TESTIMONY
OF
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BEFORE THE

HOUSE COMMITTEE ON AGRICULTURE
SUBCOMMITTEE ON COMMODITY EXCHANGES, ENERGY AND CREDIT
HEARING ON CFTC REAUTHORIZATION
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Good morning Chairman Scott and Ranking Member Scott. I am Terry Duffy, Executive Chairman and President of CME Group.[1] Thank you for the opportunity to offer market perspectives on the future of the Commodity Futures Trading Commission ("CFTC" or "Agency"). As this Committee considers reauthorization of the Agency, I would like to highlight five critical issues to the future of the Agency: EU equivalency standards, position limits, agency funding, customer protection, and central counterparty risk.

EU Equivalency Standards

Among the most critical issues facing the Commission 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 US and UK, and our US 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 an unabashed supporter of mutual recognition regimes that (i) eliminate legal uncertainty, (ii) allow cross-border markets to continue operating without actual or threatened disruption and (iii) afford US-based and foreign-based markets and market participants equal flexibility. Historically, both the US 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, US 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 US derivatives laws as equivalent to European law on demands for harmful regulatory changes by the US that would impose competitive burdens on

[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.

US, but not EU, clearinghouses and exchanges, and would harm both US and EU market participants.

After more than two years of negotiation and delay, the EU still has refused to grant US 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 US and foreign-based markets equal flexibility. Yet, the EU continues to hold up the US equivalence determination over the single issue of differing initial margining standards for clearinghouses. The specific US 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 US rules generally require equal, if not more, margin to be posted with clearinghouses to offset exposures than is the case under the EU rules. Nonetheless, the European Commission has thus far insisted that the US accept EU margin requirements, and has not agreed to any compromise. They have rejected a solution that would allow the US and EU to apply whichever margin requirement is higher, rather than imposing the EU standards on the US, or vice-versa.

By contrast, the European Commission recently granted "equivalent" status to several jurisdictions in Asia, including Singapore, which has the same margin regime as the US. Treating the US as not equivalent when the European Commission has deemed the same margin requirements equivalent in Singapore is inconsistent and should be unacceptable to the US.

In stark contrast to the EU approach, US regulations currently allow European based futures markets full access to US market participants. Today, a foreign board of trade may provide direct electronic access to persons located in the US by registering with the CFTC as a Foreign Board of Trade ("FBOT"). The CFTC grants FBOT status if it finds that the board of trade and its clearinghouse are subject to comparable regulation in its home jurisdiction. Although the CFTC has not yet approved all FBOT applications, it has granted no-action relief to several foreign boards of trade with pending FBOT applications, permitting them to continue to access US market participants without disruption until the CFTC completes its review of the FBOT applications.

The European Commission's discriminatory approach to US access to EU markets is creating significant competitive disadvantages for US markets and the participants that use those markets. Without an EU recognition of equivalence, US clearinghouses will not be able to clear EU-mandated derivatives. As market participants need to prepare for the impending effectiveness of Europe's swaps clearing mandate by year-end, already we are seeing European clearing members and other market participants taking steps to consider alternatives to US exchanges and clearinghouses.

This regulatory game of "chicken" also is causing disruptions to US futures markets because, without equivalence, the cost of clearing futures on US markets will increase significantly on June 15, 2015. Under EU laws, non-EU clearinghouses must be recognized as "qualified central counterparties" or QCCPs by June 15. To be QCCP eligible, the European Commission must determine that the clearing regulations in the applicable non-EU country are "equivalent" to EU regulation. Accordingly, without an EU equivalence determination by June 15, US clearinghouses, like CME, will no longer be treated as "QCCPs" from a capital perspective, significantly increasing the costs for European clearing firms to use US clearinghouses.

The EU's resistance to recognizing US exchanges as equivalent also has driven commercial participants away from US exchanges because their trades are treated as OTC trades unless they are executed on an exchange in an equivalent jurisdiction. Commercial end-users appropriately want to avoid the extra regulatory obligations that come with being deemed "NFC+" entities in Europe—a byproduct of trading a certain amount of non-hedging OTC derivatives—so they are leaving US exchanges or reducing their trading on US exchanges until US equivalence is granted. Make no mistake that a continued decrease in participation in US futures products will harm both EU and US market participants, reducing liquidity and impeding the ability of farmers, ranchers and other US and EU businesses to conduct prudent risk management.

