

Statement of  
Terrence A. Duffy  
Executive Chairman of CME Group Inc.

Before the

UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON FINANCIAL SERVICES

SUBCOMMITTEE ON CAPITAL MARKETS,  
INSURANCE, AND GOVERNMENT SPONSORED  
ENTERPRISES

June 9, 2009

I am Terrence Duffy, Executive Chairman of Chicago Mercantile Exchange Group Inc. (“CME Group” or “CME”) Thank you Chairman Kanjorski and Ranking Member Garrett for this opportunity to present our views on effective regulation of the OTC derivative market.

CME Group was formed by the 2007 merger of Chicago Mercantile Exchange Holdings Inc. and CBOT Holdings Inc. CME Group is now the parent of Chicago Mercantile Exchange Inc., The Board of Trade of the City of Chicago Inc., the New York Mercantile Exchange, Inc. and COMEX (the “CME Group Exchanges”). The CME Group Exchanges are neutral market places. They serve the global risk management needs of our customers and producers and processors who rely on price discovery provided by our competitive markets to make important economic decisions. We do not profit from higher or lower commodity prices. Our Congressionally mandated role is to operate fair markets that foster price discovery and the hedging of economic risks in a transparent, efficient, self-regulated environment, overseen by the CFTC.

The CME Group Exchanges offer a comprehensive selection of benchmark products in all major asset classes, including futures and options based on interest rates, equity indexes, foreign exchange, agricultural commodities, energy, and alternative investment products such as weather and real estate. We are in the process of joining with market users to operate a green exchange to provide trading and clearing services that will serve cap and trade programs respecting emissions and allowances.

Treasury Secretary Geithner's May 9, 2009, letter to Senator Harry Reid outlined the administration's plan for regulatory reform of the financial services sector. His plan proposed increased regulation of credit default swaps and other OTC derivatives. Newspaper reports have also suggested that merger of the SEC and CFTC may be open for consideration. Finally, this Committee posed seven questions for our consideration this morning.

We agree with many of Secretary Geithner's proposals, which mirror much of our recent testimony before Congress. For example, we support position reporting for OTC derivatives and agree that enhanced price transparency across the entire market is essential to quantify and control risk.

We believe, however, that the means chosen to achieve these ends should be fine-tuned to avoid adverse consequences for U.S. markets. For example, legislation mandating the clearing of all OTC derivative transactions could well induce certain market participants to transfer this business offshore, resulting in a loss to the U.S. economy. We are concerned that this may result in a significant shift of related transactions that would have been traded on U.S. regulated exchanges to foreign jurisdictions. By reducing liquidity on markets regulated by U.S. regulators, this shift could undermine the established price discovery and risk hedging missions of U.S. futures exchanges.

We believe that the administration's objective of reducing systemic risk can be accomplished by other measures that would ensure that the U.S. retains its significant role in the OTC derivatives market. Rather than compel clearing of all OTC derivative transactions, appropriate incentives in the form of reporting and capital charges for uncleared OTC positions and reduced capital charges for cleared OTC positions should contribute both to the reduction of systemic risk and transparency.

We applaud the administration's efforts to enhance transparency, stability, integrity, efficiency and fairness in the markets. We believe that slight modifications to the proposal outlined by Secretary Geithner and the inclusion of a

few additional measures would complement the administration's efforts. Focusing on the Commodity Exchange Act, we have responded to your specific questions and offer a number of recommendations and reform measures.

1. Explain your views on the need for OTC regulation broadly.

You asked us to discuss the need to regulate the OTC market. OTC derivatives cover a very broad swath of product types from collateralized obligations packaged as securities (including subprime mortgage obligations) to pure vanilla swaps that are unregulated versions of futures contracts. OTC derivatives are a tool for managing a firm's risks. Like all tools, they are neither intrinsically beneficial nor harmful. There seems to be an informed consensus that the financial crisis was attributable, in part, to the lack of regulation in the over-the-counter market, which was not subject to appropriate disclosure and risk management techniques.

