend Section 8a(7) of the CEA and grant the CFTC authority to alter or amend a DCM's rules respecting margin requirements. Previously, the setting of margin (except for equity index margin) was excepted from the Commission's authority to alter or amend exchange rules, but the Commission did have power to act in an emergency. We are deeply concerned that this grant of authority will politicize the process and move away from a regime where true experts in risk management are supplanted by an oversight agency with no experience and no incentive to set collateral requirements at appropriate levels.

It has been clearly demonstrated that the setting of collateral levels for derivatives, both at the customer and at the clearing house level, is purely a matter of safety and soundness. The operators of clearing houses that mutualize risk among their member firms have the clearest incentives and are most capable of doing the job correctly. The record of futures clearing houses in this country is unambiguous. In this regard, it is worth noting that, over a history of continuous operation dating back more than 100 years, no CME customer has ever lost funds as a result of the failure of a clearing member firm. There is no benefit to transferring this responsibility to government employees, only potential harm to DCMs as this is an invitation to politicize the margin-setting process.

F. Netting Swaps vs. Interoperability (Section 713(j)(1)(B))

Title VII prescribes that "all swaps with the same terms and conditions are fungible and may be offset with each other." We understood that the purpose of this language was to insure that clearing houses for OTC derivatives would provide open access to all trading platforms and to privately negotiated OTC transactions and that identical swap contracts, regardless of the execution venue, would be deemed fungible and could be offset against one another if the positions resided at the same clearing house. We have since learned that certain segments of the industry are lobbying to reinterpret the clause to force all clearing into a single clearing house or to force interoperability among clearing houses.

Mandated interoperability among swaps clearing houses is being promoted as a means to foster market entry by new clearing houses and encourage competition among existing clearing houses. Mandated interoperability forces all clearing houses to permit a customer with a position at clearing house A, for example, short a notional $1 billion in the XXX equity index, to direct that the position be transferred to clearing house B. Of course, in order to assure that the books of both clearing houses remain balanced, clearing house B must be substituted as the short on clearing house A's books. Clearing house A also becomes the long on clearing house B's books. Each of the clearing houses must post collateral with the other and each must make twice daily pays and collects. Each is exposed to the failure of the other. This system becomes increasingly complex as additional clearing houses are added to the chain, and ultimately, unworkable.

The ostensible goals of mandated interoperability are to reduce costs, encourage innovation and foster competition. The same demand for interoperability among futures clearing houses was rejected by the industry, the CFTC and Congress because a fair examination of the proposal revealed that forced interoperability was complex, risky and not cost effective. Specifically, it was demonstrated that:

- the linkages would subject each of the linked clearing houses to the failure of any of them and that fire breaks that ordinarily contain or limit such failures would be eliminated, thereby effectively creating significant specific and systemic risks;
- time and cost to market implementation were significant;

- the theoretical savings that might be generated by competition were outweighed by the costs of operating the system;
- innovation would be inhibited in that each linked clearing house would be required to limit its pace of innovation to the ability of the weakest;
- changes in contract specifications would require the consent of each market and clearing house; and
- genuine competition among clearing houses and exchanges would be eliminated.

At the most basic, technical level, in order to make interoperability feasible, each participating clearing house must agree on an identical set of operating procedures to coordinate collateral, variation margin and settlement flows. Each clearing house should insist that each other participating clearing house has financial resources at least equal to its own and that each conduct regular detailed financial and operational audits of each other member of the interoperability circle. Finally, no clearing house can permit changes in contract specifications that will distort future cross clearing house flows.

