TESTIMONY
OF
TERRENCE A. DUFFY
EXECUTIVE CHAIRMAN & PRESIDENT
CME GROUP INC.
BEFORE THE
SENATE COMMITTEE ON AGRICULTURE, NUTRITION & FORESTRY

Hearing on CFTC Reauthorization
May 14, 2015

Good morning Chairman Roberts and Ranking Member Stabenow. I am Terry Duffy, Executive Chairman and President of CME Group.[1] Thank you for the opportunity to offer our views on the future of the Commodity Futures Trading Commission ("CFTC" or "Agency"). As this Committee considers reauthorizing the Agency, I would like to highlight five critical issues, specifically as they relate to end-users who participate in CME's markets: position limits, European Union ("EU") equivalency standards, the supplemental leverage ratio, customer protections, and Agency funding.

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 function.

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

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1 CME Group Inc. is the holding company for four exchanges, CME, the Board of Trade of the City of Chicago Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX"), and the Commodity Exchange, Inc. ("COMEX") (collectively, the "CME Group Exchanges"). The CME Group Exchanges offer a wide range of benchmark products across all major asset classes, including derivatives based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products. The CME Group Exchanges serve the hedging, risk management, and trading needs of our global customer base by facilitating transactions through the CME Group Globex electronic trading platform, our open outcry trading facilities in New York and Chicago, and through privately negotiated transactions subject to exchange rules.

on its anti-evasion powers to enforce the limits. CME supports the CFTC allowing exchanges to administer non-enumerated hedge exemptions that meet the statutory criteria. This approach would alleviate the Agency from needlessly tying up its limited resources responding to requests for non-enumerated hedge exemptions by instead relying on the system that currently is in place today. Exchanges have the most direct experience administering hedge exemptions tailored to real world commercial end-user business operations and this experience has never been cited as having created a problem in need of the Agency's current proposed solution.

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

- 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 thus increase the risk of possible price manipulations or distortions. Neither outcome would serve the long-term interests of end-users by sacrificing market integrity for liquidity.

- 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 updated deliverable supply estimates for the core referenced futures contracts that would be covered by the Agency's re-proposal, including last month when it submitted a second updated set of estimates. The Agency must identify for the public the deliverable supply estimates it will use prior to finalizing any federal limits and require all exchanges to use those same estimates for purposes of establishing exchange-set limits. Only by using the most current deliverable supply estimates can the CFTC ensure adequate liquidity for end-users while avoiding undue risk of price manipulations or distortions.

- 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 contracts to set the federal spot-month level below this ceiling on a contract-by-contract basis, based upon the unique market characteristics of each commodity that is traded.

- Position accountability limits should apply in lieu of hard limits outside of the spot month for non-legacy agricultural commodity derivatives. Consistent with statutory requirements, CME has long supported imposing hard cap limits in the spot month as is necessary to prevent price manipulations and other distortions. However, nothing in the Commodity Exchange Act or any legislative history forecloses the possibility of using the more flexible position accountability approach in the out months as an appropriate alternative to federal hard cap limits. To the contrary, the Commodity Exchange Act authorizes it to adopt a position accountability regime as a form of limit more "appropriate" for balancing the four enumerated statutory interests. Such an approach would better serve market integrity and protect the price discovery process in the out months when diminished liquidity can severely increase the cost of hedging for end-users. 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.

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 U.S. and United Kingdom, and our U.S. futures products reach over 150 jurisdictions across the globe. Cross-border access is a core part of our global business strategy. CME has long been 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, (iii) afford U.S.-based and foreign-based markets and market participants equal flexibility, and (iv) promote a level playing field. Historically, both the U.S. and EU have mutually recognized each other's regulatory regimes to promote cross-border access.

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

After more than two years of negotiation and delay, the EU still has refused to grant U.S. equivalence. Since his arrival at the CFTC, Chairman Massad has been a tremendous leader in working toward a solution that avoids market disruption and affords U.S. and foreign-based markets equal flexibility. Yet, the EU continues to hold up the U.S. equivalence determination over the single issue of differing initial margining standards for clearinghouses. The specific U.S. margin standards in question are an important component, but not the only component, of a robust regulatory structure under the CFTC's oversight. And even considering just this component of the margin standards, the U.S. rules generally require equal, if not more, margin to be posted with clearinghouses to offset exposures than is the case under the EU rules. We applaud Chairman Massad's effective testimony on this issue before the European Parliament last week. Nonetheless, the European Commission has thus far insisted that the U.S. accept EU margin requirements. As Chairman Massad recently stated, "[The CFTC has] offered a substituted compliance framework for clearinghouse regulation which was [the European Commission's] principal concern. I believe there is ample basis for [the European Commission] to make a determination of equivalence, and I hope that they will do so soon."

