Craig S. Donohue
Chief Executive Officer

16 August 2010

CESR
11-13 avenue de Friedland
75008 Paris
France

Dear Sirs,

CME Group Inc. ("CME Group") appreciates the opportunity to comment on the Committee of European Securities Regulators' (CESR) Consultative Paper (the "Consultative Paper") on standardisation and exchange trading of OTC derivatives contracts and its questions to stakeholders. We support the principle that all responses to such consultative papers should enter the public domain and do not request confidentiality for this comment letter.

CME Group is the holding company for four futures exchanges: the 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"). Our principal regulator in the United States is the Commodity Futures Trading Commission (the "CFTC").

In the United Kingdom, CME, CBOT and NYMEX are Recognised Overseas Investment Exchanges, and CME Clearing is a Recognised Overseas Clearing House, the recognitions having been granted by the Financial Services Authority (the "FSA"). In addition, CME Group has a wholly-owned subsidiary, CME Clearing Europe Ltd. ("CMECE"), whose application to operate as a Recognised Clearing House is nearing the end of the assessment process at the FSA.

Executive Summary

CME Group supports efforts to reduce systemic risk in the marketplace. However, we do not believe that this is best accomplished through mandated exchange trading. Some degree of standardisation is likely to facilitate increased trading of OTC derivatives contracts on exchanges but we are of the view that standardisation alone cannot be used as a proxy for determining whether contracts are appropriate for exchange trading. We believe that markets must be allowed to develop their own standards and terms of trade. Some will naturally gravitate towards standardised terms; others may not and will remain highly customised. Further, we do not believe that fungibility of OTC derivatives contracts across trading venues is beneficial to the derivatives market.

We are also firmly of the view that expanded use of the CCP model will definitely enhance the collective risk certainty of a broader range of OTC derivatives markets. That said, we do not support government mandated clearing of all OTC derivatives contracts. We believe that not all standardised OTC derivatives transactions can or should be cleared by a CCP.

Introduction

CME Group considers that both exchange-traded and OTC derivatives markets are essential to the efficient functioning of global financial markets. Together, these markets provide companies, investors, and indeed governments the ability to increase the certainty in their future cash flows by protecting against price risks in assets ranging from government securities to holdings of cash, equities, foreign exchange, credit, agricultural commodities and energy, thereby increasing their confidence and ability to act. Efficiently functioning derivative markets are essential to effective management of risk across the world, and it is appropriate at this juncture, when the world economy appears to be recovering slowly from the massive financial-economic shocks of the recent past, to focus, as CESR and others are doing, on how to improve the functioning of the current OTC derivatives markets.

We note that CESR's Consultative Paper focuses on two key issues: (a) standardisation of OTC derivatives contracts, and (b) exchange trading of derivatives contracts currently traded OTC. It appears that CESR is of the view greater standardisation of OTC derivatives contracts can deliver efficiency benefits to the market and considers that the use of incentives could effectively promote exchange trading but continues to consider whether mandatory usage is desirable in light of the discussions currently taking place on this issue in international fora. We also note that the Consultative Paper has specifically stated that it does not attempt to address the issues related to eligibility for clearing. Whilst this latter issue has not been dealt with in the Consultative Paper, we believe that one cannot discuss standardisation and exchange trading of OTC derivatives contracts without considering the issues relating to eligibility for clearing.

In the US, CME Group has been an active contributor to the debate on mandated exchange trading and clearing, and related issues of open access, interoperability, standardisation of OTC derivatives contracts and eligibility for clearing. In this letter, we would like to share some of our thoughts on these important topics. We would be happy to share our further thoughts with CESR on the specific questions presented in the Consultative Paper should CESR desire.

<u>Exchange Trading</u>

In the Consultative Paper, CESR has identified a number of benefits that may be attributed to derivatives exchange trading, including transparency, price formation, liquidity, operational efficiency and equal market access. In addition to those benefits, CME Group believes that exchange trading offers the following additional benefits:

- Fairness – A level playing field is achieved through open access, as noted by CESR, and by allowing all participants to have access to the same real-time market data, including price information. Price transparency is further enhanced by an extensive global distribution network;
- Anonymity – Anonymity for traders and firms as all bids, offers and execution reports can be protected electronically; and
- Market integrity – The Market Regulatory team undertakes market surveillance and assures high standards for market integrity and supervision of trading activity.