An important consideration is that the actual benefits of moving open positions among clearing houses can be achieved privately, at no cost and without creating systemic or particular risks to any participant in the system. The customer holding a swap position at clearing house A can close out that position and reestablish it at clearing house B in several ways. First, the customer can enter into an equal, but opposite swap position, on any swap platform or privately, and submit it for clearing to clearing house A. The customer's swap position is netted to zero the moment the new trade is accepted. The customer can reestablish that position at clearing house B by means of a second swap that is submitted to clearing house B. Second, because the swap market is not subject to the CFTC's wash trading rules, the customer can enter into a matched pair of swaps to move the position without market risk. Finally, if sufficient customer demand ever develops for the service, clearing houses can enter into agreements that permit the transfer of matched trades amongst themselves. In that case, any two traders with offsetting positions who wish to transfer could do so by means of an appropriate notification and fee. All of this can be accomplished without government intervention, without cost and without creating systemic risk.

The immediate impact of mandated interoperability is to force regulated exchanges and their associated clearing houses to truncate the services that they offer to their customers by giving up control over the clearing function that provides the financial, banking and delivery services that guarantee performance of futures contracts. Exchange control of these services – either in-house or through a dedicated third party – is at the heart of current efforts to improve the value of exchange services by offering straight-through, integrated processing to clearing member firms and their clients.

It is only through differentiation that product innovation is accomplished. Differentiation with respect to product and the delivery of that product has been a fundamental tenet of CME's business strategy and, intuitively, a prerequisite for product advancement. CME opposes any suggestions to impede its ability to explore new opportunities in non-generic, unique products – accessible through unique value added trading platforms – cleared and settled on an essentially "straight-through," integrated basis.

G. The CEA's Jurisdictional Preservation Clause

The CEA's exclusive jurisdiction provision mandates that CFTC regulation is the sole legal standard applicable to virtually all futures trading. This exclusivity provision was purposely included in the CEA decades ago to prevent duplication and inconsistency in regulating the industry; indeed, the phrase "except as hereinabove provided" was inserted in the original CFTC Act so that it would supersede all others in regard to futures and commodity options regulation. Despite the success of this jurisdictional delineation to date, Title VII proposes to disrupt it. Specifically, Section 712(b) states that the CFTC's exclusive jurisdiction does not supersede any other authority's jurisdiction under the proposed legislation and would be referenced in existing CEA Section 2(a)(1)(A) as an exception to the CFTC's exclusive jurisdiction clause. Moreover, Section 728 appears to give CFTC "primary" enforcement authority over Subtitle A matters but permits other regulators to take action if CFTC does not, the effect of which would be to subject market participants to potentially conflicting standards and multiple regulators. We strongly believe that the CEA's exclusivity provision should be retained as we move forward in the regulatory reform process.

IV. ADDITIONAL ITEMS RAISED BY CHAIRMAN GENSLER FOR POTENTIAL HARMONIZATION

As previously noted, Chairman Gensler raised a number of issues that he thought should be the focus of the harmonization process. Although CME has thoughts on each of those issues, we address only a few below. We are available at your convenience to discuss any of these further as well as those issues not addressed in this testimony.

A. Manipulation

Under the CEA, price manipulation constitutes acting with specific intent to create an artificial price. In the securities market, SEC Rule 10b-5, which applies to alleged manipulation, requires a showing of neither specific intent nor artificial price effects. Adoption of the specific intent standard of Rule 10b-5 would contradict the CFTC's jurisprudence and impose a significant threat to the proper functioning of the U.S. futures markets in crude oil and gasoline. Indeed, when the CFTC was asked years ago to consider abandoning the specific intent standard as the required *mens rea* for finding manipulation, the CFTC responded that it was "unable to discern any justification for a weakening of the manipulative intent standard which does not wreak havoc with the market place." *In re Indiana Farm Bureau Coop. Ass'n,* CFTC No. 75-14, 1982 WL 30249, at *5 (Dec. 17, 1982). Likewise, elimination of the requirement to show artificial price effects in the futures realm would seriously threaten the proper functioning of the U.S. futures markets.

