

**Craig Donohue, CME Group CEO Remarks at
Managed Funds Association Network 2008
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12:30 p.m.**

Thank you, Congressman Baker, for that kind introduction. And let me congratulate you on your new role and wish you well. We look forward to working with you. It's a great pleasure to be with you today. At CME Group, we recognize the Managed Funds Association as the voice of the global alternative investment industry, with approximately \$2 trillion invested by your membership in global financial markets. We also recognize the increasing importance of the managed funds community as significant customers of CME Group, and we are pleased to be a strategic partner with MFA and its membership to advance our mutual interests.

I would also like to thank my CME Group colleagues who are here with me today, particularly, Rick Redding, Tina Lemieux and Kelly Brown, who lead our hedge fund marketing and sales efforts on a global basis. We are very proud that the hedge fund community has strongly embraced our products and services; in particular, our anonymous, flat and open electronic markets and our central counterparty clearing advantages. As a consequence of our partnership with you, we now have 26 leading hedge funds that are inactive clearing members of CME Group and we have an additional 33 corporate members, all of whom benefit from lower trading fees and other benefits.

Today, I would like to share my thoughts with you on what many regard as an arcane or philosophical topic: market structure. More particularly, given recent events, I would like to talk about the growing importance of centralized clearing and the risk management systems that are the hallmark of well-run clearing houses. As many of you are aware, there is an on-going tug-of-war between futures exchanges and investment banks over ownership and control of central counterparty clearing houses. This seemingly perennial issue resurfaced again last week with an ill-timed and ill-considered suggestion that the Department of The Treasury consider whether futures exchanges should give up their clearing houses and transfer them to a monopoly, government regulated utility.

Ordinarily, I might simply repeat many of the well established and strong arguments in favor of alternative clearing models. And while I will touch on them briefly, I want to introduce another dimension into this equation and that is the following: why in the world would anyone want to question the organization and operation of one of the best functioning pieces of our financial system plumbing at a time when subprime write-offs have cost investment banks and their shareholders approximately \$400 billion – not to mention the unquantifiable second and third order costs attributable to this debacle? Second, why would anyone question the efficacy of these exchange-owned clearing systems when we witness losses like the more than \$7 billion incurred by Societe

Generale in recent weeks. To a large extent, these situations have certain common characteristics: they involve opaque markets, inherently biased or subjective valuations of current exposures, a limited bilateral trading model that limits liquidity during times of market stress and a very questionable control environment that inhibits risk managers from understanding their true risk exposures in the marketplace. These problems exist in large part because investment banks traditionally have resisted a more centralized, transparent execution system for these products, preferring instead to maintain their dealer franchises and proprietary trading profits. And they have tended to oppose central counterparty clearing services in these markets, worried that a mutualized risk structure will dissipate their credit and balance sheet advantages in competing with a broader array of banks and non-bank financial institutions in terms of credit intermediation services.

In stark contrast to these well-publicized failures, CME Clearing has operated for more than 100 years without failure. Last year, the CME Clearing House cleared more than 2.8 billion contracts traded on the CME and the Chicago Board of Trade®, representing more than a quadrillion dollars in notional value terms. The CME Clearing House holds approximately \$57.5 billion of collateral on deposit and regularly moves approximately \$2.2 per day, with movements of up to \$10 billion on exceptionally volatile days, among market participants. We believe that our integrated clearing model has created efficiencies and confidence in our market that has produced tremendous growth. Despite our significant growth, we have improved market efficiencies, reducing capital, margining and financing costs, as well as exchange trading fees by hundreds of millions of dollars over the last decade.

I think our experience gives us some insight into the three issues I highlighted. First, it is clear for these and many other reasons that regulators should not, and likely cannot, mandate the establishment of a single monopoly provider of central counterparty clearing (CCP) services. Rather, they should continue to support alternative clearing solutions, allowing private market forces to shape clearing services in response to the very dynamic and competitive market forces that are evident in today's global financial markets. Second, rather than focusing on how to change the part of the financial system plumbing that has an exemplary track record, perhaps more emphasis should be placed on those parts that are not working at all. Shouldn't regulators be more concerned with asking whether a broader implementation of CCP services for OTC derivative trading could have mitigated effects of the subprime meltdown or the Soc. Gen. Fraud?

