Testimony of

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Chairman Shelby, ranking member Sarbanes, ladies and gentlemen of the Committee, I am Terry Duffy, Chairman of Chicago Mercantile Exchange Holdings, Inc., which owns and operates the largest U.S. futures exchange, and by critical standards, the largest futures exchange in the world. This hearing provides the Committee an opportunity to consider whether the Commodity Futures Modernization Act of 2000 ("CFMA") has lived up to its promise and/or whether a few minor adjustments may be necessary to insure that this important, complex piece of legislation fulfills its promise.

I will first summarize the positive impact of CFMA on CME and then focus on CME's suggestions for extending the positive impact of CFMA. I will discuss the explosion of off-exchange retail futures fraud and the *Zelener* loophole. I will also offer two suggestions to require joint SEC—CFTC action to accomplish exactly what Congress expected them to finish long before now. By way of a preview, we have a clear, simple agenda: 1. Reverse the impact of the *Zelener* case and close the Treasury Amendment registration loop-hole; 2. Mandate that the SEC and CFTC define Broad Based Indexes; and 3. Mandate that the SEC and CFTC take joint action to provide risk based margining for security futures products. I am confident that our solutions cause no harm, competitive or otherwise to any customer, legitimate participant in the industry or to the marketplace itself. To the contrary, our proposal will enhance the competitiveness, usefulness and integrity of US futures markets.

I. OVERVIEW OF CFMA: HISTORIC AND SUCCESSFUL LEGISLATION

CME has proved itself to be the premier industry innovator in developing new products and trading opportunities. We supported CFMA's deregulation of over-the-counter derivatives and the reduction of barriers to entry for new exchanges. We accepted a program of enhanced competition in the financial services industry in return for elimination of prescriptive regulation and **freedom to innovate. And innovate we did**, predominantly in four areas: governance (including our role as a self-regulatory organization ("SRO")); expansion of market penetration; innovation in product offerings; and pursuit of a legitimate entrepreneurial business model that is premised on meeting customer needs.

CME gained the right to demutualize and implement the form of governance necessary to complete a successful initial public offering (IPO) and to run an effective, efficient SRO. CME expanded its markets and product offerings at an unprecedented clip. We offer clearing and execution services to other exchanges and the OTC market to take full advantage of the scalability of our technology and to reduce the costs for our customers and even our competitors. Of course we are a business and these activities also flow to our bottom line.

U.S. futures markets are substantially stronger and more vibrant today as the direct result of Congress's enactment of the CFMA and, equally importantly, the CFTC's judicious and deliberate implementation of those reforms. Innovation has been encouraged and made less costly and more rewarding. The time between conception of a new product or trading system and its implementation has gone from years to days. Today, the vast majority of CME's investment in innovation is for products rather than paperwork and regulatory review. Our customers applaud CME's aggressive response to the CFMA's incentives for innovation and competition as evidenced by their enthusiastic response to our slate of products and services.

By illustration I would point out the following:

- Continuing the trend since the CFMA's enactment in late 2000, CME's average daily volume in the second quarter of 2005 increased more than 33% over the comparable period in 2004.

- Electronic trading volume on CME® Globex® averaged 2.6 million contracts per day, representing 69% of total exchange volume in August 2005.

- CME's Eurodollar futures contract remains the benchmark interest rate product around the world. Average daily volume of CME Eurodollar futures on CME Globex in August exceeded 1.1 million contracts. This represented 81 percent of total CME Eurodollar volume in August compared with 63 percent in August 2004.

- CME's FX markets continued to grow in August as average daily volume totaled more than 285,000 contracts, representing notional value of $41 billion per day and an increase of 68% from one year earlier. During August 2005, CME electronic foreign exchange products increased 101 percent from the same period one year ago to reach 240,000 contracts per day.

- Trading in CME E-mini™ equity index products averaged 1.1 million contracts per day in August, up 18 percent versus the same period last year.

- CME's commodity products also continue to trade well, with average daily volume in August at 42,000 contracts, up 20 percent from one year ago.

- Finally, the historic transaction processing agreement between CME and CBOT has delivered on its promises of efficiencies and cost savings to customers, setting new industry standards for responsiveness to customers and efficiency.

II. CFMA HAS FOSTERED INNOVATION IN SELF-REGULATION

CME takes considerable pride in our status as the only demutualized and publicly-traded futures exchange in the United States. CME is currently the largest futures exchange in the United States and the largest derivatives clearing organization in the world. Moreover, our business has steadily migrated from the trading pits to our open access electronic trading platform---CME Globex. These changes have had a profound, positive impact on our financial performance, but as importantly on our customers' perception of our performance of our self regulatory responsibilities.

