CME Group

Craig S. Donohue
Chief Executive Officer

August 29, 2011

VIA ON-LINE SUBMISSION

David Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Reducing Regulatory Burden; Retrospective Review Under E.O. 13563 (Federal Register Vol. 76, No. 126, P. 38328)

Dear Mr. Stawick:

CME Group Inc. ("CME Group"),[1] on behalf of its four designated contract markets, appreciates the opportunity to comment on the Commodity Futures Trading Commission's (the "CFTC" or "Commission") Notice of Proposed Rulemaking ("Release") that was published in the Federal Register on June 30, 2011. In the Release, the Commission seeks comment on its proposed plan to identify and evaluate its regulations periodically to determine whether any such regulations should be modified, expanded, streamlined or repealed in order to make the agency's regulatory program more effective (the "Plan"), as a means of implementing Executive Order 13563, "Improving Regulation and Regulatory Review."

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[1] CME Group is the world's largest and most diverse derivatives marketplace. CME Group consists of four separate Exchanges, including Chicago Mercantile Exchange Inc. ("CME"), the Board of Trade of the City of Chicago, Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX") and the Commodity Exchange, Inc. ("COMEX"). The CME Group Exchanges offer the widest range of benchmark products available across all major asset classes, including futures and options based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities and alternative investment products. CME Group includes CME Clearing, one of the largest central counterparty clearing services in the world, which provides clearing and settlement services for exchange-traded contracts, as well as for over-the-counter derivatives transactions through CME ClearPort®.

As a pioneer in the globalization of the futures markets, CME Group has helped to expand the customer base for futures products. CME Globex, for example, is available to users around the world for more than 23 hours a day and five days a week. To satisfy the increasing demands of the international marketplace, customers can access the CME Globex platform in more than 150 countries and foreign territories around the world. Telecommunications hubs in Singapore, London, Amsterdam, Dublin, Milan, Paris, Seoul, São Paolo and Kuala Lumpur reduce our customers' connectivity costs, increase accessibility, and deliver faster, more efficient trading. Additionally, CME Group has established international offices in London, Singapore, Tokyo, Hong Kong, São Paolo and Calgary. CME Group believes that its significant global expertise and experience will provide the Commission with a unique and valuable perspective on the matters discussed herein.

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I. Detailed Comments

A. <u>Inadequate Cost Benefit Analysis</u>

On January 18, 2011, President Obama issued Executive Order 13563 (the "Executive Order"), "Improving Regulation and Regulatory Review," 76 Fed. Reg. 3821 (January 18, 2011). The President issued the Executive Order for the purpose of improving regulation and regulatory review. In relevant part, the Executive Order requires each agency to, among other things, "propose or adopt a regulation only upon a reasoned determination that its benefits justify its costs (recognizing that some benefits and costs are difficult to quantify)," "tailor its regulations to impose the least burden on society, consistent with obtaining regulatory objectives, taking into account, among other things, and to the extent practicable, the costs of cumulative regulations," and "to the extent feasible, specify performance objectives, rather than specifying the behavior or manner of compliance that regulated entities must adopt." 76 Fed. Reg. at 3821. Further, the Executive Order required that agencies "consider how best to promote retrospective analysis of rules that may be outmoded, ineffective, insufficient, or excessively burdensome, and to modify, streamline, expand or repeal them in accordance with what they have learned." *Id.* at 3822. The Executive Order further required agencies to develop a plan to periodically review its existing regulations so as to make its regulatory program more effective and less burdensome and submit that plan to the Office of Information and Regulatory Affairs.

Although the Executive Order does not apply to independent agencies such as the Commission, it encourages those agencies to consider it and to undertake voluntary retrospective analyses of existing rules. To this end, the Commission has proposed a plan for retrospective review of its rules. The Commission asserts that "Phase One" of its retrospective review consists of its review of many of its existing regulations in determining whether such regulations needed to be modified to conform to Dodd-Frank. As such, Phase One is well underway. The Commission proposes a "Phase Two" wherein it will begin the process of examination of the remainder of its regulations. To that end, the Commission intends to solicit public comment as to which rules should be reviewed. The Commission will then prioritize the rules recommended for review and determine which rules shall be reviewed. If, as a result of this review, the Commission determines to propose a revision to a regulation, it will proceed according to the Administrative Procedure Act, allowing the public notice and an opportunity to comment on the proposed revisions.

CME Group is concerned that, in its "Phase One" review of regulations pursuant to Dodd-Frank, the Commission has failed to abide by the principles of the Executive Order. More specifically, CME Group's position is that, in its revision of regulations pursuant to Dodd-Frank, the Commission has <u>not</u>: 1) conducted a reasoned analysis of whether the benefits of proposed rules justify their costs; 2) tailored the new regulations to make them minimally burdensome and costly, and 3) relied on guiding principles, rather than prescriptive rules, wherever possible. This failure to abide by the principles asserted in the Executive Order is most noteworthy with regard to the Commission's unnecessary transition from a principles-based regulatory regime – which has allowed the U.S. futures markets to flourish and compete on a global scale over the past decade – to a largely prescriptive system of regulation for futures markets.

To begin, the Commission has not abided by the Executive Order's guiding principle that "agencies consider the costs and benefits of their regulations and choose the least burdensome path" in conjunction with many rules proposed under Dodd-Frank. 76 Fed. Reg. 38328. Moreover, the Commission has failed to comply with Section 15 of the Commodity Exchange Act ("CEA"), which requires the Commission to consider the costs and benefits of its action before it promulgates a regulation. In addition to weighing the traditional direct costs and benefits, Section 15 directs the Commission to include in its evaluation of the benefits of a proposed regulation the following intangibles: (i) "protection of market participants and the public," (ii) "the efficiency, competitiveness, and financial integrity of the futures markets," (iii) "price discovery," (iv) "considerations of sound risk management practices," and (v) "other public interest considerations."

The cost-benefit analyses included in the Commission's proposed rulemakings under Dodd-Frank take an uninformative, almost boilerplate form and fail to acknowledge many of the economic costs of the proposed rules. Many interested parties – including Commissioner Sommers, Commissioner O'Malia, individuals providing Congressional testimony, members of the public, and the Commission's Inspector General – repeatedly have expressed concern regarding the cost-benefit analyses performed with regard to rules proposed under Dodd-Frank thus far. Indeed, Commissioner Sommers forcefully called this failure to the Commission's attention as recently as February 24, 2011:

> Before I address the specific proposals, I would like to talk about an issue that has become an increasing concern of mine – that is, our failure to conduct a thorough and meaningful cost-benefit analysis when we issue a proposed rule. The proposals we are voting on today, and the proposals we have voted on over the last several months, contain very short, boilerplate "Cost-Benefit Analysis" sections. The "Cost-Benefit Analysis" section of each proposal states that we have not attempted to quantify the cost of the proposal because Section 15(a) of the Commodity Exchange Act does not require the Commission to quantify the cost. Moreover, the "Cost Benefit Analysis" section of each proposal points out that all the Commission must do is "consider" the costs and benefits, and that we need not determine whether the benefits outweigh the costs.

Commissioner Sommers reiterated her concern regarding the Commission's inadequate cost-benefit analyses in her Concurring Statement in the Release:

> I have objected in the past to the Commission's failure to conduct a robust cost-benefit analysis in connection with its Dodd-Frank proposals. And I have yet to see evidence at the proposal stage that we are truly looking for the least burdensome, most cost-effective way to meet regulatory goals.

76 Fed. Reg. at 38329.

As the Commission is aware, following Congressional testimony that raised concerns among members of Congress regarding the Commission's cost-benefit analyses, the Office of the Inspector General of the Commission (the "IG") undertook an investigation of the formulation of cost benefit analyses of four rulemakings.[2] In its investigation, the IG identified several problematic aspects of the Commission's procedures for formulating its cost-benefit analyses. In this report, the IG noted, among other things, that "the Commission staff viewed section 15(a) compliance to constitute a legal issue more than an economic one, and the views of the Office of the General Counsel therefore trumped those of the Chief Economist, at least for the four rules we reviewed." In response to the absence of an economic analysis, the IG recommended that: "any cost-benefit analysis should take account of price theory economics, which should involve the Chief Economist. While we recognize that an attorney may possess economic insights gained though his or her academic or professional background, the experience of economists who work with such questions on a daily basis should be helpful."[3] The IG also recommended that the Commission undertake a "more robust process," which should include "greater input from the Office of the

[2] "An Investigation Regarding Cost-Benefit Analyses Performed by the Commodity Futures Trading Commission in Connection with Rulemakings Undertaken Pursuant to the Dodd-Frank Act," prepared by the Office of the Inspector General, Commodity Futures Trading Commission, April 15, 2011 (attached hereto as Exhibit A) ("IG Report") at ii.

[3] IG Report at 22.

Chief Economist"[4] and cautioned the Commission that, in other contexts, agencies have recently faced the overturning of their final rules based on the failure to perform such a robust cost-benefit analysis.[5]

The IG's caution should be heeded by the Commission. Indeed, courts have recently overturned rulemakings of other agencies on the basis that the agencies' failure to properly perform the required cost-benefit or similar analysis rendered the rulemakings arbitrary and capricious. Most recently, in *Business Roundtable v. SEC*, 2011 WL 2936808, *3 (D.C. Cir. 2011), the D.C. Circuit vacated an SEC rule for failure to perform the required analysis of effects on "efficiency, competition, and capital formation."[6] The Court found that the SEC "inconsistently and opportunistically framed the costs and benefits of the rules; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters." *See also, e.g., Chamber of Commerce v. SEC*, 412 F.3d 133, 144 (D.C. Cir. 2005) (vacating an SEC rule for failure to perform required analysis of effects on efficiency, competition, and capital formation); *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166, 179 (D.C. Cir. 2010) (same); *Am. Equity Inv. Life Ins. Co. v. SEC*, 572 F.3d 923, 936 (D.C. Cir. 2009) (same); *Owner-Operator Indep. Drivers Ass'n, Inc. v. Fed. Motor Carrier Safety Admin.*, 494 F.3d 188, 206 (D.C. Cir. 2007) (finding rule arbitrary and capricious where agency failed to provide notice of and allow comment on an explanation for the methodology of a model used to support the statutorily-required cost-benefit analysis); *Gas Appliance Mfg. Ass'n, Inc. v. Dep't of Energy*, 998 F.2d 1041, 1051 (D.C. Cir. 1993) (holding that DOE failed to perform an adequate cost-benefit analysis as required by the Buildings Act); *see also, Pub. Citizen v. Fed. Motor Carrier Safety Admin.*, 374 F.3d 1209, 1218-19 (D.C. Cir. 2004) (finding rule arbitrary and capricious on other grounds but noting, at length, that cost-benefit analysis based on dubious assumptions was a matter of concern). Further, the Court found that, although the SEC did not completely ignore potential costs, it did not "adequately evaluate" those costs." *Business Roundtable*, 2011 WL 2936808, at *6-7 (stating that "by ducking serious evaluation of the costs . . . we think the Commission acted arbitrarily").

Respectfully, CME Group believes that, unless the Commission performs a more robust cost-benefit analysis, many of the rules proposed by the Commission under Dodd-Frank are vulnerable to such a challenge. Indeed, although not expressing an opinion as to the viability of such a challenge, the IG noted that such challenges to other agencies' rules had been successful and suggested "that a more robust examination of costs and benefits should only enhance the [Commission's] ability to defend its cost-benefit analyses."[7]

B. Repeal of Principles-Based Regulation

In addition to taking more seriously the principles of the Executive Order and its obligations under Section 15 of the CEA, most notably, the Commission should reassess its apparent decision to repeal the principles-based regulatory regime reinforced and extended Congress by in Dodd-Frank. While the amendments to the CEA by Dodd-Frank grant the Commission discretion, where necessary and appropriate, to promulgate rules and regulations specifically detailing how a registered entity must comply

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[4] Id. at iv.

[5] Id. at 23.

[6] Although this is not, per se, a cost-benefit analysis, the cases address the required analysis largely as a cost-benefit analysis, and in any case, the discussion of this provision constitutes the most closely-analogous analysis to the CEA standard available. *See, e.g., Business Roundtable*, 2011 WL 2936808, at *3-6 (discussing the SEC's "consideration of costs and benefits" of the rule at issue); *Am Equity II*, 613 F.3d 177 (stating in discussion of analysis that "petitioners argue that the costs of implementing Rule 151A are too burdensome and that the imposition of additional regulation would be inefficient").

[7] IG Report at 23.

with its core principle obligations, this new language was not intended to give the Commission authority to override the principles-based regulatory regime with a multitude of prescriptive rules dictating not only how registered entities comply with applicable core principles, but also how they conduct their day-to-day business operations. Indeed, the new language of the CEA added by Dodd-Frank made clear that SROs were granted "reasonable discretion in establishing the manner in which the [SROs] compl[y] with the core principles."

The Commission's action in this regard is inconsistent with the principles announced in the Executive Order for two reasons. First, the Executive Order instructs to Commission that it should "to the extent feasible, specify performance objectives, rather than specifying the behavior or manner of compliance that regulated entities must adopt." This directive from the President not only is consistent with Congress' mandate in Dodd-Frank to maintain principles-based regulation for the markets subject to the CFTC's jurisdiction, but makes complete sense from an economic perspective when one looks at the performance of the regulated futures market since the enactment of the Commodity Futures Modernization Act of 2000 ("CFMA"), which put in place the principles-based regime. As discussed in prior comment letters and in more detail below, the futures markets have prospered under a principles-based regime where core principles serve as "performance objectives" and performed flawlessly during the 2008 financial crisis. Second, the move to prescriptive regulation is problematic because the Commission has failed to properly assess the relative costs and benefits associated with its new policy. Indeed, CME Group maintains that if the Commission had performed a proper assessment of the costs and benefits of a new prescriptive, rules-based regime, it could not have proposed most of the rules that it has proposed. These concerns are echoed by Commissioner Sommers in her concurring statement in the Release:

> The Commission also cites its proposed rulemakings to implement new requirements for complying with the core principles for designated contract markets and derivatives clearing organizations as a "Phase One" retrospective analysis initiative. Again, changes to the Commission's guidance and acceptable practices for complying with core principles are in order given the Dodd-Frank amendments. My objection here is that, contrary to the Executive Orders, the Commission has proposed detailed prescriptive rules for complying with the core principles rather than preserving the flexibility that was intended by Congress and encouraged by the President.

