

**TESTIMONY OF CRAIG DONOHUE
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BEFORE THE COMMODITY FUTURES TRADING COMMISSION

ROUNDTABLE DISCUSSION

**TRADING ON REGULATED EXCHANGES AND
EXEMPT COMMERCIAL MARKETS**

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INTRODUCTION AND OVERVIEW

I am Craig Donohue, Chief Executive Office of CME Group Inc. (“CME Group” or “CME”), which was formed by the 2007 merger of Chicago Mercantile Exchange Holdings Inc. and CBOT Holdings Inc. CME Group is the parent of CME Inc. and The Board of Trade of the City of Chicago Inc. (the “CME Group Exchanges”). CME Group also owns Swapstream Operating Services Limited, an over-the-counter (“OTC”) trading facility, and owns an interest in FXMarketspace Limited, an FX trading platform that is authorized and regulated by the Financial Services Authority. CME Group Exchanges serve the global risk management needs of our customers and those who rely on the price discovery performed in the competitive markets maintained by the Exchanges. CME Group Exchanges offer a comprehensive selection of benchmark products in most major asset classes, including futures and options based on interest rates, equity indexes, foreign exchange, agricultural commodities, and alternative investment products such as weather and real estate. Additionally, we offer access to energy products through our Globex® electronic trading platform. CME Group is traded on the New York Stock Exchange and NASDAQ under the symbol “CME.”

We have been asked to participate in this hearing whose stated purpose is to examine the oversight of trading on regulated futures exchanges and exempt commercial markets (“ECMs”). I am pleased to be here and I know that a great deal of attention has been focused on the consequences of the coexistence of the natural gas futures contract of the New York Mercantile Exchange (“NYMEX”), which is subject to NYMEX’s self regulation and oversight of the Commodity Futures Trading Commission (“Commission” or “CFTC”), and the economically identical contract of the Intercontinental Exchange (or “ICE”), which is traded in a largely unregulated environment by means of its ECM status. This situation challenges the Commission’s

ability to fulfill its statutory responsibilities to prevent market-disrupting conduct. The NYMEX/ICE issue has attracted significant, justified attention, in some measure because of the underlying philosophical issues—but more because the underlying commodity, natural gas, is important to the economy and to the interests of residential, commercial and industrial users and their representatives in Congress. The representatives of NYMEX and ICE, who are on this panel, are best situated to discuss the consequences of that specific overlap.

Therefore, I would like to focus my comments today on the more general problems respecting differential regulation of certain derivatives trading platforms and the attendant regulatory systems implications of the convergence of regulated and unregulated trading systems. Before doing so, I want to emphasize that these problems, although important, exist in the context of a generally well-functioning regulatory scheme. Congress should be credited for the creation of the principles-based Commodity Futures Modernization Act of 2000 (“CFMA”) and the CFTC deserves praise for its effective implementation of the CFMA.

Under the CFMA, Congress has invested jurisdiction and authority in the CFTC to protect the public interest through self-regulatory programs by registered entities that:

- deter and prevent price manipulation or any other disruptions to market integrity;
- ensure the financial integrity of all transactions and avoid systemic risk;
- protect all market participants from fraudulent or other abusive sales practices and misuses of customer assets; and
- promote responsible innovation and fair competition among exchanges, other markets and market participants.

Historically, there have been distinctions between OTC trading platforms and regulated exchange markets. I believe that these distinctions have now blurred to the extent that disparity of regulatory treatment is no longer justified.

OTC trading platforms and regulated exchanges are rapidly converging in every material respect, except regulation. Customers for financial futures and “non-agricultural” futures (the “exempt” commodities”) on regulated exchanges or so-called Designated Contract Markets (“DCMs”) are increasingly also customers of OTC electronic trading platforms. Product innovation or extension coupled with enhanced trading functionalities, have dissipated the distinctions between exchange and OTC markets. OTC platforms today list standardized contracts that can be executed by the push of a “take” button. Similarly, regulated exchanges like CME Group are offering standardized swaps and other contracts that trade in OTC type market structures or execution mechanisms.

Similarly, credit barriers that once prevented certain customer segments from accessing OTC markets have broken down with the growth in prime brokerages services – providing credit enhancement and access to multilateral trading opportunities

in much the same way as central counterparty clearing systems provided by regulated exchanges. Indeed, as this convergence continues, I strongly believe that some form of central counterparty clearing seems to be inevitable in the OTC market.

