TESTIMONY
OF
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I am Terrence A. Duffy, executive chairman of CME Group Inc. Thank you Chairman Lincoln and Ranking Member Chambliss for inviting us to testify today. You asked us to discuss the various legislative proposals currently circulating in Congress respecting regulatory reform in the OTC derivatives and futures market. These proposals include: the "**Over-the-Counter Derivatives Markets Act of 2009**," passed by House Financial Services Committee on October 15, 2009 (the "FSC Bill"); the "**Derivative Markets Transparency and Accountability Act of 2009**," passed by House Committee on Agriculture on October 21, 2009 (the "Ag. Committee Bill"); the "**Financial Stability Improvement Act of 2009,**" released by the House Financial Services Committee on October 29, 2009 (the "FSC Systemic Risk Bill"); and the "**Restoring American Financial Stability Act of 2009**," revised by Senator Dodd on November 16, 2009 (the "Senate Bill," collectively the "pending legislation"), and in particular Titles I, II, VII and VIII of this Act. Our testimony focuses on the provisions in these bills that most directly impact derivatives clearing organizations ("DCOs") and designated contract markets ("DCMs").

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") (collectively, the "CME Group Exchanges"). 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 Commodity Futures Trading Commission (the "Commission" or "CFTC") 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.

Introduction

Last year's financial crisis has drawn substantial, in many cases well-warranted attention to the lack of regulation of OTC financial markets. We learned a number of important lessons that should permit Congress to craft legislation that reduces the likelihood of a repetition of that near disaster. However, it is important to note that two important positive lessons were also learned. First, regulated futures markets and futures clearing houses operated flawlessly. Futures markets performed all of their essential functions without interruption and despite failures of significant financial firms, our clearing house experienced no default and no customers on the futures side lost their collateral or were unable to immediately transfer positions and continue managing risk. Second, central counter party clearing with proper collateralization could have prevented or at least significantly limited some of the worst excesses and corresponding losses in the OTC market.

We support the overarching goals of Congress and the Administration 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. Unfortunately, the pending legislation does not stop at providing the CFTC with the tools necessary to achieve these goals.

Rather, the pending legislation creates a highly intrusive role for the Commission while at that same time adding layers of additional regulation to an already well-regulated industry. Among other things, under the pending legislation: (i) the Commission will become the arbiter of new contracts and new rules; (ii) principles-based regulation will be eliminated; (iii) margin setting and position limits will be politicized and impair liquidity and efficiency; and (iv) dual registration requirements will be added. The unintended adverse consequences of such provisions are the impairment of effective exchange innovation and the stifling of the most important growth paths in our industry, including the clearing of OTC transactions. Indeed, the threat of such policies has already driven major customers to move business off U.S. markets.

We believe that, with certain revisions to the pending legislation, the aforementioned goals of regulatory reform can be accomplished while avoiding unintended adverse consequences to the derivatives industry specifically, and to the U.S. economy as a whole. To this end, we discuss in detail below our recommended revisions for each of the Ag. Committee Bill, the FSC Bill, the FSC Systemic Risk Bill and the Senate Bill. We also are available to provide technical drafting assistance respecting these bills or any proposed legislation.

1. Preservation of the Commodity Futures Modernization Act's ("CFMA") Principles-Based Regime

The Commodity Exchange Act ("CEA") currently prohibits the CFTC from mandating 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)). The Ag. Committee and Senate Bills each would amend this provision and expressly grant the CFTC the authority to state that an interpretation by the CFTC may provide the *only* means for compliance with core principles.[1] In effect, such a provision grants the CFTC administrative authority to eradicate the advantages of the CFMA's principles-based regime and inhibit the ability of U.S. futures exchanges to develop innovative and potentially more effective ways of complying with the core principles.

[1] Section 5c(a)(2) is amended by striking "shall not" and inserting "may." All of the new core principles included in the draft bills 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."

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 the CFMA. The myriad 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 the 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 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. As discussed in more detail below, the pending legislation addresses those gaps by eliminating the exemptions from regulation for such classes of instruments and enterprises.