The failure to properly measure and collateralize the risks of OTC derivatives had dire consequences. In stark contrast, trading of financial futures on regulated futures markets, subject to the oversight of the Commodity Futures Trading Commission, has been a net positive to the economy, has caused no stress to the financial system and has easily endured the collapse of one and near collapse of two firms that were very active in our markets. This is a record of which the CFTC and our industry are justifiably proud.

CME has consistently promoted the superiority of regulated exchanges with central counterparty clearing. We have not sought to ban all OTC trading, we have urged that OTC trading be limited to truly sophisticated investors trading contracts that are too individualized or too thinly traded to be brought onto a trading platform for standardized products. We were right then and we are right now.

2. Explain how clearing will affect the OTC market.

Clearing should be offered to the OTC market in a form that makes it a compelling alternative to the current model. Central counterparty clearing offers a well-tested method to monitor and collateralize risk on a current basis reducing systemic risk and enhancing certainty and fairness for all participants. Our solution offers regulators the information and transparency they need to assess risks and prevent market abuse. CME's CCP offering to the OTC market includes multilateral netting and well-conceived collateralization standards; in the case of

credit default swaps, it will eliminate the risk of a death spiral when a jump to default of a major reference entity might otherwise create a cascade of failures and defaults.

3. Address whether clearing should be mandated for all products or only some.

We are not in favor of government mandated clearing, although we are strong proponents of the benefits of central counterparty clearing as an effective means to collect and provide timely information to prudential and supervisory regulators and to greatly reduce systemic risk imposed on the financial system by unregulated bilateral OTC transactions. Our support of CCP clearing and opposition to a government mandate is not inconsistent. We appear to be the direct beneficiary of legislation to force more OTC transactions through regulated clearing houses, but we expect that mandating clearing will not have the expected outcome. If the OTC dealers do not embrace clearing, they can easily transact in another jurisdiction and cause significant damage to a valuable domestic industry. We urge consideration of the implication that OTC financial markets are global. Trading systems are electronic, banking is international, and every important trader has easy access to markets that are not regulated by U.S. agencies. Prohibitions or costly impediments to legitimate business activities in the U.S. will simply divert business to jurisdictions that adopt rational measures to deal with the causes and protection against future financial meltdowns.

We favor encouragement of clearing by offering favorable capital treatment to OTC dealers that clear and subject their positions to appropriate collateralization and mark-to-market regimes subject to regulatory oversight. A capital charge and reporting requirements will incent voluntary clearing, while providing the appropriate regulators with the information necessary to monitor such transactions.

We favor the elimination of impediments to the voluntary clearing of OTC derivatives by amending the CEA and securities laws to permit a clearing house for OTC derivatives to be regulated by the CFTC or the SEC, regardless of ambiguity respecting the character of the instrument underlying the derivative. A voluntary central counterparty clearing model reduces the probability that the failure of a significant market participant would lead to a systemic failure or require a government bailout. In our view, the CFTC is the regulator best suited to oversee such clearing houses. During the recent market turmoil, CFTC-regulated clearing houses functioned flawlessly despite the collapse of one and near collapse of two SEC regulated broker-dealers that were very active in the futures markets.

4. Discuss the pros and cons of exchange trading.

CME Group operates four exchanges and is a strong proponent of the benefits of exchange trading of derivatives. We are also realists when it comes to whether exchanges can generate sufficient liquidity to make exchange trading efficient and economical for our customers. We have introduced hundreds of well designed contracts that have attracted no customer interest despite clear customer demand, surveys and expert opinion that the contract was needed. Given the multitude of specialized contracts traded in the OTC market, we are confident that government mandated exchange trading of standardized contracts as a replacement for this bespoke market will be ineffectual.

There is one clear exception to this rule. We must eliminate, by amendment to the CEA, the exemption and judicial precedent that permits off-exchange trading of retail foreign exchange and other forms of derivative contracts. As we previously predicted, there have been hundreds of enforcement actions, hundreds of millions in fraudulent losses to retail traders, and each day brings new cases and more losses. Moreover, judicial rulings allow dealers in any commodity to structure a margined contract for speculative use by retail customers and effectively place it beyond the reach of CFTC jurisdiction. These leveraged, retail contracts are identical to futures contracts and deserve the full panoply of protection of the CEA and the CFTC.