Insisting on only the EU margin standards makes no sense when principles governing margin have already been issued by global standard setters, and have been implemented by the US and jurisdictions throughout the world. The US should not be the only nation that is required to have identical margin standards to the EU. Time is of the essence. It is imperative that the European Commission take a balanced approach and allow the US and Europe to recognize each other's regulatory regimes, including margin standards, equally—and soon. If the US continues to be excluded from the European marketplace, the CFTC has many tools at its disposal to deny the generous access to US markets that foreign boards of trade and clearinghouses now have. Indeed, it would be entirely logical for the CFTC to terminate the no-action relief under which FBOTs in Europe are currently operating until the EU recognizes US derivatives regulations as equivalent and US clearinghouses as QCCPs. I hope this does not prove necessary, but all options must be considered. We urge this Committee to take any and all appropriate actions to support the CFTC's position and reach a solution as soon as possible.

Position Limits

Perhaps no other post-Dodd–Frank rulemaking has been more controversial than the Agency's position limits proposal. The Agency currently is considering public comments on rules that were re-proposed at the end of 2013. Despite a total of over four years of public comments, four notices of proposed rulemakings, and one final rule that was vacated by a federal court, the industry is still awaiting answers to some of the most fundamental questions regarding how a federal position limits regime under Dodd–Frank will work.

Significantly, the currently-proposed bona fide hedging exemption would force a dramatic step back from historical market practices by disallowing many reasonable commercial hedging strategies. There is no evidence that Congress intended for the Agency to make it more difficult through position limits rules for farmers, ranchers, and other commercial end-users to hedge their price risks. By limiting the exemption to a rigid and narrow list of enumerated hedges, the Agency's proposal threatens to inject considerable risk into commercial operations. Rather than refuse to give commercial end-users the latitude to continue using reasonable commercial hedging practices for fear that a few bad actors could abuse the system, the Agency should rely on its anti-evasion powers to enforce the limits. CME supports allowing exchanges to administer non-enumerated hedge exemptions that meet the statutory criteria. Such legislation would alleviate the Agency from needlessly tying up its limited resources responding to requests for non-enumerated hedge exemptions.

Several other critical points remain in flux. We encourage this Committee to carefully consider the following issues:

- It remains to be seen which deliverable supply estimates the Agency will use as a baseline for setting federal spot-month limits. CME continues to advocate for using the most up-to-date deliverable supply estimates that are available from a physical delivery market. To date, CME is the only U.S. exchange to have provided the Agency with current deliverable supply estimates for the core referenced futures contracts that would be covered by the Agency's re-proposal. The Agency must identify for the public the deliverable supply estimate baseline it will use prior to finalizing any federal limits, and require all exchanges to use those same deliverable supply estimates for purposes of establishing exchange-set limits.

- Consistent with past policy, the Agency should not impose spot month limits based on an absolutist approach to the 25% of deliverable supply formula across all referenced contracts. No sound economic theory or analysis supports such a uniform approach. Rather, the Agency should use 25% of deliverable supply as a ceiling and work with the exchange(s) listing the physical-delivery benchmark contract to set the federal spot-month level below this ceiling on a contract-by-contract basis, recognizing the unique market characteristics of each commodity that is traded.

- Limits for physical delivery and cash-settled "look-alike" contracts should be equal for the same underlying commodity. The proposed conditional limit exemption for cash-settled contracts threatens to drain liquidity away from the physical delivery markets to the cash-settled markets during the spot month as contracts approach delivery, thus causing harm to the price discovery process and opening the door to potential market misconduct. The Agency should not seek to artificially tip the scale in favor of cash-settled markets and increase the risk of possible price manipulation or distortion.

- Position accountability levels should apply in lieu of hard limits outside of the spot month for non-legacy agricultural commodity derivatives. Nothing in the Agency's statute or any legislative history should foreclose the possibility of using this more flexible position accountability approach in the out months as a reasonable alternative to federal hard cap limits. Such an approach would better serve market integrity and protect the price discovery process in the out months when diminished liquidity can have a severe negative impact. Exchanges have successfully relied upon accountability levels for decades to safeguard against market congestion and abusive trading practices. Based on this experience, exchanges are well positioned to partner with the Agency to administer a federal position accountability program, thus preventing any further drain on the Agency's limited resources.