With respect to increased margin authority for the Commission, we believe that the amendments to the CEA included in each of the Senate Bill, the Ag. Committee Bill and the FSC Bill respecting core principles for DCOs already impose significant direct obligations on clearing

houses to set margins at appropriate levels to protect the financial integrity of the clearing house. Generally, such provisions on the core principles provide:

(i) The derivatives clearing organization shall have the ability to manage the risks associated with discharging the responsibilities of a derivatives clearing organization through the use of appropriate tools and procedures.

(ii) The derivatives clearing organization shall measure the credit exposures of the organization to the members of, and participants in, the organization at least once each business day and shall monitor the exposures throughout the business day.

(iii) Through margin requirements and other risk control mechanisms, a derivatives clearing organization shall limit the exposures of the organization to potential losses from defaults by the members of, and participants in, the organization so that the operations of the organization would not be disrupted and non-defaulting members or participants would not be exposed to losses that they cannot anticipate or control.

(iv) Margin required from all members and participants shall be sufficient to cover potential exposures in normal market conditions.

(v) The models and parameters used in setting margin requirements shall be risk-based and reviewed regularly.

These new core principles mimic the best practices long in place at CME. We believe that they are appropriate standards and that the Commission already has adequate authority in connection with its ability to insure compliance with the existing and these new core principles, to assure itself and its fellow regulators that these principles will be appropriately applied. Accordingly, DCMs and DCOs should continue to retain discretion in establishing the manner in which they comply with the core principles and the Commission should not be granted authority to mandate margin requirements as is the case under the FSC Bill.

If, however, the Commission must be granted some additional authority respecting margin, such authority should be limited to allow the CFTC margin authority only to ensure the financial integrity of a clearinghouse; the CFTC must be explicitly prohibited from setting specific margin amounts. Such a provision was incorporated in the Ag. Committee Bill through the amendment process. We recommend that, at a minimum, legislation limit the CFTC's margin authority in a manner consistent with the Ag. Committee Bill.

2. Preservation of the Self-Certification Process for Rules and Contracts

Each of the Ag. Committee, FSC and Senate Bills impose some form of prior approval requirements on DCMs respecting new rules or new contracts and amendments to existing rules. Specifically, the pending legislation provides that a new rule and/or contract does not become effective for 10 days and the CFTC can delay the rule or contract from becoming effective for at least 90 days by filing an objection. The circumstances under which the CFTC can object are "novel or complex issues that require additional time to analyze, an inadequate explanation by the submitting registered entity, or a potential inconsistency with this Act (including regulations under this Act)."

As each of these bills are currently drafted, the certification process could revert to that which existed pre-CFMA; industry experts have testified repeatedly at the various hearings held over the past few months addressing the Treasury's Title VII and the harmonization efforts of the CFTC and SEC that this archaic process, which is currently employed by the SEC, would put participants in the U.S. futures markets at a significant competitive disadvantage when compared to their foreign competitors. This provision should be deleted or, at a minimum, restricted to rule amendments that materially change the terms and conditions of listed contracts with open interest as was done with the FSC Bill.

3. Maintain the Foundations of the Existing Regime Respecting Position Limits and Hedge Exemptions

A. Position Limits

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.

The Ag. Committee and Senate Bills would change this regime and impose an absolute obligation on the CFTC to impose hard limits and the Ag. Committee Bill requires the CFTC to hold public hearings twice a year to get input on whether the position limits are sufficient. This is completely inconsistent with the proposed amendments to the core principles (discussed in Section 1, *supra*), which impose the obligation to control limits on DCMs. It makes no sense to impose the same duty upon the CFTC and the exchanges. In fact, we believe that if this provision is not changed, the order to the CFTC will take precedence and the amendment to the core principle will be meaningless. If this language is not omitted from legislation, at a minimum, language must be added to ensure that the CFTC refrains from placing hard position limits on regulated exchanges until such time that they are simultaneously placed on the OTC market and foreign boards of trade, which is consistent with the amendment offered by Rep. Halvorson and approved by House Committee on Agriculture.