76 Fed. Reg. at 38329.

To be clear, the Commission purports to consider the cost and benefits of its new prescriptive, rule-based regulatory approach in many of its proposals. However, even a cursory review of the Commission's discussions reveal that the Commission's cost benefit "analyses" are cryptic and rote and fail to quantify any specific impacts to the industry or even more generally assess the potential detrimental effects such changes will have on the U.S. futures markets. In analyzing the costs and benefits of its prescriptive rules, the Commission fails to identify shortcomings with the fully-functional and highly successful regulatory system is already in place in futures markets. Further, the Commission fails to identify any regulatory or public benefits brought by a new, rules-based policy, and certainly none that cannot be achieved by the existing principles-based regime.

CME Group submits that if the Commission were to identify potential cost and benefits, including those identified in our comment letters on proposed rules such as the minimum centralized market trading requirement for DCMs (the "85/15 rule"), it would find that the costs of abandoning its principles-based regime would far outweigh any benefits of imposing the prescriptive regime it has proposed in several of its NOPRs. For as CME Group discussed in a paper on the market impacts of the 85/15 rule submitted on August 3, 2011,[8] this rule would, among other things, require market participants to post more than

[8] See 85/15 paper, attached at Exhibit B.

200% margin for many CME Group products that would fail the Commission's arbitrary test, result in adverse tax consequences for those same market participants, incentivize markets and market participants to move overseas, and thwart innovation and competition in the U.S. futures markets. These adverse consequences are all the more concerning given that the Commission has yet to identify a single regulatory or public benefit likely to result from the 85/15 rule. Simply put, if the Commission had considered the principles of the Executive Order and its obligations under CEA Section 15, it could not have proposed the 85/15 rule.

Beyond specific rules such as the 85/15 rule, it also is important to emphasize here that regulated futures markets and futures clearing houses operated flawlessly during the 2008 financial crisis. Futures markets performed all of their essential functions without interruption and, despite failures of significant financial firms, our clearing house experienced no default and no customers on the futures side lost their collateral or were unable to immediately transfer positions and continue managing risk. The aim of Dodd-Frank was to bring swaps, which were previously traded over-the-counter and largely unregulated, into a sound regulatory framework like that which exists for the futures market. Contrary to the Commission's efforts, Congress did not intend for the Commission to undo the regulatory regime for well-functioning futures markets. As previously noted, Congress specifically maintained principles-based regulation for futures markets and extended that regime to the newly regulated swaps market, creating core principles for swap execution facilities and swap data repositories.

From a macro-economic perspective, the principles-based regime of the CFMA has facilitated tremendous growth and innovation, allowing U.S. exchanges to compete effectively on a global scale. As we've previously commented, we believe that principles-based regulation of futures exchanges and clearing houses permitted U.S. entities to gain their competitive position in the global market. Without unnecessary, costly and burdensome regulatory review, much like that which would be imposed based on the collective set of the Commission's proposed rules, U.S. futures exchanges have been able to keep pace with rapidly changing technology and market needs by introducing new products, new processes and new methods through self-certifying compliance with the CEA. Indeed, U.S. futures exchanges and clearing houses have operated more efficiently, more economically and with fewer complaints under this system than at any time in their history. Accordingly, the Commission's proposed inflexible, rules-based regime threatens to stifle growth and innovation and drive market participants (and jobs) overseas.

As the Commission knows, most of its proposed rules in many areas are not in harmony with international regulators. For example, the EU – an agency with which the Commission has publicly stated it has been coordinating – is far from adopting an approach as prescriptive as the CFTC's across the board. To be sure, we are aware of no plans by the EU to impose hard position limits on physical commodities; nor are we aware of rules that would require European futures exchanges to trade more than 85% of a listed contract's volume in the open and competitive market or require other European trading platforms that trade swaps to require requests for quotes to go out to at least 5 market participants. Rules such as these create great incentives for market participants to move their business abroad to take advantage of the enhanced growth opportunities available there. Further, tilting the competitive playing field in favor of overseas markets threatens to export the price discovery process to overseas exchanges, a loss which would significantly reduce the U.S.'s importance in global commodities markets, particularly the crude oil market. We can think of no regulatory or public benefit of such consequences.

* * * * *

We acknowledge that the Commission appears to be initiating an effort to include more robust cost-benefit analyses in its NOPRs. More specifically, the IG Report noted "that the Chairman has initiated a review and revision of the cost-benefit analyses guidance for use with final rulemakings."[9] CME Group

[9] IG Report at 23.

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commends the Chairman and the Commission on these efforts. Given these ongoing revisions in the Commission's methodology for its cost-benefit analyses, the requirements of the Executive Order, the concern of the IG, commentators, and others, and the submission of information by commentators useful to the Commission in formulating more robust cost-benefit analyses, CME Group recommends that, as part of Phase One of its plan to respond to the Executive Order, the Commission re-issue its cost-benefit analyses for its proposed rules under Dodd-Frank with new and more robust cost-benefit analyses and allow for comment by interested parties on the revised analyses.

CME Group thanks the Commission for the opportunity to comment on this matter. We would be happy to discuss any of these issues with Commission staff. If you have any comments or questions, please feel free to contact me at (312) 930-8275 or via email at Craig.Donohue@cmegroup.com, or Christal Lint, Director, Associate General Counsel, at (312) 930-4527 or Christal.Lint@cmegroup.com.

Sincerely,

Craig S. Donohue

Craig S. Donohue

cc: Chairman Gary Gensler
Commissioner Michael Dunn
Commissioner Bart Chilton
Commissioner Jill Sommers
Commissioner Scott O'Malia

<u>EXHIBIT “A”</u>

U.S. Commodity Futures Trading Commission
Office of the Inspector General

An Investigation Regarding Cost-Benefit Analyses Performed by the Commodity Futures Trading Commission in Connection with Rulemakings Undertaken Pursuant to the Dodd-Frank Act

REPORT OF INVESTIGATION

Prepared by the
Office of the Inspector General
Commodity Futures Trading Commission

April 15, 2011

EXECUTIVE SUMMARY

The Office of the Inspector General for the Commodity Futures Trading Commission investigated the formulation of cost benefit analyses for four separate rulemakings recently published by the Commodity Futures Trading Commission:

1. Further Defining "Swap Dealer," "Security-based Swap Dealer," "Major Swap Participant," "Major Security-based Swap Participant," and "Eligible Contract Participant," 75 FR 80174 (December 21, 2010) (Joint proposed rule; proposed interpretations);[1]

2. Confirmation, Portfolio Reconciliation, Compression Requirements for Swap Dealers and Major Swap Participants, 75 FR 81519 (December 28, 2010) (Notice of proposed rulemaking);

3. Core Principles and Other Requirements for Designated Contract Markets, 75 FR 80572 (December 22, 2010) (Notice of proposed rulemaking);

4. Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, 75 FR 71397 (November 23, 2010) (Notice of proposed rulemaking).

We undertook this investigation at the request of Representative Frank D. Lucas, Chairman, House Committee on Agriculture, and Representative K. Michael Conaway, Chairman, Subcommittee on General Farm Commodities and Risk.[2] We were asked to review eight factors in our investigation, and were requested to complete our investigation by April 15, 2011.

In order to complete the investigation, we reviewed drafts of the cost-benefit analyses for the four proposed rules, staff email, and internal memoranda. In addition, we conducted interviews with 24 CFTC employees at staff and various management levels who were involved (or were reported to us as involved) with the cost-benefit analyses processes for the four rules.

The cost-benefit analyses were created as follows. Following enactment of the Dodd-Frank Act,[3] the Chairman and Division Directors created 30 rulemaking teams.[4] Because section 15(a) of the Commodity Exchange Act (the Act)[5] required the consideration of a cost-benefit analysis for each rulemaking, the Office of General Counsel and Office of Chief Economist

[1] The Commission published this proposed rule jointly with the Securities and Exchange Commission, in consultation with the Board of Governors of the Federal Reserve System. 75 FR 80174 (December 21, 2010).
[2] The request is available here: http://agriculture.house.gov/pdf/letters/cftc_inspectorgeneral110311.pdf
[3] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank Act" or "Dodd-Frank").
[4] A 31st team was later created and tasked with developing conforming rules to update the CFTC's existing regulations to take into account the provisions of the Act. Testimony of Chairman Gary Gensler before the House Committee on Agriculture, February 10, 2011, available at: http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-68.html.
[5] 7 USC sec. 19.

created a uniform methodology for cost-benefit analysis for use Agency-wide. That methodology, contained in a September 2010 memo signed by the General Counsel and the Chief Economist, set out in some detail the types of qualitative considerations that might inform a cost-benefit analysis, encouraged the use of both qualitative and quantitative data, and included a template for everyone to follow.

Although the development of a uniform methodology appeared to be an equal effort between the Office of General Counsel and the Office of Chief Economist, in practice the cost-benefit analyses involved less input from the Office of Chief Economist, with the Office of General Counsel taking a dominant role. For the four rules we reviewed, the cost-benefit analyses were drafted by Commission staff in divisions other than the Office of Chief Economist. Staff from the Office of Chief Economist did review the drafts, but their edits were not always accepted.

Staff in the Office of General Counsel created the first draft of the cost-benefit analysis for the proposed rule defining "swap dealer" and "major swap participant."[6] Staff told us the Office of Chief Economist favored addressing in some manner the operational and compliance costs that would flow from coverage under the definition of "swap dealer" or "major swap participant," but the Office of General Counsel determined only to address the costs and benefits associated with undergoing an examination or other process to determine whether one fell under the definitions, or not.

With regard to the cost-benefit analyses for the proposed rule setting out core principles for designated contract markets,[7] staff explained that the process for this rule went relatively smoothly, with staff in the Office of General Counsel drafting the cost-benefit analysis with some edits from the Office of Chief Economist and from other members of the rule-making team. However, staff from the Designated Contract Market (DCM) core principles team wanted us to know about disputes regarding an earlier rule regarding swap execution facilities. In connection with this other rule, the Office of Chief Economist edited an initial draft created by staff in the Office of General Counsel. To put the dispute in simplest terms, the Office of Chief Economist undertook a cost-benefit analysis that addressed separate tasks set out in various sections of the rule. Staff in the Office of General Counsel strongly encouraged the staff from the Office of Chief Economist not to deviate from accepted methodologies for cost-benefit analyses employed by the Commission for 10 years, which apparently limited the scope of the cost-benefit analysis under section 15(a) to an analysis of the rule as a whole. Staff from the Office of General Counsel opined that deviating from this long-standing standard could result in litigation risk, and that the adoption of a new methodology could require the Commission to engage in the same methodology for future rules (or a litigation risk could result). Inasmuch as the Commission's cost-benefit analyses in rulemakings had never been challenged in court, we consider prior practice in this instance to not carry as much weight as if it had received judicial approval. Moreover, from our review of relevant email and memoranda, it is apparent that other

[6] Further Defining "Swap Dealer," "Security-based Swap Dealer," "Major Swap Participant," "Major Security-based Swap Participant," and "Eligible Contract Participant," 75 FR 80174 (December 21, 2010) (Joint proposed rule; proposed interpretations).
[7] Core Principles and Other Requirements for Designated Contract Markets, 75 FR 80572 (December 22, 2010) (Notice of proposed rulemaking).

staff within the Office of General Counsel did not appear to embrace this view. In the end, staff in the Office of General Counsel revised the cost-benefit analyses in accordance with its views, which was approved by the team leader and the team leader's boss.

The same team that drafted the proposed rules dealing with portfolio compression and reconciliation[8] also drafted the proposed rule setting out duties for swap dealers and major swap participants.[9] The cost-benefit analysis was created, for both rules, by a sub-set of the rulemaking team, and reviewed by staff in the Office of Chief Economist. A staff member in the Office of Chief Economist who was assigned to the team told us she was not part of the sub-group that created the cost-benefit analysis, and she was not sure she was invited to all relevant meetings for the rulemaking. Instead, she was given drafts to review, and believed the drafts were complete when she received them, and made few edits.

To a greater or lesser extent for the four examined rules, the Office of General Counsel appeared to have the greater "say" in the proposed cost-benefit analyses, and appeared to rely heavily on an historic (and somewhat stripped down) analytical approach. While we offer no opinion on the cost-benefit analyses for the four rules, we note that similar economic analyses in the context of federal rulemaking have proved perilous for financial market regulators.[10] Moreover, it seems odd for an agency that regularly engages in economic analysis. We recognize that cost-benefit analysis does not possess anywhere near the exactitude of, say, calculus, but it does provide structure for evaluation. A more robust process is clearly permitted under the cost-benefit guidance issued by the Office of General Counsel and the Office of Chief Economist, and we believe a more robust approach would be desirable, with greater input from the Office of Chief Economist.

We note that the Chairman has initiated a review and revision of the cost-benefit analysis methodology for use in final rulemakings, and again we recommend that such review should lead to more robust cost-benefit analysis methodologies. We recommend that the Office of Chief Economist take on an enhanced role.