With our IPO, CME is now subjected to and complies with all the stringent corporate governance standards and listing requirements imposed by the New York Stock Exchange, public disclosure of all material aspects of its business, and continuous scrutiny from savvy analysts and institutional investors. In order to meet our obligations and to instill confidence in our shareholders, CME's Board of Directors has transitioned to one that is both fiercely independent of management and well beyond the control of floor brokers and traders.[1] CME was the pioneer in including non-exchange members in its disciplinary processes and in insuring that its important standing Board Committees were led by and included significant representation of non-industry directors. The charters of all of these committees, including the Market Regulatory Oversight Committee ("MROC") which is composed entirely of non-industry directors and is directly responsible for the independence of the SRO function, are found at CME's website.

On April 30, 2004, CME became the first futures exchange to appoint a Board-level committee devoted to self-regulatory oversight. CME's MROC is comprised solely of independent, non-industry directors. As set forth in its charter, the MROC is charged with the following responsibilities:

- to review the scope of and make recommendations with respect to the responsibilities, budget and staffing of the Market Regulation Department and the Audit Department so that each department is able to fulfill its self-regulatory responsibilities;

- to oversee the performance of the Market Regulation Department and Audit Department so that each department is able to implement its self-regulatory responsibilities independent of any improper interference or

[1] We also believe that directors who are members or end-users of an exchange organization have an invaluable understanding of the business and can provide useful perspectives on significant risks and competitive advantages. Indeed, the inclusion of exchange members on CME's Board has been beneficial in transforming CME from a century-old mutual organization to a thriving publicly-traded company and from a largely floor-based open outcry business to one of the largest electronic trading platforms in the world.

conflict of interest that may arise as a result of a member of CME serving on the Board or participating in the implementation of CME's self-regulatory functions;

- to review the annual performance evaluations and compensation determinations and any termination decisions made by senior management of CME with respect to the Managing Director, Regulatory Affairs, and the Director, Audit Department, so that such determinations or decisions are not designed to influence improperly the independent exercise of their self-regulatory responsibilities;

- to review CME's compliance with its self-regulatory responsibilities as prescribed by statute and the rules and regulations promulgated thereunder; and

- to review changes (or proposed changes, as appropriate) to Exchange rules to the extent that such rules are likely to impact significantly the self-regulatory functions of the Exchange.

We believe that the newly empowered MROC represents an aggressive and appropriate step towards independence in self-regulation.

III. CFMA HAS FOSTERED PRODUCT AND MARKET INNOVATION

We have all witnessed dramatic change in our industry during the last five years. CME has responded to these opportunities by successfully executing a growth strategy based on:

- Technology innovation;
- Continued product innovation;
- Expanding global distribution; and
- Leveraging the convergence of the cash, derivatives and over-the-counter (OTC) markets.

<u>Technology Innovation:</u>

In terms of technology innovation, we have redesigned our business model to leverage our electronic trading capability. A sign of our successful transformation is that five years ago CME had 125 people focused on technology. Today, we have over 500 talented technologists, reflecting our view of the future. CME Globex today significantly outperforms its competitors by facilitating trading around the world more than 23 hours a day, five days a week and with a 150 to 200 millisecond average turnaround time.

Technology innovation at CME has become equal in importance to product innovation. And our ability to innovate is multi-dimensional. It involves expanded user functionality and faster response times. It also involves increased reliability and the implementation of system features designed to enhance market integrity and protect customers from anomalous market conditions. Last January, we provided market users with the most sophisticated implied spreading functionality in the industry. As a result, CME Eurodollar futures on CME Globex went from 9.6 percent electronic in January 2004 to 81 percent in August 2005.

A year ago, we acquired innovative patent-pending technology that now provides market users with a sophisticated electronic solution for complex options combination trading. CME is committed to preserving and enhancing transparency and competition among market makers in electronic options markets. Transparency and price competition are the hallmarks of CME's successful market model.

Another measure of our ability to innovate with technology is something most people never see. Over the last five years, and due to the unique processing demands of our enormously successful E-mini™ contracts, CME has built an extensive and highly scalable set of platforms and infrastructure. We now process over 600,000 match transactions daily, more than any other exchange in our industry. Part of our growth strategy is to offer processing services – and other collateral and risk management services – to other exchanges and trading platforms around the world.

Products:

Throughout the last 30 years, CME has been the leading product innovator in our industry, from financial futures in 1972, to cash settlement in 1981, stock index futures in 1982, CME Globex in 1987 and E-mini contracts in 1997.