Moreover, the DCMs' enhanced obligation to impose position limits should not include a requirement to "eliminate or prevent excessive speculation as described in section 4a(a)." This phrase remains without real definition and there would be no way for a DCM to know whether it is in fact complying with its statutory obligations. In addition, legislation should mandate that each DCM or Swap Execution Facility ("SEF") 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. Indeed, it is contrary to the purposes of the CEA's prohibition on excessive speculation for an exchange with limited liquidity, volume and/or open interest to simply mimic the position limits set by another exchange.

Each of the Ag. Committee, FSC and Senate Bills also grant 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, these bills do not provide clear guidance as to how aggregate limits will be calculated. As noted above, any aggregate limits set by the CFTC should not permit free riding exchanges to set internal limits at the level of the aggregate limit, irrespective of the limits it should be setting based on its own liquidity, volume, open interest and other factors respecting trading for which it is directly responsible.

Additionally, legislation should provide that the Commission'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 not become a political tool to control the underlying prices in the cash market. Position limits are not an effective tool to control price; any attempt to use position limits for this purpose will have a devastating impact on the U.S. futures industry and participants that rely on these markets to manage risk.

Finally, allowing self-interested entities a more formal role in the setting of position limits creates incentive for them to argue what is in their own individual self-interest and politicizes a process that should not be politicized. Indeed, exchanges acting in their SRO capacity in furtherance of the public interest, in consultation with and under the oversight of the CFTC, are in the best position and have the best expertise to make the determination of what the limits should be. Therefore, the provision in the Ag. Committee Bill, requiring the Commission to hold bi-annual public hearings respecting the setting of position limits, should be eliminated.

As we have previously testified, 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. We believe that the exchanges are in the best position to impose such limits.

B. Hedge exemptions

Under the Ag. Committee Bill, a bona fide hedging position would have to be linked to a transaction to be made or position to be taken at a later time in a physical marketing channel. This narrow conception of a bona fide hedge excludes hedging of a wide range of ordinary business risks. For example, electric utilities will be precluded from hedging capacity risks associated with weather events by use of degree day unit futures contracts. That hedge involves no substitute for a transaction in a physical marketing channel. Insurance companies may not hedge hurricane or other weather risks. Enterprises that consume a commodity that is not used in a "physical marketing channel" such as airlines that use fuel, generating facilities that use gas and produce electricity, freight companies whose loads depend on geographic pricing differentials and hundreds of other important examples that readily present themselves, will not be entitled to a hedge exemption from mandatory speculative limits.

Moreover, any limitation on hedge exemptions for swap dealers will limit the ability of commercial enterprises to execute strategies in the OTC market to meet their hedging needs. Under these proposals, swap dealers could qualify for a hedge exemption only if their counterparty's transaction met the definition of a bona fide hedging transaction. Because we do

not believe that particular futures positions can be linked to identified OTC transactions, the utility of futures markets as a risk transfer venue, which is a legitimate and necessary business activity, will be seriously impaired. For example, commercial participants often need customized OTC deals that can reflect their basis risk for particular shipments or deliveries. In addition, not all commercial participants have the skill set necessary to participate directly in active futures markets trading. Swap dealers assume that risk and lay it off in the futures market, but largely will be precluded from doing so.

Market makers and spreaders are critical market participants because they provide liquidity and reduce transaction costs, permitting trades that would otherwise be costly and market distorting. Also, neither Congress nor the CFTC is an appropriate body to make the day-to-day determinations as to whether a particular hedge exemption is appropriate; this task should be remain with DCMs so as to allow DCMs to continue operating their businesses and allow the CFTC to continue functioning as a regulator. Accordingly, the definition of bona fide hedge should, at a minimum, recognize that offsetting of positions of intra- and inter-market spreaders and market makers should be netted when calculating compliance with limits. A simple amendment to the Ag. Committee Bill – namely, changing "***and***" before (iii) in subsection (A)(i) of Section 113 to "***or***" – would go a long way towards preserving the competitive position of U.S. exchanges in the global marketplace.