Agency Funding

The Administration's FY 2016 budget proposal requested a $72 million increase in Agency funding over the current fiscal year. The Administration also signaled continued support for legislative efforts to fund the Agency's budget through "user fees" assessed on transactions that the Agency oversees. While CME supports sufficient funding for the Agency to carry out its critical legislative mandates, we do not support securing this funding through the imposition of what amounts to an additional tax on the backs of America's farmers, ranchers, and other end users who hedge commodity price risks. As we all know, American consumers ultimately are the ones to pay the higher price when it costs more for producers to hedge.

In order to fully fund the CFTC at the requested level, the Administration's proposal mistakenly assumes that a user fee will not chase trading volume away to lower cost jurisdictions. This assumption is unrealistic, particularly in an age of electronic, interconnected markets where participants can and will shift their business. As financial reform legislation continues to be implemented around the world, CME is concerned that ample reasons already exist to support the flight of liquidity from U.S. markets overseas. Less liquidity at home will lead to a diminished price discovery process. Now more than ever, we believe it would be shortsighted for Congress to artificially tip the scale in favor of other jurisdictions by imposing a transaction tax to fund the CFTC.

Customer Protections

SRO Structure

CME continues to reject calls to dismantle the system of self-regulatory organization ("SRO") oversight that has governed the U.S. futures markets for decades. Today, the SRO construct no longer consists solely of a single entity governed by its members regulating its members; rather, exchanges, most of which are public companies, oversee the market-related activities of all of their participants—members and non-members—subject to corollary oversight by the CFTC and National Futures Association ("NFA"). An exchange's ground-floor vantage point into its markets provides a unique level of expertise that the CFTC alone is not equipped to have. This is not to suggest that hard lessons have not been learned in recent years and there is no room for improvement. To the contrary, CME, along with the NFA and other exchanges, have buttressed systems over the past two years to better detect and deter another MF Global or Peregrine Financial situation from occurring.

The financial incentives of SROs also benefit the safety and soundness of the markets which they oversee. Effective SRO regulation is necessary to ensure that an exchange clearinghouse that is required to have "skin in the game" does not have to tap into these reserve funds in the event of a member default, which would in turn harm shareholders. To accomplish this, exchanges devote substantial resources to their self-regulatory responsibilities. CME alone spends more than $40 million annually carrying out its regulatory functions, which includes employing over 200 financial regulatory, IT, and surveillance professionals to monitor its markets and detect financial misconduct before it occurs.

Residual Interest

CME remains fully committed to protecting Futures Commission Merchants ("FCM") customers against the full range of wrongful FCM misconduct that may result in loss of customer funds. In 2012, the CFTC proposed a rule that, under a phased-in schedule, would have required an FCM to maintain *at all times* a sufficient amount of its own funds ("residual interest") in customer-segregated accounts to equal or exceed the total amount of its customers' margin deficiencies. As noted in prior testimony, no system exists to enable an FCM to continuously and accurately calculate customer margin deficiencies in real time. The net result would be that either FCMs would be forced to post their own collateral into customer accounts, or customers would be forced to over-collateralize their margin accounts at all times. Neither outcome constitutes an efficient use of capital and would effectively render derivatives markets prohibitively expensive and unusable for end-users.

We applaud the CFTC for moving away from the "at all times" requirement and further eliminating last week the automatic acceleration in 2018 of the posting deadline to a time occurring earlier than 6:00 pm the day of settlement. This Committee codified in the Reauthorization Bill passed by the House last Congress a provision that would permanently establish the residual interest posting deadline at the end of each business day, calculated as of the close of business the previous business day. CME again supports the inclusion of such a provision in any Reauthorization Bill considered by the Committee during the current Congress.

Central Counterparty Risk

Clearinghouse Capital Contributions

Much attention recently has been paid to how much capital a clearinghouse such as CME should contribute to manage a default by one or more of its clearing members. We could not agree more with the general principles on this topic outlined by CFTC Chairman Massad two weeks ago in his keynote address to the annual meeting of the Futures Industry Association. There, Chairman Massad recognized that any discussion of clearinghouse capital contributions must take stock of the purpose clearinghouses are meant to serve—risk management—versus the purpose served by clearing members—trading, lending, or other types of risk creation. In other words, risk is concentrated not at the clearinghouse, but rather within a clearing member through the exposures it brings to the clearinghouse.