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[8] Confirmation, Portfolio Reconciliation, Compression Requirements for Swap Dealers and Major Swap Participants, 75 FR 81519 (December 28, 2010) (Notice of proposed rulemaking).

[9] Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, 75 FR 71397 (November 23, 2010) (Notice of proposed rulemaking).

[10] See, e.g., *Am Equity Investment Life Ins. Co. v. S.E.C.*, 613 F.3d 166, 177-178 (D.C. Cir.2010); *Chamber of Commerce of U.S. v. S.E.C.*, 412 F.3d 133, 142-144 (D.C. Cir.2005).

TABLE OF CONTENTS

BACKGROUND

Section 15(a) of the Commodity Exchange Act

Section 15(a) was added to the Commodity Exchange Act in 2000 with passage of the Commodity Futures Modernization Act (CFMA).[11] Section 15(a) provides:

> (a) Costs and benefits.
>
> (1) In general. Before promulgating a regulation under this Act [7 USCS §§ 1 et seq.] or issuing an order (except as provided in paragraph (3)), the Commission shall consider the costs and benefits of the action of the Commission.
>
> (2) Considerations. The costs and benefits of the proposed Commission action shall be evaluated in light of—
> (A) considerations of protection of market participants and the public;
> (B) considerations of the efficiency, competitiveness, and financial integrity of futures markets;
> (C) considerations of price discovery;
> (D) considerations of sound risk management practices; and
> (E) other public interest considerations.
>
> (3) Applicability. This subsection does not apply to the following actions of the Commission:
> (A) An order that initiates, is part of, or is the result of an adjudicatory or investigative process of the Commission.
> (B) An emergency action.
> (C) A finding of fact regarding compliance with a requirement of the Commission.

The legislative history for section 15(a) is sparse, and appears to consist of this brief statement:

> [The CFMA] amends section 15 of the CEA to add a new subsection (a) requiring the CFTC, before promulgating regulations and issuing orders, to consider the costs and benefits of its action. This does not apply to orders associated with an adjudicatory or investigative process, or to emergency actions or findings of fact regarding compliance with CFTC rules.[12]

CFTC first interpreted new section 15(a) in a proposed rule titled "Addressing a New Regulatory Framework for Trading Facilities, Intermediaries and Clearing Organizations":[13]

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[11] Commodity Futures Modernization Act of 2000, section 119, Appendix E, Pub. L. No. 106-554, 114 Stat. 2763 (2000).
[12] This statement is found in 106 H. Rpt. 711; Prt 1, *_____ (June 29, 2000); 106 S. Rpt. 390, *___ (August 25, 2000); and 106 H. Rpt. 711; Prt 3, *___ (September 6, 2000).
[13] 66 FR 14262 (March 9, 2001).

The proposed rule listed the five factors under section 15(a) and provided a brief, qualitative discussion of associated benefits and costs for each factor. The CFTC's approach to cost-benefit analysis under section 15(a) has remained relatively consistent through the years, though the Commission did drop the practice of separately listing the section 15(a) factors. [14] It appears section 15(a) has never been challenged in the courts.

Methodology for Cost-Benefit Analysis Under the Dodd-Frank Act

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act.[15] As described by the CFTC, Title VII of the Dodd-Frank Act amended the Commodity Exchange Act[16] to

> ...establish a comprehensive, new regulatory framework for swaps and security-based swaps. The legislation was enacted to reduce risk, increase transparency, and promote market integrity within the financial system by, among other things: (1) Providing for the registration and comprehensive regulation of swap dealers and major swap participants; (2) imposing clearing and trade execution requirements on standardized derivative products; (3) creating robust recordkeeping and real-time reporting regimes; and (4) enhancing the Commission's rulemaking and enforcement authorities with respect to, among others, all registered entities and intermediaries subject to the Commission's oversight.[17]

The Dodd-Frank Act required the Commission to promulgate regulations to implement the Act by July 15, 2011. CFTC began immediately to work on rule implementation, including the cost-benefit analyses.

From CFTC staff and management, we learned that from the outset the goal was to create a uniform cost-benefit analysis methodology for all Dodd-Frank rulemaking that would comply with section 15(a). Accordingly, the Office of General Counsel and Office of Chief Economist created the following template, which was distributed to staff in September 2010:

[14] See, e.g., Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulation, 75 FR 4144 (January 26, 2010).
[15] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank Act" or "Dodd-Frank").
[16] 7 USC section 1, *et seq.*
[17] Core Principles and Other Requirements for Designated Contract Markets; Proposed Rule, 75 FR 80572 (December 22, 2010).

> TEMPLATE
>
> Section 15(a) of the Commodity Exchange Act requires the Commission to consider the costs and benefits of its actions before issuing an order under the Act. By its terms, section 15(a) does not require the Commission to quantify the costs and benefits of rule or to determine whether the benefits of the order outweigh its costs; rather, it requires that the Commission "consider" the costs and benefits of its actions. Section 15(a) further specifies that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (1) protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. The Commission may in its discretion give greater weight to any one of the five enumerated areas and could in its discretion determine that, notwithstanding its costs, a particular rule is necessary or appropriate to protect the public interest or to effectuate any of the provisions or accomplish any of the purposes of the Act.
>
> Summary of proposed requirements. The proposed rule would [explain briefly the requirements of the rule].[18]
>
> Costs. With respect to costs, the Commission has determined that [draw conclusions about the costs of the rule, associating the appropriate cost-benefit categories either directly or by implication].
>
> Benefits. With respect to benefits, the Commission has determined that [draw conclusions about the benefits of the rule, associating the appropriate cost-benefit categories either directly or by implication].
>
> Public Comment. The Commission invites public comment on its cost-benefit considerations. Commenters are also are invited to submit any data or other information that they may have quantifying or qualifying the costs and benefits of the Proposal with their comment letters.

In addition, the General Counsel and Chief Economist issued the following guidance (the September 10 guidance) to be followed when completing the template:

> In the cost-benefit section of a proposed or interim final rulemaking, an initial analysis of the Commission's views of the costs and benefits of the proposed rule should be presented so that interested parties may submit comments that challenge, defend, or provide additional support for the analysis. A declarative statement of the anticipated effects of the proposed rule should be provided, in addition to requesting that interested parties submit their views on the five cost-benefit considerations enumerated in section 15.

[18] Brackets in original. Bracketed text contains instruction to CFTC staff.

> Typically, the costs typically may be presented by describing a counterfactual – what the Commission expects will happen if the rule is not adopted, with reference to previous or anticipated events. The benefits should be provided in declarative form.
>
> ...
>
> The costs discussion in the cost-benefit analysis section of a rulemaking should include a quantitative or qualitative description of the kinds of costs involved, and upon which parties they will be imposed. When presenting costs qualitatively, the costs should be compared to some relevant alternative to the rule (i.e., the benchmark). In many cases, the benchmark would be the status quo regulatory approach. In some contexts, however, an alternative benchmark may be appropriate. If the rulemaking was designed to avoid certain costs associated with an alternative rule that could have been imposed, it should be discussed here as well; essentially comparing the proposed rule to a second benchmark.
>
> ...
>
> With respect to the benefits associated with a proposed rulemaking, the comparison should be to the same benchmark(s) identified in the discussion of costs, and again the discussion should highlight the kinds of benefits anticipated, and the likely affected parties.[19]

THE COMMISSION'S COST-BENEFIT ANALYSES FOR FOUR PROPOSED RULES

1. Further Defining "Swap Dealer," "Security-based Swap Dealer," "Major Swap Participant," "Major Security-based Swap Participant," and "Eligible Contract Participant," 75 FR 80174 (December 21, 2010) (Joint proposed rule; proposed interpretations)

The Commission proposed definitions for "swap dealer" and "major swap participant," "major security-based swap participant" in December 2010.[20] With regard to cost-benefit analysis, the "entity definitions rule"[21] separately addressed the costs and benefits for each entity definition.

Discussions with CFTC staff and management and review of email indicate that some debate centered on how to craft the cost-benefit analysis in the context of a definitions rule, including some discussion whether the definitions rule would require much in the way of cost-benefit analysis at all. We were told that staff in the Office of Chief Economist prepared an initial draft that compared the qualitative costs to society of broad or inclusive definitions of

[19] Memorandum RE: *Guidance on and Template for Presenting Cost-Benefit Analyses for Commission Rulemakings*, September 29, 2010 (attached as Exhibit 1).

[20] Further Defining "Swap Dealer," "Security-based Swap Dealer," "Major Swap Participant," and "Eligible Contract Participant," 75 FR 80174 (December 21, 2010).

[21] Staff adopted nicknames for the rules assigned to the 30 rulemaking teams. We are using these nicknames in our report.

these terms versus narrower coverage. This was scrapped in favor of a draft that addressed the costs and benefits of the evaluative processes that market participants might undergo in order to determine coverage. Staff in the Office of General Counsel created the new draft. The Deputy General Counsel who reviewed the second draft was made aware of the earlier discussions but apparently did not review the earlier draft. Few changes were made to the second draft of the cost-benefit analysis.

Staff and management also considered the difficulty to the industry of evaluating and commenting on the proposed entities definitions rule concurrently with conduct rules for the defined market participants. Staff and management were aware that market participants might refrain from comment on conduct regulations in the mistaken belief that they would not fall within the definitions. However, at this stage in the rulemaking process, staff indicated the overriding concern was meeting the rule-making deadline under Dodd-Frank. Staff and management opined that the industry by and large knew that market participants conducting any significant swaps business or trading would expect to fall under the definitions of Swap Dealer, Security-based Swap Dealer, Major Swap Participant, Major Security-based Swap Participant, and Eligible Contract Participant (as appropriate). While market participants on the fringes could be expected to NOT know coverage in anticipation of the final definitions rule, these participants would constitute the minority of market participants eventually covered under the rule. Any market participant anticipating possible coverage under a new Dodd-Frank market participant definition should know to review and offer comment on the conduct rules in anticipation of coverage, staff and management in the Office of General Counsel opined.

Section 712(d)(1) of the Dodd-Frank Act required CFTC and the Securities and Exchange Commission (SEC), in consultation with the Board of Governors of the Federal Reserve System (FRB), to jointly define the terms in this rule. Another concern voiced by staff and management regarding the definitions rule was the additional time necessitated for joint rulemakings with the SEC and FRB. Collaboration would necessarily involve more time. CFTC management determined early on that the additional time necessary for the required collaboration would not permit the definitions to be adopted in advance of conduct rules.

However, in light of the collaborative requirement, an advanced notice of proposed rulemaking was published for this rule (prior to the proposed rulemaking).[22] Over 80 comments were received. The proposed rulemaking does not indicate that commenters on the advanced notice of proposed rulemaking discussed costs associated with the definitions, although several general statements indicating the definitions could lead to greater costs were received.[23] The proposed rulemaking does request further comments regarding costs.

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[22] See, Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act, Exchange Act Rel. No. 34-62717, 75 FR 51429 (Aug. 20, 2010). The comment period closed on September 20, 2010.

[23] See Comments filed by: Hess Corporation, available at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26196&SearchText=; Dairy Farmers of America, Inc., available at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26190&SearchText= ; Metropolitan Life Insurance Company, available at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26178&SearchText=.

In the proposed rule, the cost-benefit analysis[24] states that the costs to market participants associated with the proposed definition of "swap dealer" would arise "primarily from its need to review its activities and determine, as a qualitative matter, whether its activities are of the type described" in the proposed regulation. In addition, market participants would need "to repeat this review" from time to time as its activities change. Because the Commission proposed a quantitative de minimis exception, the costs associated with determining coverage under the exception would be "lower."

Benefits associated with the type of criteria selected by the Commission to indicate coverage would include the presence of a "single set of criteria to be applied by all market participants" which, according to the Commission, would create a "level playing field that permits all market participants to determine, on an equal basis, which activities" would trigger designation as a swap dealer. The benefit associated with a quantified de minimis exemption (and the exclusion of swaps in connection with the origination of loans) is the ability to make a relatively quick and low-cost determination whether the exemption applies.

Likewise, costs associated with the proposed definition of "major swap participant," would "arise primarily" from the expense associated with the analytical process necessary to determine whether the definition applies. The Commission stated it had considered more complex tests, i.e., "market-based tests of potential future exposure such as margin requirements or other valuations of the outstanding position," but opted to "define potential future exposure by a factor of the dollar notational value of the swap." Costs of a detailed analysis "would vary for each market participant."

Under the proposed rule, market participants may request limited designation as a major swap participant, but the costs associated with such requests, according to the Commission, "are difficult to predict because they would depend on the complexity of the particular case." Benefits associated with establishing limited designation as a major swap participant were not discussed.

Benefits associated with the Commission's proposed definition of "major swap participant" include the presence of a "bright-line test that can be applied at a relatively low cost." The Commission also opined that the definition of "hedging or mitigating commercial risk" was general and could be "flexibly applied." The Commission stated it had considered alternative definition methodologies, including "multi-factor analyses, stress tests and adversary processes," but concluded they would result in significantly higher costs without providing equal additional benefits.

The Commission opined that the proposed definition of "eligible contract participant" was "in line with the expectations of market participants and would impose virtually no costs while providing the benefit of greater certainty." To the extent the proposal would also clarify that certain commodity pools could not qualify as eligible contract participants under certain provisions, the Commission stated that while this clarification would potentially impose some

[24] 75 FR 80173, 80203-80205 (December 21, 2010).

costs on the commodity pools that could no longer rely on certain provisions of the definition, benefits would arise from preventing the misinterpretation of the definition.[25]

Generally speaking, it appears CFTC employees did not consider quantifying costs when conducting cost-benefit analyses for the definitions rule. As indicated in the rule's preamble, the costs and benefits associated with coverage under the various definitions (in light of the various regulatory burdens that could eventually be associated with coverage) were not addressed, and instead the cost-benefit analysis addressed the relative costs and benefits of undergoing the process of determining coverage. Costs of *being* covered would emanate from the business conduct requirements adopted through other rules.