That leadership role has positioned CME with the most diverse and successful product line in our industry. Like technology, product innovation today at CME is becoming increasingly sophisticated. We work closely with market users to continually reassess product design, delivery system, trading conventions, pricing structure and other features that drive demand for our products.

In addition to enhancing our existing core product lines, we continue to create new products. Many of our new products are more complex and highly structured to meet the needs of more narrowly defined customer segments. While such products could not be easily or economically launched in the past, electronic trading enhances our opportunity for success.

Expanding Global Distribution:

CME has been working diligently over the last three years to dramatically expand global distribution and access to our GLOBEX system. We have done this by streamlining our application programming interfaces. In addition, we have introduced more flexible connectivity options, including user defined solutions which significantly reduce costs.

To expand the global distribution of our products, last year we installed telecommunications hubs in Dublin, Gibraltar, Frankfurt, Amsterdam, Paris and Milan, in addition to the one we installed in London in 2002. This growth initiative has been successful, allowing European customers to dramatically reduce their trans-Atlantic telecommunications costs. We launched a similar hub in Singapore in June of this year, and three customers are already connected and trading.

In tandem with these technology enhancements and cost efficiencies, we put in place aggressive incentive pricing plans in both Europe and Asia to promote CME products and accessibility to CME Globex to new customers in those parts of the world.

The strong early response to this program suggests that we are succeeding in our strategy to bring new customers to CME who will find our products to be an attractive alternative to comparable euro-denominated products.

Another avenue of growth for us is to attract new distribution channel partners with the capacity to reach large numbers of nontraditional futures customers. We increased access to our products through an agreement with Bloomberg which allows all 180,000 screens worldwide to access CME products on CME Globex. Additionally, as we continue to expand trading activity in our popular E-mini contracts, we are implementing connectivity agreements with E*TRADE and Schwab's CyberTrader. These new distribution channels allow us to reach the emerging professional equity retail sector which increasingly finds E-mini contracts more attractive than cash equities, equity options and ETFs.

Most recently, we announced a growth initiative with Reuters, where we will be offering CME's electronic foreign exchange markets to Reuters' global customer base. This initiative marks the first major linkage of sell side traders in the interbank FX market to CME eFX futures markets, where hedge funds and other major buy side participants play a major role, paving the way for more dynamic and efficient markets.

Common Clearing Link:

Our transaction processing agreement with the Chicago Board of Trade (CBOT) is up, running successfully and producing even more synergies than any of us could have imagined. This common clearing link with CBOT is providing real savings to our clearing firms and market participants in excess of $1.8 billion in associated costs.

IV. CME's RECOMMENDATIONS

While CME enthusiastically applauds the success of the CFMA and recommends that we retain its historic statutory framework, the reauthorization process offers a valuable opportunity to fine tune that statutory framework based on industry experience. CME offers the following recommendations for consideration:

Security Futures Products:

CFMA needs to be modified to permit Single Stock Futures to succeed. In my Congressional testimony of June of 2003, I characterized single stock futures as "the CFMA's unfulfilled promise". I am sad to say what was true then remains so even today. As evidenced by their long-time successful use and acceptance in European markets, single stock futures can be a great product with enormous benefits to market users. However, inter-exchange competitive concerns combined with regulatory and legislative turf contests largely mitigated the hope for this product even before it was launched in this country. The regulatory system that has slowly evolved between CFTC and SEC has yet to address key issues and several of the regulations that have been produced thus far are overly burdensome and inflexible, frustrating development of products that would be both useful and desirable to market participants.

A complete fix of the problems with security futures would be to undo the regime of dual regulation that was implemented by CFMA as a compromise of the competing jurisdictional demands of the CFTC and SEC. Having the two regulators (CFTC and SEC) for a new product has proved far from optimal. Ideally, futures exchanges should trade the product as a pure futures contract and securities exchanges should be free to trade it as a securities product. This solution allows competitive forces to determine the outcome—not government. We are not asking for that relief at this time. Instead, we are asking that the agencies put U.S. markets on par with financially sophisticated markets throughout the world. We want to allow clearing houses the freedom to manage their risk in the manner in which every successful private company manages its own risk and the risks it encounters dealing with counterparties. We are asking Congress to direct the agencies to do what was contemplated in 2000 and permit risk based portfolio margining for security futures products. Our goal is to reduce the excessive costs associated with trading security futures products on U.S. markets. No one disagrees that risk based margining is the world standard, safe and effective. As noted below, any opposition to CME's proposal is based on ill conceived notions of competitive parity. The opponents of relief want Congress to suppress a potential competitor because they have been unable to get appropriate regulatory relief.