CME Group operates four exchanges and is a strong proponent of the benefits of exchange trading of derivatives. We are also realists when it comes to whether exchanges can generate sufficient liquidity to make exchange trading efficient and economical for our customers. We have introduced hundreds of well designed contracts that have attracted no customer interest despite clear customer demand, surveys and expert opinion that the contract was needed. Given the multitude of specialised contracts traded in the OTC market, we are confident that government mandated exchange trading of standardised contracts as a replacement for this bespoke market will be ineffectual. If market participants are given a fair choice respecting trading and/or clearing venues, they will naturally gravitate towards the venues that provide them the most benefits, including organised trading venues such as derivatives exchanges.

Moreover, while CME Group supports efforts to reduce systemic risk in the marketplace, we do not believe that this is best accomplished through mandated exchange trading. We believe that mandating an OTC derivatives contract into a double sided, continuous auction will produce none of the benefits of exchange trading, as outlined by CESR in its Consultative Paper, and as noted above. It will, instead, make the market less efficient. Market makers will not offer deep tight markets where there is neither direct liquidity in the product nor a certain, readily available and highly efficient hedge into a similar product. This is supported by our own experience in trying to bring futures contracts to a registered exchange.

Whilst CME Group agrees that some degree of standardisation is likely to facilitate increased trading of OTC derivatives contracts on exchanges, standardisation alone cannot be used as a proxy for determining whether contracts are appropriate for exchange trading. We believe that markets evolve over time and each must be considered on its own terms. Optimal market structure depends on a market's degree of development. Markets must be allowed to develop their own standards and terms of trade. Some will naturally gravitate towards standardised terms; others may not and will remain highly customised.

Clearing and "Standardisation" of OTC Derivatives Contracts

As previously noted, we think that the discussion of exchange trading and clearing in the futures market go hand in hand. As an initial matter, we note that the availability of CCP clearing for a particular contract is not determinative for whether that derivative contract can or should be traded on an exchange or other organised trading platform. This is because we believe that standardisation alone is not necessarily enough to permit central clearing of a particular contract, or to conclude that the market for that product will benefit from central clearing.

In this context, it is important to address an issue that is not specifically raised in the Consultative Paper but which will be an important element of implementing the recommendations contained therein, that is, determining which OTC derivatives transactions are, and can be, cleared by a CCP. Many current regulatory reform proposals would mandate CCP clearing of "standardised" OTC derivatives transactions with, in some cases, exemptions from this requirement based on the counterparties to the transaction or their reasons for entering into the transaction. As mentioned earlier, we do not believe that all standardised OTC derivatives transactions can or should be cleared by a CCP. Rather, it is critical to distinguish between transactions that are merely standardised, and transactions that are both standardised and clearable. Even if a particular contract is standardised, in order to successfully clear that contract, a CCP must be able to properly manage the associated risks, including being able to: (a) accurately determine initial and variation margin requirements which participants must post or pay, respectively, with respect to the transactions; (b) establish limits, if appropriate, on the holdings of such transactions; and (c) perform stress tests on the positions and exposures arising from such transactions. Standardisation, by itself, does not ensure that a CCP can perform each of these critical functions. Furthermore, contracts that are infrequently traded, for example, are difficult if not impossible to clear even if they contain standardised economic terms because they are hard to price daily, which makes it difficult for a CCP to calculate collateral requirements consistent with prudent risk management.

Assuming that a derivatives contract is standardised, we believe the following factors, among others, should be taken into consideration to determine whether the contract is also clearable:

- *Adequate pricing information*. The accuracy of pricing information available to the CCP is critical in order for the CCP to perform its risk-management function and to settle transactions in the product with minimal disputes from participants. Accuracy depends on: (a) whether the pricing information represents completed transactions or at least tradable bids and offers; (b) whether prices are reasonably tight across multiple sources; and (c) whether prices behave in predictable ways over time. A sufficient amount of detailed historical pricing information is required for effective clearing to begin so that the CCP can effectively model risks on the standardised products to within appropriate risk-management tolerances.
- *Publicly available reporting on market size and transaction activity on a frequent periodic basis.* This factor is an important gauge of the ability of the market in question to absorb the liquidation of cleared positions, if necessary. Growing, or at least stable, market liquidity will also enhance the CCP's overall risk management and confidence in the accuracy of pricing information received.
- *Sufficient market transparency*. In order to minimise opportunities for price manipulation, it is important to have sufficient transparency in the market for the derivatives product and, where applicable, the market for the underlying subject matter or reference entity.