We note that, in the same proposed rule, the Securities and Exchange Commission did opt to include in their analyses of costs associated with coverage under the definitions of "security-based swap dealer" and "major security-based swap participant," costs associated with the regulatory requirements associated with inclusion, e.g., the registration, margin, capital, and business conduct requirements. While the SEC acknowledged that the costs and benefits associated with compliance with regulatory requirements would be addressed in the separate rules, it welcomed comment on costs and benefits of the definitions "in that broader context."[26]

The comment period for this proposed rule closed on February 22, 2011.

2. Confirmation, Portfolio Reconciliation, Compression Requirements for Swap Dealers and Major Swap Participants, 75 FR 81519 (December 28, 2010) (Notice of proposed rulemaking)

The Commission proposed confirmation, portfolio reconciliation, and compression requirements for swap dealers and major swap participants in December 2010.[27] Section 731 of the Dodd-Frank Act added to the Commodity Exchange Act new section 4s(i), a requirement that all swap dealers and major swap participants adhere to standards adopted by the Commission relating to confirmation, processing, netting, documentation and valuation of all swaps. The team assigned to this rule called this one "the compression rule." Not all members of the team were assigned to the drafting of this rule.

Team members assigned to the compression rule explained their belief that the regulations proposed by the Commission would build upon work begun several years earlier. In 2005 the Commission participated in the OTC Derivatives Supervisors' Group (ODSG. Lead by the Federal Reserve Bank of New York, the ODSG had for several years encouraged the industry to perform many of the tasks now being committed to regulation. Team members believed the industry had complied with the efforts of the ODSG, that the proposed regulations did not impose further tasks or duties, and therefore the costs of compliance with new regulations that clarified now-current practices would be minimal. Staff were aware that start-up costs for those

[25] *Id.*, 75 FR at 80203-80205.
[26] *Id.*, 75 FR at 80207.
[27] Core Principles and Other Requirements for Designated Contract Markets, 75 FR 80572 (December 22, 2010).

entities that had not followed ODSG-encouraged practices might be significant. Staff indicated they had recently received comments from Markit[28] offering further insight into costs associated with this rule.[29] CFTC staff met with representatives of Markit in March 23, 2011 to discuss the compression rule.[30]

Staff also told us that costs were addressed during discussions regarding the technical aspects of the rule. They pointed out that they requested comments on:

- ways to reduce the burdens associated with confirmation, reconciliation and compression for the swaps market;[31]
- the feasibility of staggered or delayed effective dates for some regulations, (recognizing that some entities may not have the capacity to comply with the new regulations as quickly as the larger, established swap dealers and major swap participants);[32]

Staff stated that, in an effort to lessen potential costs of compliance, the proposed rule did not prescribe a particular venue or platform for confirmation.[33] Staff stated discussions regarding how to avoid unnecessary or minimize compliance costs were considered during the team's process of formulating the proposed compression rule. Staff explained that the benefits of portfolio compression were discussed in the text of the preamble, separate from the cost-benefit analysis section.[34]

The cost-benefit analysis section was created by a subset of the team, using the September 2010 guidance and template created by the Office of General Counsel and Office of Chief Economist.[35] Discussions with staff and management on the team and review of email indicate that there were no significant debates regarding the approach to take with regard to the cost-benefit analysis section. However, staff in the Office of Chief Economist were not sure that they were invited to all relevant meetings connected with this rulemaking and stated that, for this rule, they reviewed the cost-benefit analysis section without drafting it or having significant input. Staff in the Office of Chief Economist at that time were also concerned with the order of rulemaking, expressing concern that formal adoption of the definitions for "swap dealer" and "major swap participant" should precede adoption of regulations governing them.

In any event, the cost-benefit analysis characterized the costs of compliance as "nominal" and "minimal" because the confirmation, reconciliation and compression processes are already part of compliance practices that "many, if not most, swap dealers and major swap participants already undertake as part of their ordinary course of business." The cost-benefit analysis also stated that "most" swap dealers and major swap participants have adequate resources and existing back office systems to accommodate any changes necessitated by the new rules "without

[28] Markit is a financial information services company providing independent data, valuations, trade processing, loan portfolio management, and other services. www.markit.com.
[29] Available at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=30669&SearchText=markit.
[30] Meeting details are available here: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=32274&SearchText=markit.
[31] 75 FR 81519, 81521 (December 28, 2010).
[32] *Id.* 75 FR at 81521-81522.
[33] *Id.* 75 FR at 81523.
[34] *Id.* 75 FR at 81525.
[35] See Exhibit 1.

material diversion of resources away from commercial operations." Third party vendors are also available, and to the extent the pay per unit (i.e., number of swaps processed), the costs "would be necessarily proportionate to the benefit."

The benefits associated with the compression rule included "reduced risk, increased transparency, and greater market integrity" for swaps, as well as furtherance of the goal of "avoiding market disruptions and financial losses to market participants and the general public." The cost-benefit section also stated the compression rule would "promote levels of operational scalability and resilience that are most evident in periods of sustained high volume and market volatility."

The comment period for this rule closed on February 22, 2011.

3. Core Principles and Other Requirements for Designated Contract Markets, 75 FR 80572 (December 22, 2010) (Notice of proposed rulemaking)

Section 723(a)(3) of the Dodd-Frank Act added section 2(h)(8) of the Commodity Exchange Act to require, among other things, that execution of swaps subject to clearing under the Commodity Exchange Act must occur either on a Designated Contract Market (DCM) or on a swaps execution facility. The Commission published its proposed rule governing core principles and other requirements for designated contract markets on December 22, 2010. The proposed rules added five new core principles for trading futures and option contracts, and required DCMs that list standardized swaps for trading to comply with the same core principles applicable to trading futures contracts. The proposed rule also replaced certain "guidance and acceptable practices" with regulations. The proposed rule included several procedural changes for application for designation as a contract market, including abandonment of expedited procedures.

With regard to the cost-benefit analyses for the DCM core principles rule,[36] staff explained that the process for this rule went relatively smoothly, with staff in the Office of General Counsel drafting the cost-benefit analysis with some edits from the Office of Chief Economist and from other members of the rule-making team. However, staff from the team wanted us to know about disputes regarding an earlier rule addressing swap execution facilities. In connection with the earlier rule, the Office of Chief Economist edited an initial draft created by staff in the Office of General Counsel. To put the dispute in simplest terms, the Office of Chief Economist undertook a cost-benefit analysis that addressed costs associated with separate tasks set out in various sections of the rule. Staff in the Office of General Counsel strongly encouraged the staff from the Office of Chief Economist not to deviate from accepted methodologies for cost-benefit analyses employed by the Commission for 10 years, which apparently limited cost-benefit analysis to the rule as a whole. Staff from the Office of General Counsel opined that litigation risk could result from deviating from this long-standing standard, and that the adoption of a new methodology could require the Commission to engage in the same methodology for future rules (or a litigation risk could result). Inasmuch as the Commission's

[36] Core Principles and Other Requirements for Designated Contract Markets, 75 FR 80572 (December 22, 2010) (Notice of proposed rulemaking).

cost-benefit analyses in rulemakings had never been challenged in court, we consider prior practice in this instance to not carry as much weight as if it had received judicial approval. Moreover, from our review of relevant email and memoranda, it appears that other staff within the Office of General Counsel did not embrace this view. In the end, staff in the Office of General Counsel performed additional edits to the cost-benefit analyses, which was approved by the team leader and the team leader's boss.

The cost-benefit analysis of the DCM core principles rule stated that compliance with core principles for swaps trading on DCMs is "mandatory under the Dodd-Frank Act, and any additional costs associated with these procedures are required by the implementation of the Dodd-Frank Act."[37] The Commission recognized that, while the new regulations (replacing certain guidance and acceptable practices with regulations) generally codify existing industry practice, they may impose "some costs" on DCMs. With regard to abandonment of former expedited procedures for DCM applicants (resulting in additional costs associated with longer procedures), the Commission stated that "few DCMs have been eligible for designation under the expedited procedures, so these costs should be limited."

With regard to benefits, the Commission stated that transaction of swaps on DCMs will result in competition that will "benefit the marketplace." The Commission stated that "the ability to trade standardized swaps openly and competitively additionally will provide market participants with enhanced price transparency resulting in greater protection of market participants and the public." The new and amended core principles would, in the Commission's view, benefit the public by further enhancing the transparency and integrity of futures and options markets as well as swap markets on DCMs. Replacing former guidance and acceptable practices will benefit DCMs and the public by providing "regulatory certainty," and changes to the procedures for applying for designation as a contract market would "benefit new applicants by improving the workability and efficiency of the application process."

Certain staff on the DCM core principles rule team stated that they did not expect a lot of comments regarding costs because they believed they were putting into regulation practices that were already common in the industry. They stated that costs were a consideration during the rulemaking process, volunteering that they had attempted to take a flexible approach to compliance when possible, such as with regard to provisions for block trading and emergency procedures. They were aware the Chicago Mercantile Exchange and other commenters had raised the issue of costs in comments filed in response to the proposed rulemaking.[38] The Minneapolis Grain Exchange also suggested the proposed regulation may result in unnecessary costs,[39] as did the NYCE LIFFE U.S.[40]

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[37] Commissioner Sommers and Commissioner O'Malia dissented from the Commission's action to propose these regulations based on a disagreement with the Commission's interpretation of Core Principle 9 – *Execution of Transactions*. The cost-benefit analysis is not addressed in this dissent. The text of the dissent may be found here: http://www.cftc.gov/PressRoom/SpeechesTestimony/sommersstatement120110b.html.

[38] The CME's comment may be found here: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27876&SearchText=costs.

[39] The Minneapolis Grain Exchange's comment may be found here: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27908&SearchText=costs.

[40] The NYSE LIFFE US's comment may be found here: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27910&SearchText=costs.

On March 14, 2011, CFTC extended the original comment period for this rulemaking of February 22, 2011, to April 18, 2011.[41]

4. Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, 75 FR 71397 (November 23, 2010) (Notice of proposed rulemaking)

Section 731 of the Dodd-Frank Act added new section 4s(j) to the Commodity Exchange Act. Section 4s(j) set forth certain duties for swap dealers and major swap participants, and the Commission proposed regulations pertaining to duties for swap dealers and major swap participants in November 2010.[42] The nickname assigned to this rule by CFTC staff was "the duties rule." The duties rule for swap dealers and major swap participants was handled by the same team that created the compression rule.[43]

While the compression rule had a narrower focus, the duties rule more broadly addressed risk management infrastructure. That is, the duties rule set out the monitoring and other procedures associated with risk management (so-called "back office operations") a swaps dealer or major swaps participant would need in place in order to "do" swaps. CFTC staff and management indicated that, as with the compression rule, the duties rule would commit to regulation practices previously encouraged by the OTC Derivatives Supervisors' Group, lead by the Federal Reserve Bank of New York. While the preamble to the duties rule does not discuss the OTC Derivatives Supervisors' Group, the preamble to the compression rule does state that the OTC Derivatives Supervisors' Group "regularly set goals and commitments to bring risk management improvements to all OTC derivatives asset classes."[44]

Because the industry had begun performing many of the duties set out in the rule, the team did not anticipate that the duties rule would add additional costs for much of the industry. They were aware that entities falling under the definitions of "swap dealer" and "major swap participant" for the first time would face new costs.

As with the compression rule, the team stated that costs associated with compliance with the more detailed aspects of the regulation were discussed during the rulemaking process. For instance, team members stated that costs were discussed in connection with regulations affecting audit trail and pre-trade documentation. They discussed permissible delays in documentation balanced against the need for the certainty (and avoidance of backlogs) afforded through faster (and more expensive) processing.

Staff pointed to spots in the preamble to the proposed rule where they indicated the extent to which costs had been considered. For instance, staff noted that the preamble stated --

[41] 76 FR 14825 (March 18, 2011).
[42] Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, 75 FR 71397 (November 23, 2010) (Notice of proposed rulemaking).
[43] Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants, 75 FR 81519 (December 38, 2010).
[44] *Id.*, 75 FR at 81520.

> [T]he Commission recognizes that there will be differences in the size and scope of the business of a particular swap dealers and major swap participants. Therefore, comments are solicited on whether certain provisions of the proposed regulations should be modified or adjusted to reflect the differences among swap dealers or major swap participants.[45]

--as well as

> The Commission recognizes that an individual firm must have the flexibility to implement specific policies and procedures unique to its circumstances. The Commission's rule has been designed such that the specific elements of a risk management program will vary depending on the size and complexity of a swap dealer's or major swap participant's business operations. Risk management policies are expected to provide for appropriate risk measurement methodologies, compliance monitoring and reporting, and on-going testing and assessment of the overall effectiveness of the program.[46]

--and

> The Commission also invites comments regarding an appropriate effective date for this regulation given the amount of time and cost that may be necessary for implementation of a comprehensive business continuity and disaster recovery plan.[47]

Team members stated that the cost-benefit analysis section of this proposed regulation was drafted by a team member very early in the process, and prior to creation of the September 2010 guidance. The first draft generally followed the format generally used for cost-benefit analysis following passage of section 15(a), and presented a qualitative analysis of costs and benefits under the section 15(a) factors.

Staff indicated that the second draft of the cost-benefit analysis was performed by a few members of the team. Comparison of the first draft and the published cost-benefit analysis indicated edits designed to conform the first draft to the template issued in September 2010. As with the compression rule, the team member from the Office of the Chief Economist did not participate with the drafting process, and is not certain that she was invited to all relevant meetings. The draft was reviewed by the team member assigned from the Office of Chief Economist and the Office of General Counsel, and no staff reported significant problems or disputes.