These areas of convergence in our markets create a growing conflict between the goals of the CFMA and the exemption for ECMs found in Section 2(h)(3). In retrospect, it may be that Section 2(h)(3) did not receive adequate public scrutiny during CFMA deliberations, which would have been helpful since it conflicted even then with the findings and recommendations of the President's Working Group on Financial Markets ("President's Working Group" or "PWG").¹ However, it is now clear that many of the key purposes mandated by Congress in Section 5(b) are jeopardized if trading facilities for contracts in exempt commodities are permitted to coexist with regulated futures exchanges that list those same commodities. While this fact may not have been evident back in 2000 when Congress was in the throes of crafting the CFMA, experience since then clearly demonstrates ECMs do not have any system of "effective self-regulation" of their facilities or of their market participants. ECM contracts are traded based on the prices of commodities that have limited supplies and that may be subject to manipulative activity and disruptive market behavior. There is no mechanism in place "to deter and prevent price manipulation or any other disruptions to market integrity." The Commission cannot track the build-up of dominant positions. The ECM has no real power over its users. At best, the Commission has power to punish such conduct after the fact. We find this to be a serious problem that is at odds with Congress's intent behind the CFMA and which, if left unaddressed, can jeopardize the public's confidence in the CFTC's ability to do its job.

In light of the controversy generated by the NYMEX/ICE situation, I believe this is a very appropriate time to reexamine the Commodity Exchange Act's ("CEA's") exemptions and exclusions and consider whether any recalibration is necessary. Specifically, the elimination of the exemption for unregulated commercial markets must be seriously considered. As a result of its investments in both the regulated and the OTC markets, CME is uniquely positioned to comment on this topic. CME operates a very successful DCM for financial derivatives and also is expanding into the EBOT and OTC space with offerings on our FXMarketspace and SwapStream platforms and our Clearing 360 initiative.

This forum also gives us an opportunity to examine some of the challenges to the U.S. regulatory regime for financial markets and the unjustified efforts of some long-time proponents of transferring the CFTC's functions to the Securities and Exchange Commission ("SEC") to use criticisms of market structure and regulatory philosophy that pertain exclusively to the SEC as an excuse to increase the SEC's jurisdiction. On the contrary, as will be discussed further below, the CFMA and its administration by the CFTC provide a useful regulatory model for the SEC.

¹ See discussion beginning at page 4 below.

DISCUSSION

I. THE CONVERGENCE OF UNREGULATED OTC MARKETS AND REGULATED EXCHANGES CHALLENGES THE COMMISSION'S ABILITY TO FULFILL ITS STATUTORY MANDATE.

A. Trading standardized, cash settled, fungible commodity contracts on a multilateral execution facility is indistinguishable from futures trading.

Bi-lateral swaps, including swaps respecting energy, metals and other non-agricultural products, as defined at section 2(g) of the CEA, were excluded from the exchange trading requirement of the CEA because they had developed into an important product and a formal confirmation of their excluded status was desirable. The Commission's Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30,694 (July 21, 1989) was the first step in the direction of excluding financial product swaps. The Futures Trading Practices Act of 1992, Pub. L. No. 102-546, 106 Stat. 3590, amended the CEA and clarified the Commission's authority to exempt certain transactions from the exchange trading requirement. The Commission adopted such regulations in 1992, e.g., 17 C.F.R. 35. An excluded bi-lateral swap must be "subject to individual negotiation by the parties and not executed on a trading facility."²

CEA Section 2(d)(2) excluded electronically traded contracts based on certain financial measures that were deemed unlikely to be subject to manipulative activity (an "excluded commodity") if the contract is entered into on a principal-to-principal basis between eligible contract participants. This exclusion is based on the recommendations of the President's Working Group. The PWG carefully limited its recommendation for an excluded electronic trading platform to a class of commodities that did not include the types of commodities traded on an ECM:

"Accordingly, the Working Group unanimously recommends that Congress amend the CEA to clarify that entering into or trading excluded swap agreements (i.e., agreements between eligible swap participants that do not involve non-financial commodities with finite supplies) through electronic trading systems with certain characteristics does not affect the status of the agreements traded through the system and does not provide