CME recognizes the role of clearinghouse capital in managing risk. As a systemically important clearinghouse, CME must have financial resources available that are sufficient to meet its obligations to all of its clearing members despite a default by the two clearing members that could create the largest potential loss at any point in time. CME can meet this standard through any allocation of initial margin, its own capital, and clearing member default fund contributions. In making this allocation, CME has provided a larger capital contribution to its waterfall to date than any of its U.S. competitors. CME commits to using its capital contribution, in a first loss position, before any non-defaulted clearing member assets.

By contributing first-loss capital to the waterfall, CME has a greater incentive to prudently manage its clearing members' concentrations. However, CME also understands that arbitrary, excessively large clearinghouse capital contributions introduce negative incentives. For example, if CME were to increase its capital contribution to the CME waterfall to cover the shortfall for the largest potential defaulting clearing member, this would allow clearing members to increase their risk exposures by over 40% for the same level of default fund contributions they make today, with CME subsidizing the additional risk with its own funding. As a result, CME's increased contribution would significantly diminish the incentives of clearing members to manage their own risk by maintaining balanced portfolios, manage the risks of their clients and actively participate in the default management process to ensure their default fund contributions are not used in a fellow clearing member default.

Recent history illustrated for us the moral hazard issues created by lenders repackaging and offloading the risk of their loans via securitizations. By separating the risk from the responsibility of bearing that risk in the event of the loans not being repaid, these lenders lacked incentive to conduct appropriate due diligence on their loans. We should learn from the mistakes of securitization lenders by continuing to balance clearinghouse capital contributions in a manner that ensures that market participants are sufficiently incentivized to manage the risks they create.

U.S. Regulatory Oversight of Clearinghouses

Due to the critical role clearinghouses like CME play in mitigating systemic risk to the US economy, certain market participants recently have called upon the Financial Stability Oversight Council ("FSOC") to play a greater oversight role. Congress, however, should resist the urge to heed these calls by injecting FSOC into an existing regulatory framework that does not need "fixing." The CFTC and SEC already provide robust oversight of US clearinghouses. Furthermore, the rules and regulations already imposed by these agencies facilitate adherence to many of the principles that critics mistakenly complain are currently absent from clearinghouse governance.

First, clearinghouses, including CME, are extremely transparent to their clearing members, regulators, and the general public. Clearinghouses post their rulebooks, rule submissions, and written policies and procedures online. Clearinghouses publish public reports detailing how they comply with the international "Principles for Financial Market Infrastructures," as well as participate in a standardized financial reporting structure through the Fed's Payments Risk Committee that allows clearing members to compare among multiple clearinghouses the financial resources, collateral, central counterparty investments, and back-testing and stress-testing results of each clearinghouse. With respect to stress testing specifically, additional detailed reports already are submitted to each clearinghouse's risk committee and regulators for purposes of providing even greater transparency into the resiliency of each clearinghouse's financial safeguards.

Next, clearinghouse rules such as those of CME detail precisely what financial obligations may be incurred, now and in the future, by clearing members in the form of margin payments, default fund requirements, and assessments. These rules also detail a clearinghouse's capital contributions and waterfall structures and any changes to these rules are subject to a transparent review process that is open to the public. Clearing members can rest assured that the current regulatory framework provides certainty as to how much capital is required of each market participant and the order in which these resources will be used to cure any deficiency in a clearinghouse's funding under a clearing member default scenario.

Lastly, current regulations already require CME and other systemically important clearinghouses to prepare credible recovery and wind-down plans in the event that the viability of the clearinghouse is threatened. While CME believes that its existing default management framework is sufficient to handle multiple concurrent member defaults under normal circumstances, we appreciate the value of worst-case-scenario planning given the importance of our services. We are actively working with our Clearing House Risk Committee, clearing members, and regulators to enhance our plans that are designed to continue CME's clearing operations, and if needed, conduct an orderly wind-down, without causing systemic risk to the larger financial system. As every clearinghouse's risk profile and risk management framework is unique and the facts and circumstances of any doomsday scenario could vary widely, CME believes it would be imprudent for regulators or Congress to impose a one-size-fits-all approach to these plans or stress tests.

Conclusion

We appreciate the Committee's consideration of the views expressed in this testimony. We stand ready to assist the Committee as a resource in finalizing legislation that ensures the US will remain a competitive player in the global derivatives marketplace while enhancing the safety and soundness of futures and derivatives markets at home through a principles-based CFTC regulatory regime.