4. Remove Prohibitions Against Providing Clearing Houses With Federal Assistance During Time of Crisis

The Ag. Committee Bill includes a provision that prohibits Federal assistance to support clearing operations, including making loans to or purchasing any debt obligation of a DCO. This provision must be omitted from legislation. Indeed, CME Group and other clearing houses agree that the Federal Reserve should be permitted to provide a liquidity facility to clearing houses in the event of a market emergency.

If there is a failure of a CME clearing firm, CME Clearing expects to rely on its financial safeguards to cure the default event. However, in a default, CME Clearing will have to liquidate the collateral that it has in its possession. The liquidation proceeds will be used by CME Clearing to cure the default amount owed to it by the defaulting clearing firm. It is possible that the

securities markets may be "stressed" or illiquid at such point in time that a clearing firm defaults. In this scenario, access to the resources of the Federal Reserve would be useful. Exchange of the defaulting firm's collateral for cash would take on the profile of a short term loan, secured by high quality collateral. Overt and explicit denial of access to Federal assistance will only exacerbate the initial default.

DCOs' access to the discount window in exigent circumstances would help contain problems associated with temporary market illiquidity. Access would provide greater flexibility in the range of collateral and greater timing flexibility when managing through a default event. The DCO should be permitted to borrow on the basis of good security in the event that a liquidity crisis interferes with its established liquidity lines, and if the market for securities is in turmoil. It would be a serious mistake to force a clearing house into bankruptcy and disrupt customer positions by denying a clearing house access to the discount window in the event of a disaster that is not of its own making.

The current crisis taught us that it is important to have flexibility in making and implementing policies that help contain problems. Explicitly preventing the Federal Reserve from taking action to contain issues associated with temporary liquidity problems at a systemically important clearing house is a recipe for disaster. In times of severely reduced market liquidity, such as that which we saw last Fall, it will be important for DCOs to have the ability to get liquidity by collateralized borrowing at the discount window until market conditions normalize.

The European Central Bank and Banque de France see part of their roles as lenders of last resort to clearing houses within their jurisdictions. Even though a clearing house should be managed to avoid the need for access to a lender of last resort, it is not acceptable for a U.S. clearing house to be at an explicit disadvantage in their ability to contain systemic risk relative to clearing houses whose central banks can be a lender of last resort.

5. Eliminate A Dual Regulatory Regime

Dual registration and regulatory provisions, similar to those contained in the Senate and FSC Bills, should be eliminated. No benefits are gained through a dual-regulatory regime, particularly where both are agencies of the same government and are required to implement

almost identical rules and regulations. Legislation should provide that *either* the CFTC *or* the SEC will be the "primary" regulator depending on whether a person is otherwise subject to regulation by the CFTC or SEC, or which agency has primary regulatory contact with such persons. Similarly, instruments should be subject to regulation by *either* the CFTC *or* the SEC depending on whether their value is based "primarily" on a single, non-exempt security or narrow-based security index, or to CFTC regulation if their value is based "primarily" on other physical or financial commodities.

Such a "primary" regulator system would greatly enhance regulatory harmonization between the agencies, and would eliminate legal uncertainty that can lead to market disruption and volatility. By coordinating between a primary regulator and a secondary regulator, the agencies will reduce the risk of overlapping and inefficient oversight and can focus on ensuring market stability and transparency through proper regulation of markets, their products and market participants.

6. Provide for Open Access, Not Mandate Interoperability Among Clearing Houses

Although the FSC Bill originally included language that could have been interpreted to mandate interoperability among clearing houses, that provision was revised in the amendment process to conform to the language in the Ag. Committee Bill providing for open access. Unfortunately the Senate Bill contains language similar to the initial FSC draft, which could be read to mandate interoperability among clearing houses. While we support open access as provided for in the FSC and Ag. Committee Bills, we strongly oppose interoperability for the following reasons.

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 another to change any contract terms or specifications that will distort future cross clearing house flows. Thus, every exchange and clearing house loses the ability to innovate and distinguish itself and its products.

The immediate impact of mandated interoperability is to force regulated exchanges and their associated clearing houses to truncate the services they offer to their customers by giving up control over the clearing function, which 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.

Systemic risk also is increased. When one side of a matched trade is transferred, the original clearinghouse would automatically become exposed to the risk of the other clearinghouse. As transfers build and links between clearinghouses increase, the ability to contain a single failure decreases and risk throughout the system increases.

