TESTIMONY
OF
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EXECUTIVE CHAIRMAN & PRESIDENT
CME GROUP INC.
BEFORE THE

House Agriculture Committee
Subcommittee on Commodity Exchanges, Energy & Credit
Hearing to Review the Impact of
G20 Clearing and Trading Execution Requirements
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The G20 commitments were meant to create a global regulatory framework. However, some G20 nations have not implemented the core elements of the G20 regulatory reforms consistently. This lack of coordination has the potential to create inconsistency, uncertainty, and potential harm to the efficient functioning of U.S. and global derivatives markets.

Equivalency and Recognition

As one example of this inconsistency, regulatory requirements for clearinghouses have not been defined on a coordinated basis. Fortunately, the negotiations between the U.S. and E.U. on equivalence were successfully resolved in February, when the European Commission officially granted the CFTC "equivalent" status. The European Securities Markets Authority is now implementing that agreement by ensuring that CME Clearing is recognized as equivalent in advance of the June 21 start date for the European clearing mandate.

However, the process for U.S. clearinghouses obtaining equivalence and recognition in Europe has taken far too long. While we applaud Chairman Massad and his European counterparts for working through their differences and reaching a positive outcome, we encourage policymakers on both sides of the Atlantic to ensure that market participants do not have to deal with the uncertainty created by such long delays in reaching a cross-border agreement. This requires agreement among global regulators to implement long-term solutions for increasingly global markets and not force markets to go through national equivalence and recognition processes every few years.

If this is not the case, then regulation will artificially influence liquidity, price discovery and risk management, and competitively disadvantage individual markets in an increasingly competitive global marketplace.

Risk Management through Central Clearing

Congress has taken important steps toward strengthening the U.S. financial system post financial crisis. By way of example, a clearing mandate has been imposed for certain swaps – requiring that they be cleared through central clearinghouses like CME Clearing. These reforms increase transparency and reduce systemic risk by using the best practices of central clearing in the broader financial markets.

A clearinghouse's core function is risk management – not trading or other types of risk creation. Unlike clearing members and market participants, clearinghouses do not bring risk to the clearing system. Instead, clearinghouses are responsible for ensuring the overall safety and soundness of their markets.

Clearinghouses, like CME Clearing, utilize a number of tools, such as the financial safeguards package and waterfall structure, to monitor and limit the risks brought by its clearing members and customers and to limit the systemic impact of a failing clearing member. These tools have been tested in stressed markets and have demonstrated their effectiveness against the worst financial crises in memory. CME Clearing has never had to access a defaulting clearing member's default fund contribution, CME's own contributed capital, or the mutualized capital of its clearing members to address a clearing member default. At its core, the clearing mandate and other related financial reforms were driven by a decision by the G20 that the robust performance by clearinghouses during the financial crisis suggested that their market structure and risk management should be a template for the financial markets going forward.

In response to the swaps clearing mandate, some have called for greater scrutiny of clearinghouse risk management, including the amount of capital that clearinghouses should be required to hold. We support best practices in risk management. It is critical, however, to recognize that the central clearing mandate was adopted due to clearinghouse resiliency during the financial crisis. Furthermore, the CFTC and other global regulators have significantly enhanced the risk management standards applied to clearinghouses beyond those which performed robustly during the financial crisis. The failure to recognize the increased resiliency of clearinghouses following these changes potentially risks distracting the regulatory focus away from less robust areas of the financial markets.

Unlike the participants in our markets, risk management is the core function of CME Clearing and we have strong motivation to ensure clearing member contributions and our own capital contributions will be sufficient to avoid the mutualization of losses in a default situation. Effective risk management must strike the appropriate balance between initial margins, clearinghouse contributed capital, and clearing member guaranty fund contributions to ensure that all market participants have appropriate incentives to manage risk across the market. CME

Clearing has long advocated for clearinghouses to make meaningful, first-loss contributions to their financial safeguards packages. CME Clearing makes a sizeable contribution to each of its financial safeguards packages, which works to align our interests with those of our market participants.

In addition, CME Clearing regularly publishes public disclosures describing its risk management practices and measuring its available financial resources in compliance with local and international standards and best practices. This provides the market significant transparency into our risk management practices.

Some have also called for the introduction of a framework for addressing any losses that exceed the clearinghouse's financial resources. CME Group supports U.S. and international efforts to introduce robust recovery and resolution regimes for clearinghouses. However, we caution that no two clearinghouses are the same and the recovery and resolution framework should be tailored to the specific characteristics of each clearinghouse while ensuring that the tools prescribed are appropriately calibrated.

Clearinghouses should retain flexibility in designing their recovery tools to take into account dynamic market conditions, and the specific products and markets they serve. Clearinghouses must also have the flexibility and discretion to implement their recovery tools and maintain the ability to use all possible tools available to them prior to resolution.

Moreover, clearinghouses have the foremost expertise in managing the risks of the markets which they clear; therefore, we believe that a clearinghouse should only be put in resolution when the recovery process is exhausted. In addition to this expertise, the incentives of clearinghouses are aligned with overall market stability making them the appropriate pre-resolution decision-maker on the steps needed to recover their markets.

In some jurisdictions it is suggested that initial margin collateral provided by market participants should be used other than for its sole, intended purpose as collateral for cleared positions, but as a means to allocate losses or as a temporary source of liquidity. This is commonly referred to as "haircutting" initial margin collateral. CME Group strongly opposes the haircutting of initial margin collateral whether during recovery or resolution, both as unlawful in regards to clients under the Commodity Exchange Act and Dodd-Frank Act and as a matter of policy, due to its destabilizing impact on markets and its negative capital impacts.

Collateral haircutting directly impacts participants in pension funds and other end users by appropriating their assets which are not designed to address mutualized risk and such appropriation is prohibited under U.S. law. Effectively, the haircutting of client collateral amounts to a taxpayer bailout due to the fact that the assets of participants in pension plans, the

very people we are trying to protect, are put up as client collateral and would be at risk of appropriation if the haircutting of client collateral were permitted.

Haircutting of client collateral also creates a lack of incentive for market participants to actively participate in the default management process. CME Clearing is a strong supporter of sound risk management underpinned by the belief that market participants must be incentivized to manage the risks they create.

We encourage Congress to avoid inappropriate shifts in costs to end users and reduction in clearing member incentives to actively manage their risk. The appropriate balance must be struck between initial margins, clearinghouse contributed capital, and clearing member guaranty fund contributions to ensure that all market participants have appropriate incentives to manage risk across the market.

Leverage Ratio

Finally, highlighting a regulatory inconsistency with regard to the G20 commitments, the supplemental leverage ratio rule adopted by the Basel Committee and the Federal Reserve is directly at odds with the G20 commitment to clearing.

Plainly speaking, the supplemental leverage ratio will make clearing more expensive and less accessible given its failure to recognize appropriately segregated client collateral in the centrally cleared derivatives markets. Customer collateral is required by law to be segregated, reduces exposures, and cannot be used to increase leverage. The Basel Committee has recently proposed changes to its leverage ratio framework; however it has stopped short of endorsing client collateral offsets for client cleared derivatives. Continued failure to do so will needlessly make more difficult a clearing firm's ability to accept a portfolio of fully margined clients of a defaulted clearing member.