However, it is our view that ultimately each CCP must, at its discretion and risk judgment, decide which derivatives contracts it will accept for clearing. Only CCPs that interpose themselves contractually in the chain of derivatives transactions can determine whether particular contracts present the risk and default-management profile necessary to be susceptible to central clearing without imposing undue costs on market participants or undue risk on the clearing house and its members. It is up to each CCP to set risk tolerances and determine whether particular transactions fall within that tolerance.

Although some degree of standardisation is likely to be necessary for OTC derivatives to be traded on an exchange or other organised trading venues, fungibility (i.e. one contract could be substituted for another contract) is not necessary, nor it is desirable. Fungibility for OTC derivatives contract across multiple exchanges or trading venues serves only to provide linkages, or interoperability, among various clearing houses providing clearing services for the exchanges or trading venues listing such contracts. Interoperability among clearing houses increases systemic risk to each clearing house and the financial system as a whole. Indeed, when one side of a matched trade is transferred, the original clearing house automatically becomes exposed to the risk of the other clearing house. As transfers build and links between clearing houses increase, the ability to contain a single failure decreases and risk throughout the system increases.

Whilst we oppose fungibility of OTC derivatives contracts across trading venues, we support open access for such contracts. Open access respecting OTC derivatives contracts coupled with permitting end-users to choose their clearing venue regardless of their trading venue, provides the benefits of fungibility across exchanges or other trading venues for end-users without increasing systemic risk. Specifically, if end-user A goes long versus dealer B and directs the trade to clearing house C, A can go short against dealer D (or any other dealer) and net out of its position by also directing the trade to clearing house C.

It is the view of CME Group that the most effective way to reduce systemic risk without creating unintended adverse consequences is by increasing transparency and incentivising centralised clearing. CME Group is a strong proponent of the benefits of CCP clearing of OTC derivatives contracts as an effective means of reducing systemic risk whilst at the same time collecting and providing timely information to prudential and supervisory regulators. Its view derives from considerable experience of acting as a CCP in respect of exchange traded derivatives, and a more recent experience of acting in the same role in respect of OTC derivatives contracts based on commodities.

With a CCP model, the risk of one participant's default is, if the defaulter's assets held by the CCP are insufficient to cover the costs of managing the failure, mutualised across all members of the clearing house, each of which will bear responsibility in proportion to its level of participation. An independent and neutral CCP guarantor ensures that no market participant is uniquely exposed to the failure of another, and, provided that the risk management is entirely sound, the market has no reason to concern itself with the containment of failure or default by one or more participants.

Notwithstanding the above, CME Group does not support government mandated clearing of all OTC derivatives contracts. We believe that the relatively small number of organisations that are willing to act as CCPs for OTC derivatives should operate in a fair and competitive market: the provision of a range of choice of CCPs should not be prevented by national regulators mandating the exclusive use of particular services. Instead, the regulatory environment should allow multiple models, each with the highest standards of risk integrity, to offer a choice to serve the markets' needs. In that context, regulation should be appropriately flexible, incentive-based and risk-based to avoid damaging efficiency, competition and market innovation. We consider that appropriate incentives for clearing OTC derivatives should be in the form of mandatory reporting requirements and higher capital charges for uncleared OTC positions, and significantly lower relative capital charges for cleared OTC positions. Those incentives together with CCP clearing would introduce the twin benefits of enhanced transparency and much reduced systemic risk. This approach should incentivise voluntary clearing of appropriate contracts, whilst providing competent authorities with information necessary to fulfill their regulatory objectives.

In closing, we recognise the value of the consultative process undertaken by the CESR and we appreciate the opportunity to play a part in this policy process.

Sincerely,

Craig S. Donohue

Craig S. Donohue
Chief Executive Officer
CME Group