Finally, 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 futures clearing houses' business strategies and, intuitively, a prerequisite for product advancement. Any suggestions to impede clearing houses' 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 should be rejected. Accordingly, legislation should include the open access language contained in the Ag. Committee and FSC Bills, and not the language in the current draft of the Senate Bill.

7. Encourage, Not Mandate, Exchange Trading and Centralized Clearing

We are strong proponents of the benefits of central counter party 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. While we support efforts to reduce systemic risk in the marketplace, we do not believe that this is best accomplished through mandated exchange trading and centralized clearing. Rather, we believe that the most effective way to reduce systemic risk without creating unintended adverse consequences, such as steering market activity to foreign jurisdictions with more favorable regulatory regimes (which will result in less liquidity and more price volatility in the U.S. for both exchange and OTC markets, where price discovery and hedging also would

suffer) is by increasing transparency and incentivizing centralized clearing. Moreover, not all standardized contracts can be cleared. Contracts that are infrequently traded, for example, are difficult if not impossible to clear even if they contain standardized economic terms because they are hard to price daily, which makes it difficult for a clearing house to calculate collateral requirements consistent with prudent risk management.

We believe that the provisions in the each of the Bills aimed at increasing transparency are adequate, and, when coupled with appropriate incentives to trade on exchanges and use centralized clearing – such as appropriate capital charges on non-cleared trades – will significantly reduce systemic risk in the U.S. marketplace. Legislation should not include a mandate for exchange trading or centralized clearing, but rather should include incentives to trade on exchanges and use a centralized clearing system. Accordingly, we believe that each of the Bills should be revised in this regard. We would be happy to work with the Committee to shape such measures for inclusion in legislation.

8. Protect Customer Funds and Collateral Respecting Swap Transactions

Each of the Bills contains a provision addressing the treatment of customer funds and collateral respecting swap transactions, providing that such funds and collateral must be segregated from the property of the customer's DCO or FCM. The drafting of the language of this provision, however, is ambiguous and should be revised to clarify what appears to be the intent of this provision. Specifically, this provision in each of the Bills should be amended to clarify that, to the extent that a single clearing house clears both swaps and security-based swaps, if a DCO is holding positions, once cleared these positions and supporting collateral will be treated as "customer property" within the meaning of Subchapter IV of Chapter 7 of Title 11. With such treatment, the collateral will be required to be placed in a segregated commodity account, and be treated as "customer property" in relevant bankruptcy proceedings. We have been working with the CFTC on language for such an amendment and would be pleased to share that language with the Committee.

9. The CFTC's Jurisdiction

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, the FSC and Senate Bills propose to disrupt it. Specifically, these bills provide that the CFTC's exclusive jurisdiction does not supersede any other authority's jurisdiction thereunder and would be referenced in existing CEA Section 2(a)(1)(A) as an exception to the CFTC's exclusive jurisdiction clause. Moreover, these bills appear to give CFTC "primary" enforcement authority over matters respecting swaps, but permit other regulators to take action if CFTC does not, and another provision allows other agencies to apply "any other applicable law." The effect of these provisions would be to subject market participants to potentially conflicting standards and multiple regulators. Accordingly, as contemplated by the Ag. Committee Bill, the legislation should maintain, in substance, the CEA's exclusivity provision.

10. Eliminate Stay Respecting DCOs in the Event of a Default of One of Their Members

Centralized clearing and settlement of financial transactions through clearing organizations such as those serving exchange markets is generally acknowledged to reduce systemic risk, and for this reason proposed regulatory reform legislation seeks to impose clearing requirements on OTC derivative contracts to the fullest extent possible. However, central clearing can achieve its risk reducing function only to the extent that the regulated clearing organizations are themselves able to ensure timely settlement of transactions. Provisions of Title II of the Senate Bill and Subtitle G the FSC Systemic Risk Bill of the give broad authority to a receiver or qualified receiver to take actions to repudiate contracts, avoid transfers, and otherwise affect the rights of counterparties and creditors of a financial company that is subject to the resolution process.