What we propose and how it works: We propose directing the Federal Reserve Board, or the SEC and CFTC jointly if so delegated by the Board, to prescribe regulations to permit risk based portfolio margining for security futures products. The draft amendment language proposed by CME, marked to show changes to current law, is set out below:

Section 7(c)(2)(B) of the Securities Exchange Act of 1934 is amended as follows:

B. Criteria for issuance of rules

Within six months of the date of enactment of this Act, the Board shall prescribe, or, if the authority is delegated pursuant to subparagraph (A)(ii), the Commission and the Commodity Futures Trading Commission shall jointly prescribe, such regulations to establish margin requirements, including the establishment of levels of margin (initial and maintenance) for security futures products under such terms, and at such levels, as the Board deems appropriate, or as the Commission and the Commodity Futures Trading Commission jointly deem appropriate--

i. to preserve the financial integrity of markets trading security futures products;

ii. to prevent systemic risk;

iii. to permit national securities exchanges to recognize historical correlations between and among option classes, related securities and other derivatives and to grant such exchanges authority to adjust, without prior notice or approval, margin levels and intra and inter option offsets in response to changing market conditions.

~~iii.to require that--~~
~~I.the margin requirements for a security future product be consistent with the margin requirements for comparable option contracts traded on any exchange registered pursuant to section 78f(a) of this title; and~~
~~II.initial and maintenance margin levels for a security future product not be lower than the lowest level of margin, exclusive of premium, required for any comparable option contract traded on any exchange registered pursuant to section 6(a), other than an option on a security future;~~
~~except that nothing in this subparagraph shall be construed to prevent a national securities exchange or national securities association from requiring higher margin levels for a security future product when it deems such action to be necessary or appropriate; to ensure that the margin requirements (other than levels of margin), including the type, form, and use of collateral for security futures products, are and remain consistent with the requirements established by the Board, pursuant to subparagraphs (A) and (B) of paragraph (1).and~~

iv. to ensure that the margin requirements (other than levels of margin), including the type, form, and use of collateral for security futures products, are and remain consistent with the requirements established by the Board, pursuant to subparagraphs (A) and (B) of paragraph (1).

We have not drafted a provision granting similar relief for security options or equity securities, although we expect that proponents of such relief will come forward with their own proposals. CME does not oppose relief for the security option exchanges.

What Is Risk-Based Portfolio Margining: In the futures industry, "margin" is a short-hand description of the performance bond required to secure futures commission merchants and clearing houses against loss if a customer defaults. Risk-based margining is the methodology currently used to set margins for most futures products. The principle underlying risk-based margining is that the performance bond should be set high enough to cover almost any price change that the contract might be expected to experience from one day to the next. The level is determined by reference to historical and likely price moves to estimate the worst historical or worst foreseeable loss over a given period of time.

Margins on Security Futures Products: Risk-based margining is not used for Security Futures Products (SFPs) in the U.S. SFPs are margined at the customer level using rule-based margining at a minimum of 20% regardless of the individual product's volatility. For many SFP products, this rate is five or more times the rate that would be required under risk-based margining. Requiring margin far in excess of reasonably predictable losses may make participation in the market too expensive for many who would add to the liquidity and efficient functioning of these markets. This is especially true when foreign competitors employ rational margining systems.

Example:

Three largest daily price changes over the past year for Johnson & Johnson SFP

December 16, 2004	4.1%
January 25, 2005	3.6%
October 7, 2004	-3.0%

The current rate (20%) is almost five times the largest price change (4.1%).

In addition, the current rule only requires 20% margins for highly volatile products which under risk-based margining would require much higher margins. CME currently requires the higher risk-based rates for these products.

Example:

Three largest daily price changes over the past year for Elan Corp. SFP

February 28, 2005	-70.2%
March 31, 2005	-54.0%
May 2, 2005	22.0%

The rate based on the existing rule (20%) does not even cover the third largest price change over the last year (22%).

The one size fits all approach of rule-based margining results in too much margin being required for low volatility products and too little being required for highly volatile products.

Margins on SFP Spreads: In addition to setting margin rates for individual products, rates are set for spreads between two different products or contracts.

Example: A portfolio contains one long August 3M SFP and one short September 3M SFP. 3M's earnings release is higher than Wall Street expected. The price of the August 3M SFP changes from $7,300 to $7,400 and the price of the September 3M SFP changes from $7,400 to $7,490. Therefore, the portfolio makes $100 on the long August position and loses $90 on the short September position for a net gain of $10.