Among other benefits, CCPs that are not dominated by a few large interested parties, guarantee three essentials-- independence, neutrality and transparency:

1) transparency of valuation – a CCP establishes daily mark-to-market prices available to all market participants and the market at large. These prices are provided by a neutral third party with no position to protect and no personal stake in the market's direction.

2) transparency of P&L – in addition to publication of daily settlement prices, the discipline of daily payment of settlement variation makes it difficult for traders to hide losses or to disguise unusual profits.

3) enhanced control environment – CCP means real time confirmations from a trusted counterparty directly to the back office and the risk manager. Risk management systems know the trade the moment it is done. Conversely, no confirmation means no trade. Our clearing house provides auto assisted reconciliation services. The clearing house provides all market participants with datasets that facilitate the twice daily automated reconciliation of positions and money balances across all activity. While most clearing participants perform the automated reconciliation once a day, CME makes the information available intra day as well, and they can call for it on demand.

The benefits that flow from the efficient operation of a neutral, independent and transparent CCP are clear—we:

- Reduce and contain certain systemic risks;
- Ensure and guarantee the performance of all obligations between and among market users;
- Limit bilateral credit risks and exposures;
- Reduce capital and operational costs for market users through multilateral netting arrangements; and
- Better align risk and margin or performance bond requirements through risk-based portfolio margining.

Of course, we are all awaiting with interest a clearer report of the details of the means employed to defraud Soc. Gen. Preliminary reports suggest that the trades done on Eurex and cleared there resulted in red flags and reports to the Soc. Gen. risk managers. It seems that the trader was able to continue because only one half of the supposed hedge was subject to CCP clearing. False reports about the balancing half of the alleged hedge cannot withstand real time reporting of transactions and twice daily reporting of gains and losses.

Second, I want to discuss the recent suggestion to Treasury that CCPs be divorced from exchange ownership. That position is based on a fundamental conceptual error and a numerous secondary logical, historical and economic errors compounding the original error. This mistaken assumption contends that the bid-offer spreads and trading costs in the securities industry were reduced as a result of the divorce between clearing and exchange ownership and presumed that a similar result would follow if CME and the other exchanges gave up their clearing houses. This reasoning presumes that new entry would be easier and that such competition would lower costs.

The business model of separate clearing houses in the U.S. equity options and equity markets is not new. It is not clear how anyone can conclude that new levels of inter-exchange competition are attributable to a business model that has been in place for almost forty years. Competition and new entry is the result of the elimination of anti-competitive rules and agreements in that market.

U.S. derivatives markets are fundamentally different from securities markets. First, derivatives exchanges are centralized transaction systems for a wide array of innovative risk management products. Exchanges like CME continually develop and create new products, usually following lengthy and expensive periods of research and development. In some cases, our innovations have protectable intellectual property interests. In contrast, newly public companies list their stock on a securities exchange, which does little more than provide transaction execution facilities. The existence of five or six separate options exchanges offers market users very little more than could be accomplished by a single central limit order book in which all of the market makers competed on an even footing.

Second, unlike domestic stock and options exchanges, domestic futures exchanges compete directly with non-U.S. futures exchanges, where 70% of all futures and options contracts traded globally are cleared on or through exchange owned or controlled clearing facilities. Any failure to recognize that fact would create an un-level playing field for U.S. futures exchanges at a time when U.S. futures exchanges are the strongest example of how to maintain our overall competitiveness in global financial markets - a key area of concern in recent times.

CME's innovations are well established. In 1972, we made exchange traded financial futures work. We developed the first cash-settled contracts, leading to the development of structured derivatives on intangible assets not readily deliverable and we created the world's first successful stock index futures markets. More recently, we have created exchange traded and cleared risk management markets in areas such as weather and residential real estate indexes. Apart from our R&D investments and calculated risk taking, we invest considerable resources in education, training and marketing of our new innovations. In securities markets, the issuer invests in marketing and developing its own brand in order to attract investors and traders. In derivatives markets, it is the exchanges that must promote awareness and interest among market users. We believe that continued innovation and calculated risk taking will suffer in a single monopoly CCP system where all exchange competitors can freely usurp the innovations and investments of market leaders.