5. Address the potential benefit of increased electronic trading.

Most futures contracts offered by the CME Group exchanges are electronically traded. In our view, electronic trading levels the playing field, enhances price transparency and liquidity, speeds execution and straight through processing, eliminates many classes of errors and mismatched trades and is generally enormously beneficial to the market and our customers. Electronic trading, when coupled with our intelligent audit and compliance programs, allows us to better monitor our markets for fraud and manipulation and gives us the tools to effectively prosecute anyone foolish enough to engage in misconduct in a forum with a perfect audit trail and highly skilled enforcement staff.

6. Discuss how to best achieve a balance between price discovery and liquidity.

We understand this question to raise concerns respecting speculation in derivative markets and how we balance the need for liquidity against problems that

are allegedly caused by excessive speculation. There is no dichotomy between effective price discovery and liquidity. We understand that recent spikes in fuel and food prices are shocking and painful to consumers and the economy. Unfortunately, the pressure to control price spikes has led some to look for a simple causal agent that can be neutralized with the stroke of a pen. The favored culprit is the traditional villain--speculators. But speculators sell when they think prices are too high and buy when they think prices are too low. They are not a unified voting block and are on both sides of every market. Speculative selling and buying send signals to producers and processors that help keep our economy on an even keel. High futures prices for corn induced farmers to bring new acreage to market. High forward energy prices encourage exploration and new technology to exploit existing untapped reserves.

Futures markets perform two essential functions—they create a venue for price discovery and they permit low cost hedging of risk. Futures markets depend on short and long term speculators to make markets and provide liquidity for hedgers. Futures markets could not operate effectively without speculators and speculators will not use futures markets if artificial barriers or tolls impede their access. Blaming speculators for high prices diverts attention from the real causes of rising prices and does not contribute to a solution.

Regulated futures markets and the CFTC have the means and the will to limit speculation that might distort prices or distort the movement of commodities in interstate commerce.

7. Address whether books and records are appropriate for all trades and whether warehousing is appropriate for all trades.

We operate trading systems and a clearing house in which every bid and offer and every completed transaction is instantaneously documented and where those records are preserved for an extended period of time.

## SEC/CFTC MERGER

The SEC and CFTC both apply regulatory principles that protect their respective markets and public customers of their markets, but SEC law and regulation is antithetical to successful regulation of futures markets. Merger is likely to result in the application of the SEC's, the dominant agency's, policies and principles to the detriment of futures markets.

One of the grounds offered for merging the SEC and CFTC is that the financial meltdown would not have occurred if information had not slipped through the crack between those agencies. This claim is not supportable. Derivative transactions conducted on CFTC regulated futures exchanges and cleared by CFTC regulated clearing houses did not contribute to the current financial crisis. Moreover, both agencies lacked regulatory authority to deal with the instruments most implicated in the meltdown. A merger would not have cured that defect. Information sharing, which can close the gap, does not require merger; it requires that there be reliable information, that each agency collects information on a timely basis and that the information is responsibly shared. We understand from recent public comments that the two agencies are now placing renewed focus on the productive and timely sharing of information.

Futures markets and securities markets serve very different purposes. Futures markets provide price discovery and a means to hedge economic risk. Terms and conditions of each futures contract are unique and are specifically designed based on market demands. In contrast, securities markets provide a forum to trade securities on a level playing field where insiders and others are precluded from taking advantage of inside information. There is little to no overlap in the regulatory regimes of futures and securities markets and no real public efficiency presented by a merger.

Congress clearly intended to set futures apart from securities regulation and that grant of exclusive jurisdiction to the CFTC must be preserved. In the global economy, where networks easily penetrate national borders, U.S. derivative markets cannot compete if the principles based regulatory regime created by CFMA is replaced for U.S. markets by a prescriptive regulatory regime that is administered by the SEC and its staff who are unversed in the intricacies of derivatives trading and clearing.

## CONCLUSION

We appreciate this opportunity to present our views on these important issues. We hope that our views on the importance of the OTC market and the costs and dangers of mandating clearing and exchange trading will be given significant weight given our position as the apparent beneficiary of such mandates.