The prices of the two contracts in the example above are highly correlated and usually move by similar amounts because they both have the same underlying security. Because the long contract is likely to make money when the short contract loses money and vice versa, the portfolio overall is not likely to lose very much. Rather than charging the full margin on each of the two contracts ($2,960 in the example above), a calendar spread rate is set based on the volatility of the differences in the prices between the two contracts ($370 in the example above).

Spread rates for most futures are set using risk-based margining but for SFP calendar spreads, rates are set using rule-based margining. SFP spreads at the customer level are set at 5%. The same issues that arise using rule-based margining for individual products arise when using rule-based margining for spreads. The volatility of most SFP calendar spreads is much lower than the 5% rate and market participants are not being given enough credit for the dramatic risk reductions they have put into place when they put on calendar spreads.

Example:

Three largest daily spreads over the past year for 3M SFP

March 18, 2005	0.5%
February 14, 2005	0.4%
February 23, 2005	0.2%

The current rate (5%) is 10 times the largest spread over the past year (0.5%).

In addition to the calendar spreads described above, spreads can be offered between different products. For example when two SFPs are highly correlated for some reason (e.g. they are both in the same industry), margins can be reduced when a portfolio contains positions in both of these companies on opposite sides of the market. An example of this would be a portfolio that is long the Ford Motor Company SFP and short the General Motors SFP. Another type of spread that could be offered is between broad-based indices and SFPs. For example, the Nasdaq 100 contract vs. Nasdaq 100 Tracking Stock SFP. Both are futures based on the value of the Nasdaq 100 and they are very highly correlated. There are many of these spreads offered between different futures products that are highly correlated, such as S&P 500 vs. Nasdaq 100 or soybeans vs. soybean oil. These types of spreads are not currently allowed for SFPs.

Margins on SFP Options: Finally, rule-based margining for customer level accounts precludes market participants from receiving full credit for the reduced risks they carry when their portfolios contain options on futures to offset their futures positions. Risk-based margining takes these offsets into account by calculating total gains and losses on futures and options on futures positions for an entire portfolio.

What The World Does: CME performed a global analysis on the margining treatment of single stock futures (SSF) and single stock options (SSO), which we will be happy to make available to the Committee. Our study unequivocally demonstrates that financially sophisticated regimes and regulators chose risk based portfolio margining as the safest and most efficient way to calculate and collect performance bond.

Outside of the United States, portfolio margining is applied to SSF 100% of the time and 99.86% of SSO activity. International markets currently house 96% of the world's single stock futures activity, overwhelming the domestic markets. The picture is different in the SSO market with the US market being much larger. For this reason – the dominance of the domestic options market--the percentages showing the use of portfolio based margining in the non-US markets are the compelling numbers – virtually all non-US SSF and SSO business is margined using a portfolio based approach.

The predominant tool for SSF portfolio margining outside the US is SPAN, holding a 59% market share. SPAN is the system created by CME and validated by its worldwide adoption.

Conclusion: Risk-based margining has been used successfully for most futures products in the U.S. since 1988 and is already used for SFPs in many countries including India, Singapore, Spain, and the UK. It takes into account the risk offsets present in individual portfolios and results in higher margin requirements for those portfolios with positions in exceptionally volatile products. Using risk-based margining would allow customer level accounts to receive margin breaks for offsetting positions but would still allow those setting the requirements to determine what offsets are allowed and the magnitude of those offsets.

Why The Option Exchanges Want More: There is no controversy among industry participants respecting the soundness and value of a properly operated risk based portfolio margining system for security futures, or, for that matter, for security options. The security option exchanges have been concerned that the SEC has been slow to permit that system and has argued that they will suffer competitive harm if SSF exchanges get relief before the SEC allows the options exchanges similar relief. The argument is unsound on its face: it urges that bad business practices be forced on security futures markets to protect option exchanges from an unresponsive regulator. The proper solution is obviously to direct the SEC to approve appropriate margining treatment for options exchanges.

But even beyond the intrinsic unfairness of the argument, the practicalities demand that the efforts of the securities option exchanges to deny relief to the SSF exchanges be rejected. The options exchanges claim they will suffer competitive injury. This claim is baseless. The average daily trading volume of the option exchanges is about 5,000,000 contracts per day. One SSF exchange has already failed and the other trades about 6,000 contracts on an average day. No customer has stopped trading options to trade security futures products. No one has ever marketed or touted security futures products as a substitute for security options. There is no real threat to any legitimate interest.