The cost-benefit analysis for the duties rule did include quantified costs.[48] The estimated annual cost to implement a comprehensive risk management program for swap dealers and major swap participants was $20,450.00 (each), or 204.5 hours at an hourly rate of $100/hour. One wonders how compliance cost estimates for swap dealers and major swap participants could be identical, given the differences between those two types of market participants. Moreover, the

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[45] *Id.*, 75 FR at 71398.
[46] *Id.*, 75 FR at 71399.
[47] *Id.*, 75 FR at 71401.
[48] *Id.*, 75 FR at 71403.

Paperwork Reduction Act (PRA)[49] discussion also estimated 204.5 hours for swap dealers and major swap participants "to generate, maintain, or provide information to or for a Federal Agency."[50] In any event, the basis for the estimated cost to implement a comprehensive risk management program is not given, and appears to be an error. The hourly rate of $100/hour was explained in the PRA discussion, and it was based on statistics published by the Bureau of Labor.

Under the heading, "Costs," some benefits are listed. The "Costs" section includes the statement: "the new regulatory requirements are far outweighed by the benefits to the financial system as a whole," and:

> For example, a swap dealer or major swap participant would need to consider, among other things, the experience and qualifications of relevant risk management personnel, as well as the separation of duties among personnel in the business unit, when designing and implementing its risk management policies and procedures. These considerations would help facilitate the development of a risk management program that appropriately addresses the risks posed by the swap dealer's or major swap participant's business and the environment in which such business is being conducted. In addition, these considerations would guide a swap dealer or major swap participant in the implementation of specific policies and procedures unique to its circumstances.

As with the compression rule, the cost-benefit section of the duties rule stated:

> Most swap dealers and major swap participants have adequate resources and existing risk management structures that are capable of adjusting to the new regulatory framework without material diversion of resources away from commercial operations.

CROSS-CUTTING ISSUES ASSOCIATED WITH THE FOUR PROPOSED RULES

For the four proposed rules we were requested to investigate, we identified several cross-cutting concerns raised by CFTC staff and management, and raised by our Office. Issues raised across the board by CFTC staff and management include:

1. Unprecedented Nature of the Regulatory Initiative/Paradigm Shift.

From all CFTC divisions, the staff and management emphasized that Dodd-Frank required regulation of the swaps industry for the first time and therefore presented unprecedented challenges. Calculating costs to establish a swaps execution facility, for instance, which had never before existed under CFTC regulations, was described as a formidable challenge. Staff hoped to obtain cost estimates in comments submitted in response to the proposed rules. Staff indicated that comments were currently being assessed.

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[49] 44 U.S.C. chapter 35; see 5 C.F.R. Part 1320.

[50] *Id.*, 75 FR at 71402 (quoting 44 U.S.C. 3502(2)).

2. Historic Difficulty of Quantifying Industry Costs.

Staff and management agreed that, historically, the industry has not presented the CFTC with quantified costs associated with compliance with existing or proposed regulations. Staff opined that the industry considers compliance costs to be proprietary and confidential information. Consequently, staff opined that commenters would be highly unlikely to quantify projected costs for compliance in the context of a federal rulemaking due to the fact that comments are made available to the public. CFTC staff stated they were certain that the industry has calculated its projected costs; however, there is no requirement to disclose cost information to the CFTC in connection with the proposal and adoption of a rule.

3. Frustration with Confusion Surrounding the Paperwork Reduction Act.

Staff expressed some frustration with a perceived confusion of costs listed under the PRA[51] section of the proposed rules as compared with the cost-benefit analysis. PRA only requires a tally of costs associated with completing and filing forms, but does not require other costs associated with completion of forms, such as legal and supervisory review. PRA costs necessarily will be lower than overall costs to complete forms, and lower than overall compliance costs. Staff did express a desire to better explain PRA in the future. We agree.

4. Need to Avoid Addressing Costs and Benefits for the Mandatory Aspects of Dodd-Frank.

To the extent the Dodd-Frank Act imposed mandatory requirements, staff uniformly stressed a desire to refrain from expressing mandatory rules in terms of costs and benefits. If Congress required certain conduct, then Congress necessarily had determined that the benefits would outweigh costs.

5. Costs were Considered During the Process of Constructing the Dodd-Frank Rules.

Staff on the rule-making teams stressed that costs were considered during the rulemaking process. In both internal discussions and meetings with industry representatives[52] costs were raised with a view to determining how to implement requirements that would result in less cost without sacrificing legitimate regulatory needs. Staff had difficulty quantifying time devoted to cost-benefit analysis for this reason.

In addition, our Office identified the following issues that applied to all four rulemakings we reviewed:

[51] 44 U.S.C. chapter 35; see 5 C.F.R. Part 1320.

[52] CFTC has had at least 675 meetings with outside individuals concerning the Dodd-Frank rules. Testimony of Chairman Gary Gensler before the Senate Committee on Banking, Housing and Urban Affairs, available at http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-77.html.

1. Section 15(a) Compliance was Grouped with PRA and Regulatory Flexibility Act Discussions.

For all four rules we were asked to examine, the cost-benefit analysis was placed at the end of the preamble to the proposed text of the regulation, next to the PRA discussion and the Regulatory Flexibility Act discussion. These three portions were considered non-technical and we got the impression that, prior to enactment of Dodd-Frank, they were generally the province of the Office of General Counsel rather than the CFTC staff tasked with crafting the technical details of a rule. The cost-benefit analysis, PRA discussion, and Regulatory Flexibility Act discussion was referred to by team members as the regulation's "caboose." This treatment of the cost-benefit analysis discussion might have given the impression that it was merely an administrative task associated with the rulemaking, rather than a substantive analysis of the rule.

2. Nobody Quantified Internal Costs Associated with Rule Implementation by CFTC.

Across the board, staff and management alike indicated that CFTC's internal costs were not calculated for purposes of analyzing the costs and benefits associated with the four proposed rulemakings. CFTC management stated that staff labor necessary to implement Dodd-Frank had been calculated overall by each Division, and these quantified estimates were included in CFTC budget submissions, but the cost to implement each regulation had not been quantified. Implementation costs were not reflected in the cost-benefit analyses for the four rules requested for investigation, or in any other rules we reviewed. CFTC also did not quantify or estimate opportunity costs, that is, the extent to which implementation of Dodd-Frank with existing staff would be expected to diminish regulatory efforts in other areas. We would note that Executive Order (EO) 12866 recommended the consideration of costs to the government of enforcement as part of the process of regulatory analysis.[53]

DEVELOPMENTS FOLLOWING PUBLICATION OF THE FOUR PROPOSED RULES

CFTC published the four rules suggested for this investigation between November 23, 2010 and December 28, 2010. On January 18, 2011, President Obama issued EO13563,[54] which states, among other things:

> [e]ach agency is directed to use the best available techniques to quantify anticipated present and future benefits and costs as accurately as possible. Where appropriate and permitted by law, each agency may consider (and discuss qualitatively) values that are difficult or impossible to quantify, including equity, human dignity, fairness, and distributive impacts.
>
> ***
>
> Where relevant, feasible, and consistent with regulatory objectives, and to the extent permitted by law, each agency shall identify and consider regulatory

[53] EO 12866 (September 30, 1993), 58 FR 51735, 51736 (October 4, 1993).
[54] 76 FR 3821 (January 18, 2011).

> approaches that reduce burdens and maintain flexibility and freedom of choice for the public.[55]

By its terms, EO 13563 did not apply to the CFTC. The Office of General Counsel briefed the CFTC Chairman on this new Executive Order. In light of instructions contained in EO 13563, CFTC created a new Dodd-Frank rulemaking team tasked with developing conforming rules to update the CFTC's existing regulations to take into account the provisions of the Act. [56]

Also in 2011, and as detailed in the March 11, 2011 letter requesting this investigation, cost-benefit analyses issued by the CFTC in connection with the Dodd-Frank rulemakings were subjected to various degrees of criticism by members of Congress, CFTC Commissioners, the industry, and the media.

On March 14, 2011, CFTC extended the original comment period for the DCM Core Principles rulemaking from February 22, 2011, to April 18, 2011.[57] CFTC also extended the comment period for proposed rules addressing risk management requirements for derivatives clearing organizations.[58] It does not appear that CFTC has published notice of an extension to file comments for any other proposed rules issued in accordance with the Dodd-Frank Act. The CFTC Chairman, however, told us that CFTC is accepting late comments as they are received.

The Chairman has informed us that he has directed the Office of General Counsel and Office of Chief Economist to provide guidance to staff for addressing cost-benefit analysis in final rules under Title VII of the Dodd Frank Act, including responding to public comments. It will assist teams in presenting the costs and benefits of final rules under Title VII of Dodd Frank and will incorporate elements of EO 13563.

ANALYSIS OF THE EIGHT FACTORS POSED BY CHAIRMAN LUCAS AND CHAIRMAN CONAWAY

1. The methodologies the CFTC uses to evaluate costs and benefits

This factor is fully addressed at pages six through 8 of this report.

As stated earlier, CFTC began an initiative to rework and improve the cost-benefit methodology under section 15(a). This enhancement to the existing policy overhaul was motivated by comments received to proposed Dodd-Frank rules, as well as criticisms of the cost-benefit analyses from the media and other sources. We understand the process of amending the cost benefit analysis methodology is currently ongoing.

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[55] *Id.*

[56] Testimony of Chairman Gary Gensler before the House Committee on Agriculture, February 10, 2011. Available at: http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-68.html.

[57] Comments Extension: 17 CFR Parts 1, 16, and 38 Core Principles and Other Requirements for Designated Contact Markets, 76 FR 14825 (March 18, 2011).

[58] Comments Extension: 17 CFR Part 39 Risk Management Requirements for Derivatives Clearing Organizations, 76 FR 16587 (March 24, 201).

2. Whether the sequence by which rules are proposed impacts the CFTC's ability to adequately evaluate costs and benefits

CFTC staff and management opined that, with regard to the definitions for both swaps and major swap participants, industry participants should broadly be aware of expected coverage of common terms. However, staff is aware that "fringe" products and industry participants are anticipating these rules. Agency staff and management are of the view that individuals and entities that anticipate possible coverage should review and comment on all rules that may apply. The CFTC Chairman has stated that no rules adopted under Dodd-Frank will be adopted prior to adoption of the definition rules that are currently proposed.

3. The extent to which, in light of budget constraints, the CFTC has sought outside input and expertise in evaluating costs and benefits

We are not aware of any entity or individual hired by CFTC specifically to assist with cost-benefit analyses under Dodd-Frank. The Chairman stated that CFTC has consulted individuals and entities in the course of numerous meetings held in connection with the Dodd-Frank rulemaking effort and noted on the CFTC website. Staff indicated that costs were addressed in both internal and public meetings in the course of the rulemaking effort.

4. The extent to which the CFTC has evaluated and distinguished the costs and benefits of proposed regulations on market participants of diverse sizes and from diverse sectors.

We did not encounter examples of CFTC requesting comment specifically aimed at smaller entities. However, staff stated that costs were discussed during the process of drafting the regulations, including costs for smaller entities. For instance, with regard to the compression rule,[59] team members told us that costs were discussed during meetings regarding the technical aspects of the rule. They pointed out that they requested comments on ways to reduce the burdens associated with confirmation, reconciliation and compression for the swaps market. They told us that, in an effort to reduce the potential burden on compliance, they requested comments on the feasibility of staggered or delayed effective dates for some regulations, and recognized that some entities may not have the capacity to comply with the new regulations as quickly as swap dealers and major swap participants. Staff stated that, in an effort to lessen potential costs of compliance, presumably for smaller as well as larger entities, the proposed rule did not prescribe a particular venue or platform for confirmation. Staff stated discussions regarding how to avoid unnecessary or minimize compliance costs were considered during the team's process of formulating the proposed compression rule.

With regard to the DCM core principles rule,[60] team members stated that costs were a consideration during the rulemaking process, volunteering that they had attempted to take a flexible approach to compliance when possible, presumably to accommodate smaller (and larger) entities. For instance, staff said they suggested a flexible approach regarding block trading and emergency procedures.

[59] Confirmation, Portfolio Reconciliation, Compression Requirements for Swap Dealers and Major Swap Participants, 75 FR 81519 (December 28, 2010).
[60] Core Principles and Other Requirements for Designated Contract Markets, 75 FR 80572 (December 22, 2010).

In the notice of proposed rulemaking for the duties rule,[61] the Commission stated:

> [T]he Commission recognizes that there will be differences in the size and scope of the business of a particular swap dealers and major swap participants. Therefore, comments are solicited on whether certain provisions of the proposed regulations should be modified or adjusted to reflect the differences among swap dealers or major swap participants.

5. The extent to which the CFTC gives special consideration to evaluating the costs and benefits for small businesses

Again, we found no indication that CFTC gave special consideration to evaluating the costs and benefits for small businesses (above and beyond the Regulatory Flexibility Act[62] statements), other that the statements from staff discussed above in response to the fourth question, discussed above.

6. The amount of time, on average, that Commission staff spent per rule evaluating costs and benefits as required by 15(a)

Obtaining an average time Commission staff spent per rule evaluating costs and benefits was not easy. We asked the team leaders to identify the individuals who had drafted the cost-benefit sections for the four rules, and then sat down with those individuals. If those individuals named other team members who had assisted with the cost-benefit analysis section, we interviewed those individuals as well, and so forth. Occasionally we encountered an individual named as an author or co-author of the cost-benefit analysis who told us he (or she) had done no drafting. From these individuals we learned that every team member reviewed every rule, including the cost-benefit analysis section; however, if cost-benefit analysis wasn't the focus of your work for the team, time spent reviewing it would be minimal. We questioned team members (from all Divisions) and team leaders. We have not included time spent by management in the Office of General Counsel or Division Directors on the cost benefit analyses.