² (g) Excluded swap transactions

No provision of this chapter (other than section 7a (to the extent provided in section 7a(g) of this title), 7a-1, 7a-3, or 16(e)(2) of this title) shall apply to or govern any agreement, contract, or transaction in a commodity other than an agricultural commodity if the agreement, contract, or transaction is--

- (1) entered into only between persons that are eligible contract participants at the time they enter into the agreement, contract, or transaction;
- (2) subject to individual negotiation by the parties; and
- (3) not executed or traded on a trading facility.

a basis for regulation of the system. *Over-the-Counter Derivatives Markets and the Commodity Exchange Act*, Report of The President's Working Group on Financial Markets, at 18-19 (November 1999) (emphasis supplied)

CME supported and continues to support those portions of the CFMA that exclude bi-lateral swaps in financial commodities. We also support the electronic trading of financial derivatives on Exempt Boards of Trade as provided in CFMA. But, the contracts traded on ECMs are not such bi-lateral swaps. They are standardized derivatives whose terms are set by the operator of the trading platform. Identical contracts become fungible if the platform provides central counterparty clearing. Consequently a buyer can offset his position by selling an equal and opposite contract. The price of the transaction is set at the time of the transaction but delivery is deferred. We do not consider these to be forward cash contracts because they are not regularly settled by the delivery of a specific cash instrument; rather they are cash settled like many financial futures contracts.

The only significant differences between traditional DCMs and ECMs is the "eligible contract participant" (ECP) qualification of the ECM's customers and the requirement that ECM customers execute transactions without a broker or other intermediary. However, it is only those traders that are large enough to satisfy the ECP requirements who are likely to be involved in manipulative activity. Of course, CME Group Exchange customers can also directly enter their orders into the GLOBEX trading system and most customers do qualify as eligible contract participants. That difference may justify a different set of customer protection rules for ECMs, but it does not justify the lack of a self-regulatory system, large trader reporting or information sharing with other exchanges.

B. Coexisting regulated and unregulated markets for economically equivalent commodity contracts impair information flows necessary to prevent misconduct.

Large trader reports are the key element of Commission and self-regulatory organization surveillance programs to prevent disruptive market activities. ECMs do not require large trader reports and do not participate in the Intermarket Surveillance Group, which shares information across exchanges. There is no logical basis for this distinction. If the prevention of disruptive market behavior is to remain a goal of derivatives regulation, information collection and sharing is essential.

The intensity of concern respecting this lack of information depends on the likelihood of manipulation or other market disruptions that may be caused by trading particular underlying products, i.e. excluded versus exempted commodities. Again, the 1999 PWG report is instructive. The PWG's recommendations for eliminating the exchange trading requirement and easing regulatory burdens on electronic trading facilities, hosting transactions involving derivatives based on excluded commodities,

were premised on its considered judgment respecting the risks of manipulative and market distorting activity in the excluded commodities:

“Where regulation exists, it should serve valid public policy goals. The justifications generally cited for regulation of the futures markets include the goals of protecting retail customers from unfair practices, protecting the price discovery function, and guarding against manipulation. With similar policy goals in mind, the Working Group has recommended limiting the proposed exclusion for swap agreements to eligible swap participants trading for their own account It has also recommended limiting proposed exclusions to markets that are not readily susceptible to manipulation and that do not currently serve a significant price discovery function.” *Over-the-Counter Derivatives Markets and the Commodity Exchange Act*, Report of The President’s Working Group on Financial Markets, at 22 (November 1999) (emphasis supplied)

The PWG made it abundantly clear that trading facilities for energy and metals products should not be exempted:

“Due to the characteristics of markets for non-financial commodities with finite supplies, however, the Working Group is unanimously recommending that the exclusion not be extended to agreements involving such commodities. For example, in the case of agricultural commodities, production is seasonal and volatile, and the underlying commodity is perishable, factors that make the markets for these products susceptible to supply and pricing distortions and to manipulation. There have also been several well-known efforts to manipulate the prices of certain metals by attempting to corner the cash or futures markets. Moreover, the cash market for many non-financial commodities is dependent on the futures market for price discovery.” *Id.* at 16 (emphasis supplied)

The testimony adduced at the recent congressional hearings on the Amaranth episode and energy trading issues confirms the validity of the PWG’s concerns about an exclusion for energy trading facilities.