B. Insider Trading

Adopting the SEC's insider trading prohibitions in the commodities markets could impair price discovery and efficient markets. Insider trading prohibitions in the securities markets are based upon the premise that corporate executives and other fiduciaries should not use their privileged access to information to trade when such material information is not available to the broader marketplace. In the commodities derivatives markets, however, market participants typically trade based upon their own informed self-interest, often hedging price risks that are, by definition, based upon information that is not available to the broader marketplace and which contributes to the futures price formation process. The price discovery function is optimized when all market information known to hedgers or to speculators is reflected in the market price of a given contract. Moreover, hedging depends upon knowledge of cash market positions, physical market conditions, and other manner of information to determine the appropriate position to take or hedge to place on a futures market. If such information were required to be publicly disclosed in advance of trading on futures markets, hedging would be impossible.

CFTC Rule 1.59(d) does, however, prohibit exchange governing board members, committee members, members, employees and consultants from disclosing or trading in any commodity interest on the basis of material, nonpublic information obtained through their official exchange duties. Furthermore, this rule also prohibits any person from trading in any commodity interest, whether for such person's own account or on behalf of another person, on the basis of material, nonpublic information that such person knows was obtained in violation of the CFTC rule from an exchange governing board member, committee member, member, employee or consultant.

C. Customer Suitability

As the National Futures Association ("NFA") testified during the harmonization hearings, in 1985 it adopted a Know-Your-Customer rule (NFA Compliance Rule 2-30) that provides protections comparable to the Financial Industry Regulatory Authority's ("FINRA") suitability rule but that are tailored to the unique requirements of the futures industry. NFA explained the necessary distinction between its rules and FINRA's: Since all futures contracts are highly volatile and risky instruments, a suitability determination should be made on a customer-by-customer basis, rather than trade-by-trade. We agree with NFA that it makes no sense to say that a customer is suitable for a recommendation to invest in heating oil futures but not in Treasury note futures. In general, NFA's rule requires its members to obtain basic information about each prospective customer and determine whether futures trading is appropriate for each customer. The rule imposes an affirmative obligation to inform customers in appropriate circumstances that futures trading is simply too risky for that customer.

IV. GUIDING PRINCIPLES OF HARMONIZATION

CME Group proposes the following five principles to guide regulatory reform legislation respecting the CFTC, SEC and OTC derivatives:

RECOMMENDATION ONE: The CFTC and SEC should jointly adopt regulations in accordance with Title VII of the Administration's proposal, but a single agency should function as the primary regulator to administer those rules and regulations. Where an exchange, clearing house, or financial services enterprise is engaged in both commodities and securities businesses, its primary regulator should be based on a predominance test. Where no segment of the firm's business clearly predominates, the firm should be free to pick its regulator. For example, the CME derivatives clearing organization should be primarily regulated by the CFTC even if it also clears security-based swaps. As many of the participants in the recent joint SEC/CFTC hearings noted, a primary regulator should take front-line responsibility for the oversight of the regulated enterprise, including oversight of its SRO responsibilities, where applicable. This primacy should extend to audits and enforcement.

RECOMMENDATION TWO: The CFTC and SEC should avoid jurisdictional conflict respecting novel contracts and products that include both commodity and security features by institutionalizing last year's Memorandum of Understanding ("MOU") for Novel Derivatives Products. Such an approach would ensure the recognition of mutual regulatory interests while operating under principles designed to promote, among other things, innovation and competition as well as market neutrality.

RECOMMENDATION THREE: The principles-based regulatory regime adopted by CFMA should provide the model for the joint regulations adopted by the CFTC and SEC. No retreat from principles-based regulation should be accepted without clear justification.

RECOMMENDATION FOUR: The existing customer segregation regime for customers of a CFTC derivatives clearing organization should be preserved for all customers of that clearing house. The SEC's SIPA regime should continue to apply to securities account holders. Legislation should be adopted to rationalize the treatment of the separate classes of customers in the event of a bankruptcy of a combined broker-dealer/futures commission merchant.

RECOMMENDATION FIVE: Interoperability among clearing houses should not be mandated by legislation or regulation. As has been previously demonstrated, forced interoperability is complex, risky and not cost effective. The actual benefits of moving open positions among clearing houses can be achieved privately, at no public cost and without creating systemic or particular risks to any participant in the system.