Staff time devoted to cost benefit analyses for the four rules follows:

1. Further Defining "Swap Dealer," "Security-based Swap Dealer," "Major Swap Participant," "Major Security-based Swap Participant," and "Eligible Contract Participant."

For the definitions rule for swap dealers and major swap participants,[63] the team member who crafted the first draft worked in the Office of General Counsel, and estimated he spent approximately 20 hours creating the first draft. The team member from the Office of Chief Economist estimates he spent approximately 3 to 4 hours reviewing and editing the draft cost-

[61] Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, 75 FR 71397 (November 23, 2010).
[62] 5 U.S.C. sec. 601, et seq.
[63] Further Defining "Swap Dealer," "Security-based Swap Dealer," "Major Swap Participant," "Major security-based Swap Participant," and "Eligible Contract Participant," 75 FR 80174 (December 21, 2010).

benefit analysis. The team leader stated that she spent minimal time on the cost-benefit analysis, and spent most of her time on the technical aspects of the proposed rule.

2. Confirmation, Portfolio Reconciliation, Compression Requirements for Swap Dealers and Major Swap Participants.

and

4. Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants.

The same Dodd-Frank rulemaking team handled both the compression rule[64] and the duties rules for swaps dealers and major swaps participants.[65] With regard to the duties rule, the first draft of the cost-benefit analysis was created by a team member from the Division of Clearing and Intermediary Oversight, based on prior cost-benefit analyses published following passage of section 15(a) but before the September 2010 guidance issued for the Dodd-Frank rulemaking teams.[66] That first draft took about an hour and a half.

Following issuance of the September 2010 template, a sub-team undertook to create a second draft of the cost-benefit analysis for the duties rule. We were not able to ascertain the identities of the sub-team that undertook the second draft. A team member from the Office of General Counsel indicated that he spent couple hours editing the second draft.

The cost-benefit analysis for the compression rule was also drafted by a sub-team. We were unable to pin down which members of the team comprised the sub-team that created the first draft. Consequently, our time estimate for the cost-benefit analysis for the compression rule and the duties rule likely is not complete. A member of the team from the Office of General Counsel indicated he spent a couple hours reviewing the cost-benefit analysis section for each rule after it was drafted. The team leader for both the duties and compression rules estimated she spent approximately five to 10 hours working on the cost-benefit analysis section for each rule, but stressed that costs and benefits were also discussed at various points during the rule-making process.

The team member from the Office of Chief Economist stated she did not spend a great deal of time on the cost-benefit analyses for the compression and duties rules because she believed they were complete when she received it. She was not sure she was invited to all relevant meetings for either rule. She indicated that during that period she was reviewing a great deal of draft proposed rules under Dodd-Frank for multiple teams, often with quick turn-around times. She was not a part of the sub-team that drafted the cost-benefit analysis for the duties rule or the compression rule.

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[64] Confirmation, Portfolio Reconciliation, Compression Requirements for Swap Dealers and Major Swap Participants, 75 FR 81519 (December 28, 2010).
[65] Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, 75 FR 71397 (November 23, 2010).
[66] See Exhibit 1.

3. Core Principles and Other Requirements for Designated Contract Markets.

With regard to the DCM core principles rule, the team member (from the Office of General Counsel) who drafted the cost-benefit analysis stated she spent approximately a half day working on the cost-benefit analysis for about a week (roughly 20 hours), and spent additional time dealing with revisions suggested by the team member from the Office of Chief Economist. The team member from the Office of Chief Economist told us he spent a great deal of time on the cost-benefit analysis section of the rule, but could not give us a precise number of hours. He also stated that costs were considered throughout the rulemaking process. The team leader for the definitions rule stated that he reviewed drafts of the entire rule throughout the process, but did not spend significant time editing the cost-benefit analysis section.

7. When one proposed rule is highly dependent on another, as is often the case in Title VII, the extent to which the CFTC gives consideration to the impact preceding or subsequent rules may have on the costs or the benefits of the rule under consideration

CFTC management asked about this factor indicated the same approach as to the situation created with proposed definitions rules preceding conduct rules for defined entities and products. Again, where a rule must be created in cooperation with other Agencies, these rules necessarily would run on a different schedule in order to assure compliance with the deadline for the Dodd-Frank rulemaking. Staff also stated that, to a very great extent, the rules are setting out in regulation what the industry has been moving toward for a number of years. The Chairman stressed that the definitions would be finalized prior to rules hinging on the final definitions. He also stressed that CFTC was continuing to receive comments past the rule closing dates, which presumably would permit commenters to respond in light of subsequently published related proposed rules. On March 16, 2011, the Chairman set out with some specificity his plans to issue Dodd-Frank rules in three stages structured to avoid adverse impact to the industry.[67]

8. The impact the current statutory deadline of Title VII has on the Commission's ability to conduct meaningful cost-benefit analysis and the extent to which an extension of the statutory deadline would improve the Commission's ability to consider the costs associated with proposed rules

As stated, above, the Chairman has determined not to adhere to the Dodd-Frank deadline and instead has initiated a structured approach, with intended promulgation of all rules by early Fall.[68] Presumably, this should permit a more extensive cost-benefit analysis of various rules to be employed.

[67] Gary Gensler, Remarks, "Implementing the Dodd-Frank Act," FIA's Annual International Futures Industry Conference, March 16, 2011; available at: http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-73.html.
[68] Id.

CONCLUSIONS AND RECOMMENDATION

Since enactment of the Dodd-Frank Act, CFTC has published more than 50 proposed rules, notices, or other requests related to the new law.[69] In accordance with section 15(a) of the Act, CFTC has published cost-benefit analyses with each proposed rule. We examined the cost-benefit analyses for four proposed rules dealing with definitions,[70] swaps portfolio compression and reconciliation,[71] DCM core principles,[72] and duties for swap dealers and major swap participants.[73]

While the methodology initially adopted by the Office of General Counsel and the Office of Chief Economist[74] would permit a detailed and thorough approach to the task, in the four proposed rules we examined it appears the Commission generally adopted a "one size fits all" approach to section 15(a) compliance without giving significant regard to the deliberations addressing idiosyncratic cost and benefit issues that were shaping each rule, and were often addressed in the preamble.

In our view, two analytical processes proceeded on separate tracks during the construction of each of the four rules. One the one hand, team members devoted to the technical aspects of the rule considered costs (and benefits) associated with the details of the proposed rule's specific instructions. Separately, other team members, who (often) were not as involved with the technical aspects of the proposed rule, drafted cost-benefit analyses in accord with the September 2010 guidance, and the cost-benefit analyses did not always appear to us to acknowledge the cost issues addressed by the technical side of the rule-making team. Even when the technical staff on a given team drafted the cost benefit analysis for a rule, which was the case for the duties rule and the compression rule, it appears that the economic factors considered and embraced or rejected during the course of constructing the rule were not included in the cost-benefit analysis, and instead the cost-benefit analysis was given an homogenized treatment. This separation was demonstrated in the placement of the cost-benefit analysis with the proposed rules' "caboose." Where costs of compliance with duties for swap dealers and major swap participants were quantified in some detail, the basis for the data was not provided.

Other aspects of the cost-benefit analyses gave us pause during our review. The confusion between cost-benefit analyses and the required PRA statement was troublesome. While PRA necessarily requires calculation of some costs associated with compliance, it does not present a complete (or even substantial) estimate. This needs to be better explained in proposed and final rules.

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[69] Statement of Jill E. Sommers, Commissioner, Commodity Futures Trading Commission, Before the Subcommittee on Oversight and Investigations, House Committee on Financial Services, March 30, 2011, available at: http://financialservices.house.gov/media/pdf/033011sommers.pdf .
[70] Further Defining "Swap Dealer", "Security-based Swap Dealer", "Major Swap Participant," "Major Security-based Swap Participant," and "Eligible Contract Participant," 75 FR 80174 (December 21, 2010).
[71] Confirmation, Portfolio Reconciliation, Compression Requirements for Swap Dealers and Major Swap Participants, 75 FR 81519 (December 28, 2010).
[72] Core Principles and Other Requirements for Designated Contract Markets, 75 FR 80572 (December 22, 2010).
[73] Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, 75 FR 71397 (November 23, 2010).
[74] See Exhibit 1.

We were also troubled at the lack of available (and verified) data pertaining to compliance costs borne by the industry, at least at the proposed rulemaking stage. Staff indicated that industry and market participants historically have not provided compliance costs to the Agency. However, information is being provided to the Commission at this point that does quantify costs. In addition to the rule comments cited throughout this report discussing costs (and we did not cite them all), we would recommend review of the transcript of the Third meeting of the CFTC Technology Advisory Committee presented by the Commission earlier this year. [75] At that meeting, the Commission was presented with a $1.8 billion cost estimate[76] to implement compliance with information technology requirements necessitated under Dodd-Frank, for the top 15 large dealers. We believe the Commission will have a formidable task verifying estimated costs submitted by industry sources, and squaring them with the apparent staff view that the Dodd-Frank rules (or at least the four we reviewed) largely document current practices. We have not attempted to do so here.

We note that the cost-benefit analyses for all four rules lacked any data whatsoever regarding the CFTC's internal costs to implement the Dodd-Frank rules. Inasmuch as the CFTC is projecting these costs in their budget submissions to Congress, we believe it would be feasible to estimate the costs of implementing the each regulation and include it in any cost-benefit analysis. CFTC's opportunity costs might also be considered.

We detect there was some impetus, at least among some staff, to continue to use the same methodology to conduct cost-benefit analyses that had been used since passage of the CFMA when other approaches were suggested by the Office of Chief Economist. Because section 15(a) compliance had never been challenged in the courts, it would appear there was no precedent approving (or disapproving) the Agency's older methodology. Moreover, the joint guidance issued in September 2010 did not require or emphasize adherence to prior methodologies. Instead, the September 2010 guidance would permit a detailed and in-depth qualitative or quantitative approach. We believe it should be followed in a more robust fashion.

In any event, it is clear that the Commission staff viewed section 15(a) compliance to constitute a legal issue more than an economic one, and the views of the Office of General Counsel therefore trumped those expressed by the Office of Chief Economist, at least for the four rules we reviewed. We do not believe this approach enhanced the economic analysis performed under section 15(a) for the four rules.

We believe that as a market regulator, any cost-benefit analysis should take account of price theory economics, which should involve the Chief Economist. While we recognize that an attorney may possess economic insights gained through his or her academic or professional background, the experience of economists who work with such questions on a daily basis should be helpful.

Although we have raised concerns regarding both the methodology and the resulting cost-benefit analyses for each of the four rules, a determination whether the cost benefit analyses

[75] Third Meeting of the Technology Advisory Committee, Washington, D.C. (March 1, 2011), page 179-available at: http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/tac_030111_transcript.pdf.

[76] "Technology Implications and Costs of Dodd-Frank on Financial Markets," Larry Tabb, Founder & CEO, TABB Group (March 1, 2011), available at: http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/tacpresentation030111_tabb.pdf.

would survive judicial scrutiny is not the object of this investigation. The Commission's performance under section 15(a) of the Commodity Exchange Act has never been challenged; however, in recent years the courts have identified weaknesses in the application of economic analysis to regulatory decisions, resulting in rules being sent back to regulators for further consideration.[77] We would suggest that a more robust examination of costs and benefits should only enhance the Agency's ability to defend its cost-benefit analyses.

We note that the Chairman has initiated a review and revision of the cost-benefit analyses guidance for use with final rulemakings. Work is ongoing, and we recommend that the Office of Chief Economist take on an enhanced or greater role under both the September 2010 guidance and any future methodologies for cost-benefit analyses.

We are encouraged that concerns regarding deadlines and the order of rulemaking raised in the March 11 request from Chairman Lucas and Chairman Conaway appear to be diverted, at least for the moment. The recently proposed plan to adopt the Dodd-Frank rules through a staggered approach may alleviate some concerns. We appreciate the Commission's good intentions in accepting late comments for closed rulemakings.

In closing, we believe that compliance with section 15(a) should not represent a ceiling when it comes to supporting regulation through economic analysis. We are mindful of the adage, "just because something is legal, doesn't make it right." And we wholeheartedly agree that, "[i]n the end, economic analysis is more than about satisfying procedural requirements for regulatory rulemaking."[78]

[77] See, e.g., *Am. Equity Investment Life Ins. Co. v. S.E.C.*, 613 F.3d 166, 177-178 (D.C. Cir. 2010) ; *Chamber of Commerce of U.S. v. S.E.C.*, 412 F.3d 133, 142-144 (D.C. Cir. 2005).

[78] Testimony of James A. Overdahl, Vice President, National Economic Research Associates, Before the Committee on Financial Services, Subcommittee on Oversight and Investigations, United States House of Representatives March 30, 2011, available at: http://financialservices.house.gov/media/pdf/033011overdahl.pdf.

Exhibit 1

U.S. COMMODITY FUTURES TRADING COMMISSION
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TO: Rulemaking Teams

FROM: Dan M. Berkovitz
General Counsel

Jim Moser
Acting Chief Economist

RE: *Guidance on and Template for Presenting Cost-Benefit Analyses for Commission Rulemakings*

DATE: September 29, 2010

Section 15(a) of the CEA requires the Commission to consider the costs and benefits before promulgating rules and certain orders.[1] Section 15(a) further specifies that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (1) protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. The Commission may in its discretion give greater weight to any one of the five enumerated areas and could in its discretion determine that, notwithstanding its costs, a particular rule is necessary or appropriate to protect the public interest or to effectuate any of the provisions or accomplish any of the purposes of the Act.