C. The Remedy: The Section 2(h)(3) exemption for unregulated commercial markets should be eliminated.

Potential disruption of regulated markets and the cash market for certain exempted commodities justifies an increase in the flow of current information from organized OTC markets to the Commission. One seemingly simple solution is to change reporting requirements. Our experience suggests that this will be a failure. In order to provide accurate reports, a market needs an effective surveillance and compliance system. This implies that an effective system of self regulation must be put in place. The logical conclusion is you must implement at least the core principles required of a Designated Transaction Execution Facility (“DTEF”) to get a useful result.

The 2(h)(3) special exemption for commercial markets trading commodity futures contracts based on energy, metals and other non-enumerated commodities is directly contrary to the recommendations of the President's Working Group on which CFMA was based. The PWG expressly found that an exemption for exchange-like trading of derivatives based on underlying commodities that were not immune from manipulation was not appropriate. The legislative history of the CFMA provides no explanation for why Congress deviated from the PWG recommendations.

If the CFTC needs any further justification for taking action to reverse this hole in the CEA's regulatory safety net, Intercontinental Exchange's Jeffrey Sprecher's recent testimony before Congress adequately confirms that there is ample need for it now. He conceded that it is essential to the performance of the CFTC's oversight function that there be enhancements "to the quality and quantity of information currently available to the CFTC and, in particular, its ability to integrate data from ICE and NYMEX."³ Additionally, our sense is that the CFTC devotes an outsized proportion of its human and financial resources to trying to stay abreast of problems in the ECM market and dealing with other off-exchange trading. Eliminating the 2(h)(3) category would produce significant efficiencies of administration and more effective regulatory oversight without any adverse implications for innovation, competition or market flexibility. Any trading facility that is now successfully operating as an ECM can easily and inexpensively convert to a DTEF or DCM. Beyond the market protections reflected in a DTEF's core principles, a DTEF has an affirmative obligation to deter market abuses and to implement systems and procedures to comply with that obligation⁴. The Commission has oversight powers to insure that the obligation is met. The existing DTEF regulatory scheme would appear to provide an effective remedy to the problems identified with ECMs without the need to invent something new.

The Commission's publicly available list of ECMs confirms our belief that there appears to be no barrier for ECMs to convert to DTEFs or DCMs. There are numerous providers to whom any servicing needs, such as clearing and/or compliance, can be outsourced efficiently. The significant entrants, such as ICE, ChemConnect, Inc.,

³ Testimony of Jeffrey C. Sprecher, Chairman and Chief Executive Officer, Intercontinental Exchange, Inc., Before the House Agriculture Subcommittee on General Farm Commodities and Risk Management Committee on Agriculture, page 8 (July 12, 2007).

⁴ CEA Section 5a (c)(2) provides as follows:

Deterrence of abuses.---

The board of trade shall establish and enforce trading and participation rules that will deter abuses and has the capacity to detect, investigate, and enforce those rules, including means to--

(A) obtain information necessary to perform the functions required under this section; or

(B) use technological means to--

(i) provide market participants with impartial access to the market; and

(ii) capture information that may be used in establishing whether rule violations have occurred.

Chicago Climate Exchange, Inc., and TradeSpark have affiliates that are already regulated by the Commission. HoustonStreet seems to be a marketplace for physical crude oil and other refined products that makes certain NYMEX ClearPort products available in a linkage arrangement. NetThruPut Inc. appears to be a cash crude oil trading system. It is unclear, from its websites, what ICAP is actually doing as an ECM. Some, such as Optionable, Inc. and Commodities Derivative Exchange, Inc., are out of business. Others appear to be trading agricultural commodities like pulp and salmon, which, not being exempt commodities, are not within the purview of ECMs.

II. THE CFTC'S PRINCIPLES BASED REGULATORY MODEL AND ITS POLICY OF CROSS-BORDER ACCESS TO WELL-REGULATED FOREIGN EXCHANGES ARE USEFUL EXAMPLES FOR U.S. SECURITIES MARKETS.

While the primary subject of today's hearing involves an area where the CEA may need amendment to redress a shortcoming, it is important to put that area of controversy in its proper perspective. The problems associated with ECMs are not representative of what is the overwhelming success story that is the current CEA as amended by the CFMA. As earlier noted, CME Group enthusiastically applauds Congress, and particularly the congressional agriculture committees, in having the wisdom and courage back in 2000 to enact a modern, progressive, principle-based regulatory regime for the CFTC.