CME's proposal eliminates the requirement that margins on security futures and on options be identical. In a risk based portfolio margining system, that requirement is unworkable. Each clearing house uses its own software to perform the analysis of portfolio risk. While all clearing houses use similar methodologies, the results of the calculations will be different, though immaterially so.

Defining Broad Based Security Indexes:

The Commodity Exchange Act (CEA) promulgated in 1974, provided the CFTC with exclusive jurisdiction over transactions involving the sale of commodities for future delivery. See 7 U.S.C. §2(a)(1)(A). A dispute between the SEC and CFTC regarding futures on securities and security indexes resulted in the Shad/Johnson Accord, which allocated jurisdiction between the agencies. In 1981, in codifying the Shad/Johnson Accord, Congress confirmed the CFTC's exclusive jurisdiction over futures on broad-based security indexes. See 7 U.S.C. 2(a)(1)(C)(ii). Approximately 100 futures contracts on broad-based security indexes—both domestic and foreign—were approved for trading between 1975 and 2000 when the CFMA was passed.

Prior to passage of the CFMA, the CFTC coordinated with the SEC in approval of broad-based security indexes. Congress maintained the CFTC's exclusive jurisdiction over futures on broad-based security indexes in the CFMA. Congress only provided joint jurisdiction with the SEC over futures on single stock and narrow-based security indexes—CEA §2(a)(1)(D)—NOT with respect to futures on broad-based security indexes. CFMA only defined one class of broad based security indexes and left it to the agencies to create an inclusive definition.

The ramifications of this problem are significant. The US markets are at a competitive disadvantage vis a vis foreign competitors who offer these products. What is at stake here is our competitiveness and our leadership in product innovation.

Our proposal that Congress compel the agencies to promulgate a broad based index definition is necessary to fill in the statutory void that the agencies left unattended for the past five years. The statutory terms distinguishing between broad-based and narrow-based security indexes apply to all securities, but were drafted without clear consideration of the significant differences in size and trading velocity between equities and fixed income securities. U.S. fixed income securities are not typically traded on organized exchanges, and their trading volume is significantly smaller than stock volume. Foreign exchanges also trade much smaller volumes. CFMA did not distinguish between the two very different classes of securities or the different national markets with the result that the same criteria are applied in determining which indexes can be the basis for futures contracts.

It is almost universally accepted that exchange-traded futures and options are complementary to cash products, and can lead to significant improvements in transparency and liquidity in those cash markets. Market regulators are concerned about the lack of liquidity and transparency in U.S. fixed income markets and have made some efforts to improve the situation, with mixed success. Therefore it is tragic that the distinctions drawn for equity markets are a great deterrent to listing futures on indexes of corporate bonds, security-based swaps and other fixed-income-related instruments. In a recent joint order of the SEC and CFTC the Commissions confirmed this view:

> "The statutory definition of the term narrow-based security index is designed to distinguish among indexes comprised of individual stocks. As a result, certain aspects of that definition are designed to take into account the trading patterns of individual stocks rather than those of other types of exchange-traded securities, such as options. However, the Commissions believe that the definition is not limited to indexes on individual stocks. In fact, Section 1a(25)(B)(vi) of the CEA and Section 3(a)(55)(C)(vi) of the Exchange Act give the Commissions joint authority to make determinations with respect to security indexes that do not meet the specific statutory criteria without regard to the types of securities that comprise the index." Commodity Futures Trading Commission Securities and Exchange Commission, Release No. 34-49469, Joint Order Excluding Indexes Comprised of Certain Index Options from the Definition of Narrow-Based Security Index pursuant to Section 1a(25)(B)(vi) of the Commodity Exchange Act and Section 3(a)(55)(C)(vi) of the Securities Exchange Act of 1934

The CEA does not adequately define broad based security indexes, subject to the exclusive jurisdiction of the CFTC, and narrow based security indexes subject to joint SEC and CFTC jurisdiction. What the SEC and CFTC have done to date by joint order has offered very narrow relief and is contrary to CFMA's model for sound development of new futures products. The agencies have not negotiated a general joint order that would clarify the issues that Congress expected them to resolve on this point. Currently, relief must be sought through costly, time consuming individual petitioning for a joint order every time a new product is conceived. This is inconsistent with the CFMA's incentives for market innovation. As a result, futures exchanges and U.S. futures commission merchants have been unable to provide their customers with broad based indexes on U.S. debt obligations, foreign debt obligations and foreign equity securities. The CFTC, futures exchanges and FIA are in agreement in principle that this should be fixed now.