While certain provisions applicable to a "qualified financial contract" or "QFC" under the legislation provide protection for counterparties to such contracts, one destabilizing aspect of QFC treatment is the stay on the exercise of any acceleration for one business day while the receiver makes the determination whether to assign the contract to a third party. Such a delay would interfere with the ability of a clearing organization to close out exposures to a failed institution and thereby reduce risk to other participants. Institutions are most likely to fail in

volatile market conditions. Forcing clearing organizations to wait for even one business day before closing out positions of a failed member may cause collateral that would have been sufficient to fund an immediate close-out to become inadequate, maybe dangerously so. Since clearing organizations are central risk-mitigation bodies, it is essential that their ability to immediately close out exposures be protected in order to avoid spreading rather than eliminating risk. Thus, while provisions facilitating the transfer of positions of an insolvent clearing member to a solvent one are desirable, the legislation should make clear that the receiver or qualified receiver appointed under Title II of the Senate Bill/Subtitle B of the FSC Systemic Risk Bill with respect to a member of a clearing organization must meet all margin and settlement obligations of the clearing member to the clearing organization when due if feasible, and that if the receiver fails to do so, the clearing organization will not be prevented from exercising all available remedies under its rules and applicable law.

Accordingly, Title II of the Senate Bill/Subtitle G of the FSC Systemic Risk Bill should be amended to require that the receiver use its best efforts to meet all margin and settlement obligations of the covered financial company to the clearing organization when due. Such amendment should further provide that, if the receiver or qualified receiver fails or is unable to meet such obligations in full for any reason, the clearing organization shall have the immediate right to exercise, and shall not be stayed by any provision of the Act or by order of any court acting under authority of the Act from exercising, all of its rights and remedies under its rules and/or any other applicable law. Indeed, such an amendment should explicitly provide that the clearing organization maintains the right to, among other things, liquidate all positions and collateral of such clearing member, net the settlement rights and obligations of such clearing member, and suspend or cease to act for such clearing member, all in accordance with the rules of the clearing organization.

11. Prudential Regulation Under the Senate and FSC Systemic Risk Bills

Last, but by no means least, many provisions in the Senate Bill and FSC Systemic Risk Bill should be revised to eliminate duplicative and unnecessary regulation of entities, such as DCOs and DCMs, that are already subject to substantial prudential regulation by the CFTC. This can be achieved through the elimination of certain titles or subtitles and tightening the language in the draft legislation to ensure that it comports with Congressional intent.

Both Bills appropriately address a gap in oversight of payment systems by giving statutory authority to the Agency for Financial Stability ("AFS" or "Agency") (in the case of the Senate Bill) or the Federal Reserve Board (the "Board") (in the case of the FSC Systemic Risk Bill) to oversee inter-bank payment systems. As currently drafted, however, they potentially go further by also authorizing the AFS or the Board to effectively regulate securities, futures and derivatives clearing houses and exchanges. In addition to prescribing standards, the Agency or the Board would have the authority to directly examine compliance with and make recommendations for enforcement and implement those recommendations in certain circumstances. Thus, both Bills may effectively set up a system of dual regulation of clearing houses and exchanges between the market regulators on the one hand and the Agency or Board on the other.[2]

Specifically, the broad definition of "financial companies" in both Bills is so overly inclusive that the CFTC regulated clearing houses and designated contract markets may be designated as "identified" or "specified" "financial holding companies" subject to the provisions of Titles I and II in the case of the Senate Bill or Subtitles B and G in the case of the FSC Systemic Risk Bill, and subjected to a set of regulations and prescriptions that are not logically applicable to such enterprises. CFTC Chairman Gary Gensler testified on November 17, 2009 before the House Committee on Agriculture, that "[w]hile seeking to address the gaps and inconsistencies that exist in the current regulatory structure of complex, consolidated financial firms, [Titles I and II/Subtitles B and G] also may have unintentionally encompassed robustly regulated markets such as securities and futures exchanges."[3] Chairman Gensler correctly

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[2] A further inappropriate, and probably unintended, consequence of including clearing houses and exchanges within the definition of "financial company" is that they could become subject to the resolution authority of Title II and Subtitle G, which clearly were not drafted with such entities in mind.