As the Commission's rulemakings have long recognized, section 15 does not require the Commission to quantify the costs and benefits of an action. However, the Commission cannot consider the costs and benefits of an action unless they are presented either quantitatively or qualitatively. Moreover, as courts have interpreted section 553 of the APA, interested persons must be fairly apprised of the issues involving a proposed rulemaking and must be given an opportunity to comment on the substantive inputs into an agency's decisionmaking.[2]

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[1] 7 U.S.C. 19(a).

[2] See, e.g., American Equity Inv. Life Ins. Co. v. S.E.C., 613 F.3d 166, 177 (D.C. Cir. 2010) (the SEC's consideration of the effect of a rule on competition, which was required by statute, was found to be arbitrary and capricious because a reasoned basis for that conclusion was not disclosed), Chamber of Commerce v. S.E.C., 412 F. 3d 133, 144 (D.C. Cir. 2006) (SEC failed to satisfy its statutory obligation to consider the economic consequences of a rulemaking when it did not apprise itself, or the public and the Congress, of the expected consequences through section 553 notice and comment); and Portland Cement Association v. Ruckelshaus, 486 F.2d 375, 394 (D.C. Cir. 1973) ("[i]t is not consonant with the purpose of a rule-making proceeding to promulgate rules on the basis of inadequate data, or on data that,[in] critical degree, is known only to the agency"), cited by American Radio Relay League v. FCC, 524 F.3d 227, 237 (D.C. Cir. 2008).

In the cost-benefit section of a proposed or interim final rulemaking, an initial analysis of the Commission's views of the costs and benefits of the proposed rule should be presented so that interested parties may submit comments that challenge, defend, or provide additional support for the analysis. A declarative statement of the anticipated effects of the proposed rule should be provided, in addition to requesting that interested parties submit their views on the five cost-benefit considerations enumerated in section 15.

Typically, the costs typically may be presented by describing a counterfactual – what the Commission expects will happen if the rule is not adopted, with reference to previous or anticipated events. The benefits should be provided in declarative form. It is not necessary to present costs and benefits serially for each of the five considerations contained in section 15. Rather, as the costs and benefits are presented, they may be associated with the appropriate considerations in the narrative.

Finally, the requirement to present the costs and benefits of a rulemaking should also assure compliance with the agency's obligations under the Congressional Review Act. Among other things, the Congressional Review Act requires agencies to submit their cost benefit analyses for Congressional review at the time a rule of general applicability is finalized.[3]

GUIDANCE FOR PRESENTING COSTS AND BENEFITS

Costs. The costs discussion in the cost-benefit analysis section of a rulemaking should include a quantitative or qualitative description of the kinds of costs involved, and upon which parties they will be imposed. When presenting costs qualitatively, the costs should be compared to some relevant alternative to the rule (i.e., the benchmark). In many cases, the benchmark would be the status quo regulatory approach. In some contexts, however, an alternative benchmark may be appropriate. If the rulemaking was designed to avoid certain costs associated with an alternative rule that could have been imposed, it should be discussed here as well; essentially comparing the proposed rule to a second benchmark.

> EXAMPLE 1: "The costs of the new capital requirements imposed on FCMs will consist primarily of lower profits to FCMs, as they need to attract more capital to support the same number of positions. These higher capital requirements may also lead FCMs to take smaller proprietary positions, or charge higher fees to customers, potentially reducing the liquidity of some markets.

Benefits. With respect to the benefits associated with a proposed rulemaking, the comparison should be to the same benchmark(s) identified in the discussion of costs, and again the discussion should highlight the kinds of benefits anticipated, and the likely affected parties.

> EXAMPLE 2: "The primary benefit of additional capital requirements is the additional customer protection against FCM failure, especially in the event of another liquidity shortage, such as the one that affected the economy in 2008."

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[3] See 5 U.S.C. 801(a)(1)(B)(i).

For assistance on applying this guidance to specific rulemakings, please contact the Office of Economic Analysis and the Office of General Counsel.

STANDARD TEMPLATE

The following standard template has been prepared to assure consistency across Commission rulemakings:

> Section 15(a) of the CEA[4] requires the Commission to consider the costs and benefits of its actions before issuing a rulemaking under the Act. By its terms, section 15(a) does not require the Commission to quantify the costs and benefits of rule or to determine whether the benefits of the rulemaking outweigh its costs; rather, it requires that the Commission "consider" the costs and benefits of its actions. Section 15(a) further specifies that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (1) protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. The Commission may in its discretion give greater weight to any one of the five enumerated areas and could in its discretion determine that, notwithstanding its costs, a particular rule is necessary or appropriate to protect the public interest or to effectuate any of the provisions or accomplish any of the purposes of the Act.
>
> Summary of proposed requirements. The proposed rule would [explain briefly the requirements of the rule].
>
> Costs. With respect to costs, the Commission has determined that [draw conclusions about the costs of the rule, associating the appropriate cost-benefit categories either directly or by implication].
>
> Benefits. With respect to benefits, the Commission has determined that [draw conclusions about the benefits of the rule, associating the appropriate cost-benefit categories either directly or by implication].
>
> Public Comment. The Commission invites public comment on its cost-benefit considerations. Commenters are also are invited to submit any data or other information that they may have quantifying or qualifying the costs and benefits of the Proposal with their comment letters.

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[4] 7 U.S.C. 19(a).

EXHIBIT “B”

CME Group

The CFTC's Proposed 85% Rule: Less Innovation, Higher Cost, Exporting Price Discovery and Increasing Systemic Risk

I. Executive Summary

The Commodity Futures Trading Commission ("CFTC" or "Commission") released a proposed rulemaking on December 22, 2010 (Proposed Regulation 38.502 – Minimum Centralized Market Trading Requirement) that, amongst other provisions, would require that a minimum of 85% of volume in futures and options contracts be conducted on the centralized market (the "85% Rule"). Thus, this Rule would limit "ex-pit" or non-competitive transactions (*e.g.*, block trades and exchange-for-physical transactions) to no more than 15% of total volume in such contracts.[1] The CFTC's proposal would force futures and options contracts exceeding the 15% threshold off of the listed exchange and onto either a swap execution facility ("SEF") or into the over-the-counter ("OTC") market. The Commission's stated rationale is to "balance the goal of protecting the price discovery process of trading in the centralized market, with the goal of allowing off-exchange transactions for bona fide business purposes."

The CFTC's 85% Rule is arbitrary, not required by The Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA"), and would result in the following unintended negative consequences:

- hindering the ability of U.S. futures exchanges to successfully develop new products
- incentivizing U.S. futures exchanges to list new products outside the U.S.;
- forcing mature and liquid futures contracts off of exchanges and onto SEF or OTC venues;
- increasing margin requirements for "reclassified contracts" by over 200%;
- creating market risk and adverse regulatory and tax consequences for market users;
- limiting access to "reclassified" contracts because only Eligible Contract Participants ("ECPs") may trade on SEF or OTC venues; and
- adversely impacting the CME ClearPort® offering, increasing systemic risk and reducing liquidity in U.S. energy futures.

For the reasons discussed below, the CFTC should abandon this arbitrary test and let exchanges, SEFs and market participants determine, through market forces, how any derivative instrument should be listed and traded. No public benefit is gained by one-size-fits-all rules, whether set by DCMs or the Commission. Indeed, every market is different and the value of the core principles regime is that it allows each registered entity the flexibility to tailor rules to fit the characteristics of the various products it lists and makes available for trading. So long as a DCM makes a good faith effort to support and develop an open and competitive market, it should be deemed to have fulfilled its obligations under Core Principle 9 to "provide a competitive, open and efficient market and mechanism for executing transactions."

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[1] An ex-pit transaction is one which is executed in a context apart from the traditional open outcry or electronically traded central limit order book ("CLOB") environments. These transactions include block trades and Exchanges for Related Positions ("EFRPs" or more commonly referred to as "EFPs"). CME Rule 538 defines ERRPs a transaction consisting "of two discrete but related simultaneous transactions. One party to the EFRP must be the buyer of (or the holder of the long market exposure associated with) the related position and the seller of the corresponding Exchange contract. The other party to the EFRP must be the seller of (or the holder of the short market exposure associated with) the related position and the buyer of the corresponding Exchange contract." However, there are several recognized varieties of EFRPs including Exchange for Physical ("EFPs"); Exchanges for Risk ("EFR"); and, Exchanges of Options for Options ("EOOs"). An EFP entails matching a futures position with an offsetting related cash position; an EFR matches futures with an OTC instrument; while an EOO matches an Exchange option position with an offsetting OTC option. But they are all collectively referred to as EFRPs per Exchange Rules.

II. Overview and Summary of Legislative History

Swap and futures contracts can be designed to replicate the same economic exposure to an underlying instrument, commodity or asset – making them indistinguishable in material economic effect for the user. Congress confirmed this fact in Dodd-Frank provisions that now codify equivalent regulatory treatment for futures and "economically equivalent" swaps. *See* e.g., Commodity Exchange Act ("CEA") 4a(a)(5). Such equivalency makes it extremely difficult, if not impossible, to separately define and categorize economically-equivalent swaps and futures. That swaps and futures can be economic equivalents is not new and has existed for decades. Historically, however, swaps were distinguishable from futures in the following manner:

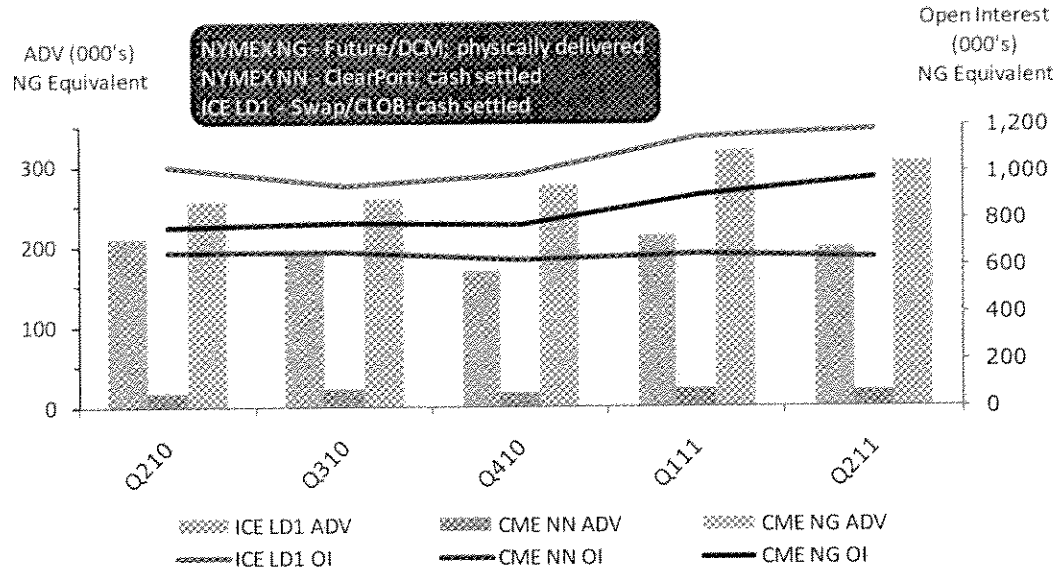
	Swaps	Futures
Degree of Standardization	Lack of standardization; negotiability of material terms	Fully standardized across all terms and conditions
Trading Model	Privately negotiated among sophisticated investors	Mainly centralized trading on an exchange
Regulatory Framework	Largely exempt from regulation within OTC space	Comprehensively regulated
Credit Model	Generally entail bilateral counterparty credit exposures	Centralized clearing model with clearing house guarantee.

CFTC Regulations, reinforced by exemptions enacted by the Commodity Futures Modernization Act of 2000 ("CFMA") further blurred the line between swaps and futures. CFMA permitted futures on certain commodities to be traded between ECPs in the OTC market. CFMA also permitted so-called swaps to be traded on electronic markets and centrally-cleared, but not intermediated. Significantly, nothing in CFMA limited exchanges' ability to list for trading futures products that mimicked non-exchange "swap" products and vice versa.

An example of the convergence between futures and swaps facilitated by CFMA is ICE's LD1 natural gas swap contract, depicted in Table 1 below. LD1 is a swap contract that is based on and prices off of NYMEX's physical delivery Henry Hub Natural Gas futures contract ("NG"). Both trade in a central limit order book environment, both are considered by the CFTC to be liquid "price discovery contracts" and both are centrally-cleared in the same manner as most actively-traded futures contracts; however, ICE's LD1 swap contract is traded as a swap on an Exempt Commercial Market whereas, NYMEX's NG futures contract trades on a designated contract market.[2]

[2] NYMEX also lists for trading a cash-settled version of NG, NN. Like NG, NN is a futures contract. Unlike NG, significant NN volume is transacted by bilateral trades.

Table 1: Trading Activity in Contracts Supporting Natural Gas Price Discovery



The market turmoil and financial crisis of 2008 highlighted the benefits of central counterparty clearing systems – long employed in the regulated futures markets – and the dangers of overreliance on bilateral OTC markets. Throughout the financial crisis, CFTC-regulated futures exchanges and clearing houses operated flawlessly, performing all of their essential functions without interruption. Indeed, while large financial firms regulated by other oversight agencies failed, CME Group's clearing house experienced no default and no customers on the futures side lost their collateral.

In response to the financial crisis, Congress enacted DFA in July 2010. Among other things, DFA is aimed at reducing systemic risk in OTC markets through central counterparty clearing and by increasing the transparency, liquidity and efficiency in OTC markets. To achieve these objectives, DFA established a new regulatory regime similar to that which exists for CFTC-regulated futures exchanges and their market participants, one that arguably mirrors the direction in which a number of OTC markets were headed under CFMA. In essence, DFA requires that standardized OTC products be cleared by a central counterparty and executed on a futures exchange or a SEF. DFA also establishes a comprehensive reporting regime for swaps and imposes enhanced prudential regulations on persons and entities trading those products.