What We Propose And How It Will Work:

To accomplish the objective of advancing the development of broad based index products while preserving the respective jurisdictions of the two relevant agencies, CME proposes that Congress mandate a joint process by those agencies in accord with the following language:

> “The Commodity Futures Trading Commission and the Securities and Exchange Commission are hereby directed to exercise the authority granted by Section 1a(25)(B)(vi) of the Commodity Exchange Act and Section 3(a)(55)(C)(vi) of the Securities Exchange Act of 1934 jointly to establish criteria, by rule, regulation or order, to exclude indexes based on U.S. debt instruments, other U.S. securities, foreign equities and foreign debt instruments from the definition of the term "narrow-based security index." Such criteria shall be adopted and made effective within six months of the enactment date of this Section. Such criteria shall be consistent with the capitalization, trading patterns and trade reporting conditions in the market for such securities and shall exclude from the definition of the term "narrow-based security index" indexes that include a representative sample of a class of securities in the relevant market if the index is not readily susceptible to manipulation. If no joint final rule, regulation or order has been made effective within six months of the enactment of this section, the Commodity Futures Trading Commission shall be authorized to establish criteria, pursuant to Section 1a(25)(B)(vi), permitting entities subject to its jurisdiction to trade futures on indexes based on U.S. debt instruments, other U.S. securities, foreign equities and foreign debt instruments which the Commission determines should be included in the definition of the term "non-narrow-based security index."

Preventing Fraudulent Off-Exchange Retail Futures Trading:

The CFMA needs fine tuning respecting CFTC jurisdiction over retail trading of futures contracts that have been crafted to slip into the *Zelener* loophole. Off exchange promotion of futures contracts to retail customers is a continuing source of injury to consumers, embarrassment to the industry and an unnecessary draw on the resources of the CFTC. In particular, over the past four years of the CFMA, the CFTC has brought 70 enforcement actions involving 267 companies and individuals for illegal retail foreign exchange trading. CFTC estimates that these cases involved trading with over 20,000 customers and resulted in imposition of over $240 million in penalties and restitution orders. This is just the tip of the iceberg. The confluence of the massive continuing frauds committed against retail customers in the OTC foreign exchange (“FX”) market, and the recent, unfortunate decision of the 7th Circuit Court of Appeals in *CFTC v. Zelener,* compel this industry to reexamine the public policy implications of how the CFMA addresses retail foreign exchange futures and the threshold definition of what transactions should be subject to CFTC jurisdiction.

The fact that the CFTC is compelled to devote substantial resources to protecting retail customers from widespread fraud in the OTC FX market is evidence enough that a serious problem exists with the CFMA that cries out for reform. Moreover, in the aftermath of the *Zelener* decision, OTC dealers apparently can offer a retail product that all of us in this room today would agree is a futures contract but which has now been defined by the court to be a cash product outside of the CFTC's jurisdiction. Under the *Zelener* case, it does not matter what the dealer actually does or what the customer actually expects. The sharp operators and bucket shops have already figured out that the rationale of the *Zelener* opinion can apply to commodities other than FX. How soon will it be before the CFTC's jurisdiction and its retail consumer protections are reduced to irrelevance?

At a minimum, the retail investing public needs an amendment that will preclude dealers from end-running CFTC's jurisdiction by simply inserting a one line caveat on their internet sites notifying counterparties that the dealer is not absolutely obligated to enter into an opposite, offsetting transaction or that under some circumstances an opposite transaction will not offset existing positions. The challenge for the futures industry---and this Committee--- is to find an effective solution that will politically survive the reauthorization process.

Our *Zelener* fix reduces CFTC's regulatory costs and burdens and makes it possible to put the crooks out of business before they have spent their ill-gotten gains or moved the money offshore. Our proposal permits the CFTC to shut down those scamsters who have not registered or who sell based on outrageous internet claims before the fraud is completed. Our fix protects the public against fraudulent oil and orange juice scams that will very predictably replace currency scams if the legislative response, as proposed by others, is limited in focus to foreign exchange scams. Our proposed fix protects against this proliferation of the fraud to other commodities without impairing any legitimate business operation.