CME agrees that CCP services should operate in a competitive market, but believe that a regulatory directive that creates a single monopoly provider of CCP services is inconsistent with competition and more likely to be destructive than beneficial. If competition is the goal, regulators and policy makers should support a competitive environment that fosters innovation and the development of new and alternative solutions that allow the market to advance. There are several reasons underlying our belief that the case has not been made for mandating a single monopoly provider of CCP services for U.S. financial derivative markets.

First, the true cost savings of moving to a single monopoly CCP or creating interoperability among multiple CCPs has not been quantified.

Second, the suggestion that the very significant cost of fragmenting futures market liquidity pools can be avoided by replicating a national market trading system

wrongly presumes that an NMS that preserves the order books of the separate exchanges can be implemented at a reasonable cost and that it can operate effectively in the high volume, high velocity and high volatility world of futures trading. This solution effectively reduces the function of the exchanges to a point where they serve no purpose. If this is the goal, then the solution is a government utility to operate the central limit order book and the CCP. Forget about innovation and competition.

Third, there has not been sufficient discussion of the potential problems associated with an investment bank-owned/controlled CCP. While one can reasonably argue that some exchange-owned CCPs may seek to extract monopoly rents, one must also be willing to acknowledge that investment bank-owned CCPs may limit CCP activities in some markets in order to maximize trading and dealing profits for their owners at the expense of smaller members of the CCP and true end-users. It is not clear how the suggested government regulation can cure this problem.

Fourth, experience demonstrates that the conflicting interests of the exchange user/owners and the investment bank owners of certain CCPs impair their efficiency in terms of technology development and bringing new business innovations to market. Advocates for a single monopoly CCP solution appear unconcerned with the potential for these efficiency losses.

SwapClear is an example of how a user-owned, user-governed clearinghouse could choose to create a solution tailored to a small group of market participants. SwapClear caters to the interests of the 19 largest swap dealers rather than the broader universe of market participants. Additionally, it has limited its product set to plain vanilla interest rate swaps in major currencies. The highest profit margin products, including credit derivatives and equity swaps, have been excluded, benefiting dealer profitability at the expense of reducing systemic risks and transaction costs in these markets.

In contrast to the limited participation approach taken at SwapClear, at CME, we seek to provide the benefits of CCP services to a significantly wider audience. Today, we provide CCP services in the spot OTC foreign exchange market through FXMarketSpace, our joint venture with Reuters; we recently introduced cleared interest rate swaps through our Swapstream subsidiary with incredibly strong support from the hedge fund community; and we provide clearing and cross-margining linkages with other leading exchanges, including Singapore, China and now Brazil, as well as nearly all of the major clearing houses around the world. These are all excellent examples of how exchange-owned CCPs can enhance trading alternatives and promote efficiency for market users.

As a shareholder value-driven organization, we can take calculated risks and make speculative investments that have the potential to generate returns for our shareholders. Investment bank-owned/controlled utilities are generally rewarded for cost minimization rather than growth and value creation for shareholders. In consequence, in the long run they neither minimize costs nor create value. For that reason, regulators and policy makers should more carefully assess the impact of the structure on innovation, market development and industry growth.

In conclusion, there is no evidence that either a vertical or horizontal market model is “right” in all situations. Nor is there evidence that either model is “wrong” in all situations. The only way to ensure that markets develop efficiently is to focus regulation on financial soundness and allow market forces to determine the structures and solutions that work best.

From my perspective, market participants must have a voice in the governance of a clearing house. At CME Group, our market-driven approach allows for the integrated control of execution and clearing services by a publicly held company, as we believe that best serves the public interest. I leave you with this thought: what better way to ensure that clearing and settlement providers truly serve the public interest than by having them be owned by the public?

Thank you for allowing me to be with you today.