The success of foreign capital markets in attracting new listings to the apparent detriment of U.S. markets has focused attention on the U.S. regulatory system for securities exchanges and markets. The discussion has tested the premise that US financial markets have been hamstrung in meeting international competition by a panoply of federal and state regulators and the overly-prescriptive and expensive nature of regulation. A strong case has been made that innovation is slowed and U.S. markets cannot attain a first mover advantage because of the lag between idea and implementation. It is notable that these complaints do not arise from participants in the US futures markets which have enjoyed unparalleled growth, competition, and innovation since the CFMA's enactment.

We believe that the marked success of the U.S. derivatives industry under the regulatory regime created by the CFMA provides a compelling example for the securities industry. In our view, reducing or limiting barriers to entry in the global futures and options industry has strongly contributed to business growth and increased competition. For example, the compounded annual growth rate of the global futures and options industry from 2001 through 2006 was 28% compared to only 4% for equity securities markets (based on notional values). This is due, at least in part, to the fact that U.S. investors can directly and electronically trade foreign futures and options contracts from the U.S. Correspondingly, European and Asian investors can directly and electronically trade products listed by CME and other U.S. futures and options exchanges. Moreover, foreign boards of trade can efficiently offer U.S. customers access to products also traded on U.S. exchanges, thereby increasing global

competition in these markets. In contrast, under current SEC rules, U.S. investors cannot directly and electronically trade foreign equity securities of foreign issuers that do not comply with SEC disclosure standards or U.S. GAAP accounting standards. The CFTC has wisely promoted global growth and competition while recognizing that comparability in regulatory standards is superior to insisting upon additional, but not necessarily better, regulatory requirements.

We are concerned, however, that most discussions of regulatory shortcomings in the U.S. lump derivatives and securities markets together under the aegis of financial markets and treat the regulatory problem as if it were caused by separate regulation of those two sectors. We have not discovered a single, considered explanation of why separate regulation of futures and securities has adversely impacted securities markets.

The fact is that the US futures industry was able to keep its place as a world leader and innovator because CFMA adopted a principles-based regulatory regime and the Commission embraced and fostered the concept. The CFMA was revolutionary in concept and scope and unleashed unprecedented incentives for competition, innovation and international expansion of our domestic futures markets. Since enactment of the CFMA, we have witnessed explosive growth in futures volume, a revolution in the use of cost-effective electronic trading, the creation of new exchanges and forms of off-exchange futures trading, and the CFTC's approval of numerous new domestic and international competitors, both regulated and unregulated, in our markets. No other US financial market, especially those that see themselves mired in overly-burdensome regulatory regimes, can boast a shadow of the robustness, vibrancy, health, and success the futures markets have achieved under the CFMA.

Some observers argue that the occasional jurisdictional "overlap" between the CFTC and SEC with respect to some innovative new products demonstrates a dysfunctional system that must be changed. Those "border disputes" certainly exist and are unfortunate, but they have no bearing on the effective and efficient regulation of the great mass of futures products that lies solely within CFTC's jurisdictional purview. The proper resolution is the course that the Commission has pioneered, that is, finding a solution that permits the new products to trade under both regimes and permitting the "market" to choose.

The continuing calls for merging the CFTC and the SEC may sometimes appear justified as a means to resolve these minor conflicts. However, such a merger has no value for futures markets which already enjoy principal-based regulation. There is no benefit to the customers, since the most likely outcome will be the elimination of the better regulatory system. The inadequacies of securities market regulation cited by critics need to be resolved by reform of that regulatory regime, not by subjecting derivative markets to a system that is not effective in a global economy.

CONCLUSION

The CFTC should be complimented for both its able administration of the CEA and its willingness to ask difficult questions as to whether the CEA can be improved based on experience and evolving market needs. The CEA has been tremendously successful and the CFTC has administered it extremely well to the great benefit of customers and the nation's economic health. That said, the record indicates that there are important issues arising in the context of ECMs that need to be addressed. CME Group supports CFTC's review of those issues and urges responsive action in that regard.

On behalf of CME Group, I thank the Commission for this opportunity to participate and offer our insights. We are prepared to assist the Commission in any way that you might find helpful.