We propose to create a presumption that leveraged sales of a commodity for future delivery that are offered to retail investors for speculative purposes are futures contracts. This is squarely in keeping with the history and purpose of the CEA. Unless specifically exempted from CFTC regulation by the Treasury Amendment or another exemptive provision of the CEA all pertinent registration and other customer protection provisions apply. Our proposal is simple: CME suggests that the courts be directed to presume what has always been the law, specifically, that leveraged speculative transactions involving retail customers who have no reasonable expectation of delivery are futures contracts. CME's proposed amendment to Section 2(i)(3) of the CEA, set out below, accomplishes this result:

> (3) Leveraged or margined transactions that are offered to, or entered into with, persons who are not eligible contract participants, shall be presumed to be contracts for the sale of a commodity for future delivery subject to this Act if such non-eligible contract participant does not have a commercial use for the commodity or a reasonable expectation of delivery. This presumption may be overcome by showing that the transaction was: (i) primarily marketed to eligible contract participants or (ii) not marketed or offered to non-eligible contract participants as a means to speculate on price movement in the underlying commodity.

CME supports the principle that the CFTC should have responsibility and regulatory authority for futures contracts, but only for futures contracts. We believe that a contract of sale of a commodity for future delivery that involves a retail trader who is trading on a leveraged/margined basis for purely speculative purposes is a futures contract that is subject to the CFTC's jurisdiction. CME believes that retail futures contracts on all commodities should be treated alike, although we emphasize that we do not challenge the Treasury Amendments special treatment of foreign currency futures. CME's proposal:

- REVERSES the hyper technical reading of the Zelener decision that permits traditional futures contracts to escape CFTC scrutiny (i.e. DOES NOT expand CFTC's traditional jurisdiction).

- INSURES that CFTC can protect retail customers for traditional futures contracts before the fraud is consummated and before the money is hidden offshore.

- DOES NOT affect the Treasury Amendment's exceptions for retail foreign exchange transactions executed by banks, brokers and other specifically designated entities and does not give CFTC jurisdiction over such transactions.

- DOES NOT apply to the interbank currency market.

- DOES NOT subject spot or forward transactions in any commodity to CFTC jurisdiction.

- DOES NOT affect commercial entities contracting for actual delivery of commodities.

- DOES NOT limit any of the CEA exclusions or exemptions for OTC transactions involving Eligible Contract Participants.

- DOES NOT PRECLUDE FCMs or their affiliates, banks, broker dealers or their affiliates, insurance companies, or other financial institutions that are otherwise regulated by a federal agency from offering retail foreign currency products to eligible contract participants (i.e. sophisticated investors) or retail customers (i.e. unsophisticated investors).

- DOES NOT preempt state law enforcement against fraudulent activity (i.e. makes no change in existing CEA provisions permitting states to take anti-fraud actions).

Some parties to this debate are proposing that the CFTC be given responsibility for prosecuting fraudulent activity involving certain off-exchange currency contracts, if a retail customer is involved, regardless of whether the contract is a future. However, they would exclude all similar fraud involving any other commodity from such CFTC anti-fraud jurisdiction. The proponents of such proposals refuse to concede that such contracts are futures, thus depriving CFTC of any power to control who is selling these products, how they are being sold, whether the customers' money is segregated, whether the firm is financially sound, etc. The result is that CFTC's entire retail consumer protection regime is avoided, which not only is bad news for the retail customer but is an open invitation to fraudsters to expand their victimization of the retail market. These proposals deprive CFTC of any effective power to shut down the fraudulent operators, bucket shops and boiler rooms before they have swindled unsophisticated retail customers and either spent the money or shipped it off-shore. Such proposals leave CFTC to employ expensive and time consuming litigation against individual fraudsters which usually produces little, if any, compensation for the defrauded customers. CME opposes such ineffective and insufficient proposals and urges Congress to fashion legislation which is responsive to the broad threat facing retail customers. That threat is not just limited to being scammed on currency transactions. The contract used in *Zelener* can be used with any commodity. If Congress fails to adequately fix the Zelener problem it will leave the door open to broad and continuing fraud of unsuspecting investors.

To that end, CME's proposal provides an effective means of preventing the type of fraud we have already seen regarding currency contracts from being used to perpetuate abuse with any other commodity. And our proposal does so without expanding CFTC's jurisdiction beyond its area of expertise and its traditional exclusive authority over commodity futures. CME's proposal uses CFTC's traditional exclusive jurisdiction over retail futures and thereby empowers the agency to utilize its entire set of retail consumer protections to more effectively and efficiently stop fraud at its earliest stages before victims are actually scammed.

V. CONCLUSION:

The CME, its customers and the financial markets have prospered to the substantial benefit of the nation's economy under the CFMA. In the current reauthorization process, Congress faces the challenge of making discreet corrections to the CFMA to materially improve the utility, efficiency, competitiveness and fairness of our futures markets for our customers and all market participants. CME looks forward to working with the Banking Committee and the Agriculture Committee to produce legislation that meets that objective.