[3] Although Chairman Gensler was specifically referencing the provisions the FSC Systemic Risk Bill, as discussed herein, the provisions of Subtitles B and G of that bill are substantially similar to the referenced provisions in the Senate Bill.

reasoned that the intent of these Titles/Subtitles cannot be applied to CFTC and SEC regulated clearing houses or exchanges.[4]

Titles I and II and Subtitles B and G however, may end up being applied to these fully regulated enterprises because they operate within a holding company structure and, depending on whim, may fall under the rubric of a "financial company." As discussed in more detail below, these holding companies and their subsidiaries, such as the New York Stock Exchange or the Chicago Mercantile Exchange, are currently comprehensively regulated by the SEC or the CFTC.

Obviously, Titles I and II and Subtitles B and G were drafted to deal with bank holding companies, and are not reasonably applied to clearing houses or exchanges. For example, Title I/Subtitle B prohibits any specified financial holding company from having credit exposure to any unaffiliated company that exceeds 25% of the identified financial holding company's capital stock and surplus. Clearing houses would be unable to comply with such a limitation because they do not trade or take market risk and, in connection with their central counterparty clearing function, rely primarily on operating a fully matched book, performance bond, security deposits, twice daily mark-to-market and other well-understood means to protect against loss. Clearing houses exist to reduce risk, not to take risks for profit. In addition, standards would be set for risk-based capital requirements and leveraging, yet clearing houses and exchanges themselves conduct no investment activity. In short, the standards contemplated by Title I/Subtitle B simply do not pertain to how clearing houses or exchanges function.

The application of Titles I and II and Subtitles B and G to clearing houses and exchanges is unnecessary and Title VIII of the Senate Bill is unnecessary in its entirety because clearing houses and exchanges are already subject to specific regulation under the CEA, and certainly will be subject to enhanced prudential regulation with the passage of proposed OTC legislation. Indeed, under both the Ag. Committee Bill and the FSC Bill, and under Title VII of the Senate Bill, important enhancements to the CFTC's oversight of clearing houses and designated contract

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[4] Although Title I/Subtitle B purports to define "financial company" for purposes of "this Act," which could be interpreted to include all Titles/Subtitles, the term is nevertheless redefined (differently) in Title II/Subtitle G. Accordingly, the definitions should be consistent in making clear that regulated exchanges and clearing houses are not covered.

markets were included, both for futures and OTC derivatives. These provisions clarify and materially enhance the CFTC's ability to regulate clearing houses and exchanges, write rules and oversee the setting of margin to protect the financial integrity of clearing houses and exchanges. For example, in the Ag. Committee Bill, the CFTC is granted authority respecting the setting of margin for CFTC-regulated derivatives clearing organizations to protect the integrity of the clearing house and the integrity of the transactions conducted therein; the core principles of the FSC and Senate Bills provide that DCOs must have adequate financial resources to discharge their responsibilities, which shall, at a minimum, enable each DCO to (i) meet its financial obligations to its members and participants notwithstanding a default by the member or participant creating the largest financial exposure for that DCO in extreme but plausible market conditions, and (ii) to cover its operating costs for a period of one year, calculated on a rolling basis. Moreover, each of the FSC, Ag. Committee and Senate Bills require that DCOs measure their credit exposures to their members and participants at least once each business day and monitor such exposures throughout the business day. All these new provisions are designed to insure that CFTC-regulated clearing houses and exchanges avoid situations that might create systemic risk for the financial system and to allow the CFTC to transparently monitor these entities on a real-time basis so that action may be taken before such risk is created.

For all these reasons, Title VIII should be deleted from the Senate Bill as was done with Subtitle E of the FSC Systemic Risk Bill and no such provision should be included in legislation. Similarly, Titles I and II and Subtitles B and G of the Senate Bill and FSC Systemic Risk Bill respectively should be amended to clarify that neither regulated clearing houses (such as DCOs) nor regulated exchanges (such as DCMs) qualify as "financial companies" for purposes of such legislation.