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

In stark contrast to the EU approach, U.S. regulations currently allow European-based futures markets full access to U.S. market participants. Today, a foreign board of trade may provide direct electronic access to persons located in the U.S. 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 U.S. market participants without disruption until the CFTC completes its review of the FBOT applications.

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

This regulatory game of "chicken" also is causing disruptions to U.S. futures markets because, without equivalence, the cost of clearing futures on U.S. markets will increase on December 15, 2015. Under EU laws, non-EU clearinghouses must be recognized by this date as "qualified central counterparties" ("QCCPs"). 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 December 15, U.S. clearinghouses, like CME, will no longer be treated as "QCCPs" from a capital perspective, thus significantly increasing the costs for European clearing firms to use U.S. clearinghouses. The European Commission has extended this deadline twice now, which has averted disaster but nonetheless continued the current market uncertainty.

The EU's resistance to recognizing U.S. exchanges as equivalent also has driven commercial participants away from U.S. 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 U.S. exchanges or reducing their trading on U.S. exchanges until U.S. equivalence is granted. Make no mistake that a continued decrease in participation in U.S. futures products will harm both EU and U.S. market participants, reducing liquidity and impeding the ability of farmers, ranchers and other U.S. and EU businesses to conduct prudent risk management.

Insisting that EU margin standards be implemented makes no sense when principles governing margin have already been issued by global standard setters, and have been implemented by the U.S. and other jurisdictions throughout the world. The U.S. 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 U.S. and Europe to recognize each other's regulatory regimes, including margin standards, equally—and soon. We appreciate Chairman Roberts' recognition of this crucial issue and wholeheartedly echo the concerns that were raised in his letter to Treasury Secretary Lew in March.

If the U.S. continues to be excluded from the European marketplace, the CFTC has many tools at its disposal to deny the generous access to U.S. 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 U.S. derivatives regulations as equivalent and U.S. 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.

Supplemental Leverage Ratio

One of the pillars of the G-20's commitment to reforming derivatives markets was to transition standardized OTC swaps to the centralized clearing model that futures contracts have traded under in the U.S. for decades. To complement this risk-reduction initiative, the Federal Reserve, in consultation with the Basel Committee on Banking Supervision, last year proposed a Supplemental Leverage Ratio rule intended to limit the amount of leverage that the largest banking organizations can hold on their balance sheets. By keeping balance sheet leverage low, regulators seek to further mitigate systemic risk in the event of a default, including for a bank that is a clearing member of a central clearing counterparty such as CME. The Supplemental Leverage Ratio, however, could have the unintended effect of costing end-users up to five times more to clear trades than it currently costs due to clearing members passing along the cost of the additional capital they must hold to stay within the limit imposed by the ratio. These excess capital costs have already contributed to the decision by some clearing members to exit the market altogether, thus concentrating risk among a smaller pool of central counterparties. Higher clearing costs and fewer clearing members in turn would only exacerbate—not mitigate—the risks central clearing is intended to address.

The Supplemental Leverage Ration's main flaw is that it fails to allow clearing members to net segregated margin held for a cleared trade against the clearing member's exposure on the trade. By law, clearing members cannot use segregated margin to add leverage to the clearing member's balance sheet. Instead, the segregated margin can only serve to offset the exposure a clearing member has on a trade through its guarantee of the trade provided to the clearinghouse. Accordingly, the only real exposure a clearing member has on any trade is the amount of the guarantee to the clearinghouse that exceeds the amount required to be posted to the clearing member as segregated margin (whether by law or by the clearing member as a term of doing business). CME appreciates the steps Chairman Massad has taken recently to address this issue with prudential regulators in the U.S. such that end-users do not find themselves priced out of cleared derivatives markets.

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 daily, hands-on administration of compliance and market surveillance programs for 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, has buttressed its systems over the past two years to better detect and deter another MF Global or Peregrine Financial situation from occurring to the financial detriment of farmers, ranchers, and other commercial end-users who rely on robust customer protections for their livelihood.

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 in March the automatic acceleration in 2018 of the posting deadline to a time occurring earlier than 6:00 pm the day of settlement. Last Congress, this House passed a

Reauthorization Bill that would codify a provision to 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.

Agency Funding

The White House'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 commercial end-users 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 and increased hedging costs for end-users. 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.

Conclusion

We appreciate the Committee's consideration of the views expressed in this testimony. Please note that the issues discussed herein represent only a handful of the most important points CME believes the Committee should address in reauthorizing the CFTC. We stand ready to assist the Committee as a resource in finalizing legislation that protects and strengthens the liquidity, fairness, and integrity of our markets for ranchers, farmers, and other commercial end-users.