With the amendments to the CEA by DFA, virtually all significant distinctions between futures and swaps have been eliminated. DFA, however, preserves "customer choice." That is, under DFA, market participants retain the option to trade products as either "futures" or "swaps"; in the case of an ECP, DFA allows market participants to choose the execution venue for trading swaps (with certain limitations). DFA does not – either in letter or spirit – force market participants out of the futures market and into the swaps market, or vice versa.

III. The CFTC's Proposed Rule Capping Trades Outside the Centralized Market

Core Principle 9 for DCMs – Execution of Transactions – states that a DCM "shall provide a competitive, open and efficient market and mechanism for executing transactions that protects the price discovery process of trading in the centralized market." Core Principle 9, however, expressly authorizes transactions outside the centralized market so long as those transactions are executed pursuant to DCM rules.

Specifically, Core Principle 9 provides that "the rules of a board of trade may authorize . . . (i) transfer trades or office trades; (ii) an exchange of (I) futures in connection with a cash commodity transaction; (II) futures for cash commodities; or (III) futures for swaps; or (iii) a futures commission merchant, acting as principal or agent, to enter into or confirm the execution of a contract for the purchase or sale of a commodity for future delivery if that contract is reported, recorded, or cleared in accordance with the rules of the contract market or [DCO]." In fact, amended Core Principle 9 explicitly recognizes that transactions on a DCM – whether futures or swaps – may be executed privately and bilaterally in order to serve a "bona fide business purpose."

In conflict with the plain terms of Core Principle 9, CFTC proposed rule 38.502(a) would require that 85% or greater of the total volume of any contract listed on a DCM be traded on the DCM's centralized market, as calculated over a 12 month period. Specifically, in relevant part, proposed rule 38.502 provides that no DCM "may continue to list a contract for trading unless an average of 85% or greater of the total volume of such contract is traded on the designated contract market's centralized market, as calculated over a 12 month period". This proposed rule would apply to contracts that are listed as of the effective date of the rule and any products listed after the effective date of the rule. If a contract fails this test, the DCM is required to delist the contract and transfer the open positions in the contract to a SEF (either one it operates or one operated by another entity) or require market participants to liquidate the contract within 90-days of performing the requisite calculation.

There will be significant adverse consequences for exchanges and market participants if this rule is adopted, yet there is no regulatory or public benefit from such rule. Access to the newly-styled "swap contract" on the SEF is limited to ECPs, prohibiting many potential customers with an interest in such product from trading the product. Disrupting the market in this manner will, among other things, artificially constrain the development of liquidity in affected products, harming customers in a manner that is directly contrary to the very purposes of the CEA and the mission of the CFTC. To be sure, other CFTC proposed rules would require margin levels for the reclassified "swap" contract to be significantly greater and would be set based on the execution venue, not the liquidity characteristics and referential pricing reliability for such product. Moreover, cross-margin benefits currently favoring customers who maintain open interest in both types of products likely would be significantly reduced or eliminated in some circumstances because of the above-referenced margin rule and the lack of clarity as to how swap and futures cross-margining will work given that there are separate account classes and rules governing collateral for futures and swaps. Finally, there may be market risk and adverse tax and regulatory consequences for market participants as a result of being forced into the swaps market. We discuss these issues in detail below.

IV. Unintended Adverse Consequences of the CFTC's Arbitrary Rule

1. **The 85% Rule will hinder the ability of exchanges to successfully develop new products.** The CFTC's arbitrary 85% test will significantly deter the development of new products by existing exchanges like CME Group, and furthermore deter any new futures exchanges from being established. New futures products often initially build open interest and gain trading momentum in exchange sanctioned non-competitive transactions, and in many instances, it takes years before trading on the centralized market becomes the predominant mode of trading. Based on our internal studies on new product performance, we have found that, on average, it sometimes takes as long as 36 months for new products to "achieve traction," which is defined as average daily volume ("ADV") > 1,000 contracts.[3] Specifically, the study showed that:

   - Agricultural Commodity and FX Products follow the overall trend, although their growth from months 6 to 36 is less pronounced so it takes them longer on average to achieve traction.

[3] To be clear, "achieving traction" does not mean that the product would pass the 85% test.

- Equity and Interest Rate products exhibit above-average growth and generally need less time to achieve traction.
- Alternative investment products exhibit sporadic growth, possibly due to their reliance on seasonal factors like weather and their lack of correlation with existing successful products.

During the introductory stage, a product is novel and volume may be slow. Marketing efforts may be extremely important in prompting customers to try the product. In the context of futures or other derivatives, the participation of market makers is paramount in "jump-starting" these products. This market making activity may be facilitated through electronic trading portals such as CME Globex® or through ex-pit transactions, which essentially represent a means through which customers may enter a "request for quote" ("RFQ") to be privately negotiated and executed.

Flexible block and EFP rules may be extremely helpful in sustaining nascent markets as they traverse the various product lifecycle stages, mustering liquidity in the process. But this process is very uneven across markets. Many, if not most, novel contracts fail to get past the introductory stage and may be delisted. As indicated in Tables 2 and 3 below, during the introductory stage of new contracts such as CBOT 5-Year Swap Futures and CME Ethanol Futures, the proportion of non-competitive trading activity may be relatively high, often in excess of the arbitrary 15% limit on such transactions.

Table 2: CBOT 5-Year Swap Futures – Total Volume and % of Ex-Pit Volume

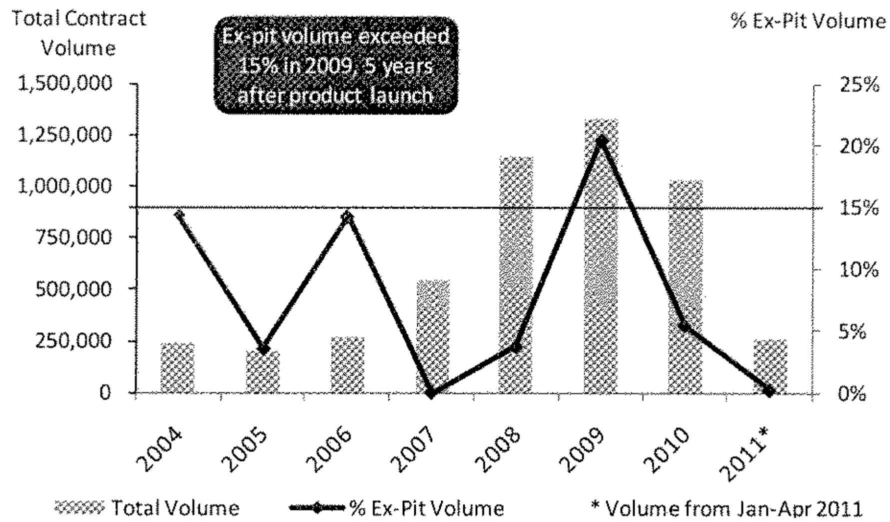
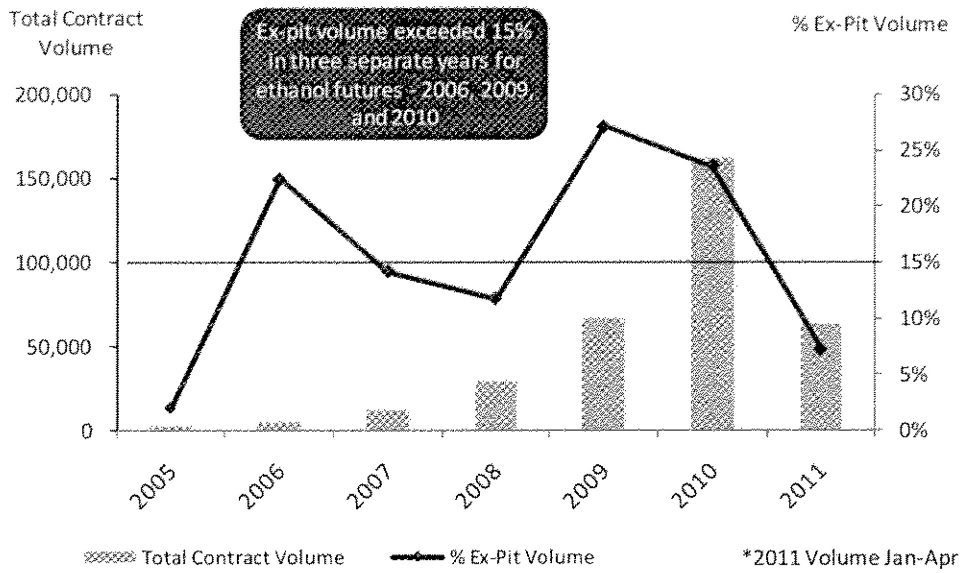


Table 3: CBOT Ethanol Futures – Total Volume and % of Ex-Pit Volume



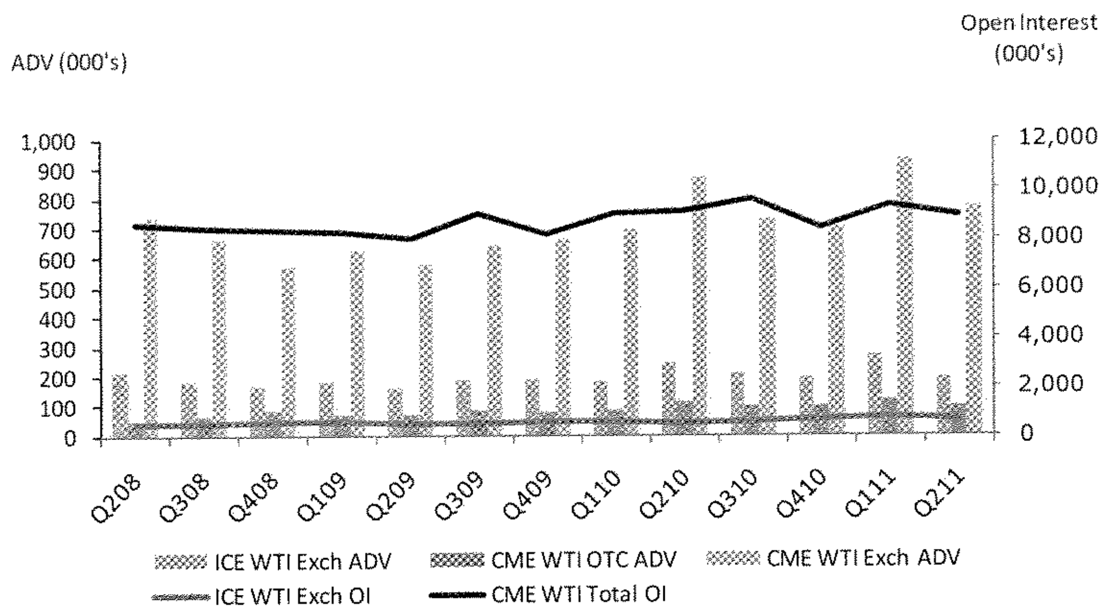
With a prescriptive rule requiring a futures product to be delisted if it fails the centralized market trading requirement threshold, customers likely will not establish new futures positions in nascent contracts. Doing so would subject them to the risk that, within 12 months, the product they were utilizing to hedge their position would no longer be available as a futures contract on a DCM. Customers prefer trade certainty and will therefore seek to trade the same product on a SEF or in the uncleared OTC market. Consequently, the proposed rule will significantly erode the potential for future innovation in futures markets, discouraging exchanges from listing anything but the most promising contracts while simultaneously discouraging customers from participating in building liquidity in any new products.

2. **The CFTC's 85% Rule will incentivize U.S. exchanges to list new products outside the U.S.** As illustrated above, new products are aided in developing liquidity in the centralized market by transactions executed outside the centralized market and the 85% Rule would arbitrarily and prematurely prevent many products from achieving traction and succeeding as futures products. With the risk of failing to meet the 85% Rule looming for both U.S. futures exchanges and their market participants, foreign regulatory regimes become an attractive alternative for listing new products or trading contracts offered by foreign exchanges that are not subject to this arbitrary rule, including cash-settled contracts that price off of and settle to the final settlement price of physically-delivered contracts trading on a U.S. exchange.

   An example of this can be seen in energy markets, where crude oil futures and swaps contracts are actively traded on both the CFTC-regulated NYMEX exchange and the foreign-regulated ICE exchange. The predominant price discovery contract for crude oil, WTI, is listed on NYMEX. NYMEX and ICE both list cash-settled futures contracts which are economically equivalent to NYMEX's WTI contract, as shown in Table 4 below. Based on current trading volume, NYMEX's cash-settled version of WTI would fail the Commission's proposed rule because more than 15% of the contract's volume is executed bilaterally, and submitted for clearing through CME ClearPort®. Failing this test would require NYMEX's cash-settled version of WTI to be delisted from the futures exchange and made available to trade as a swap on a SEF if NYMEX chose to continue to offer the product to the market. ICE's cash-settled version of WTI, however, would continue to be made available to trade as a futures contract because it is listed for trading on a European exchange, which is not subject to such an arbitrary regulatory requirement.

Rather than run the risk of failing the Commission's arbitrary test, it is likely that CME Group would seek to list a cash-settled version of WTI on a foreign exchange affiliate to ensure that we are able to effectively compete by offering customers a comparable cash-settled contract. Indeed, as discussed below, listing NYMEX's cash-settled WTI contract on a SEF would make it uncompetitive with ICE's cash-settled alternative because, among other things, market participants would lose margin offsets between their physical and cash positions, overall margin requirements would more than double due to 5-day margining requirements and certain market participants would be forced to hold increased capital in order to continue trading the product.

Table 4: Crude Oil Market Participants Heavily Use Cash-settled Swap Contracts in Addition to Physically-delivered Futures Contracts

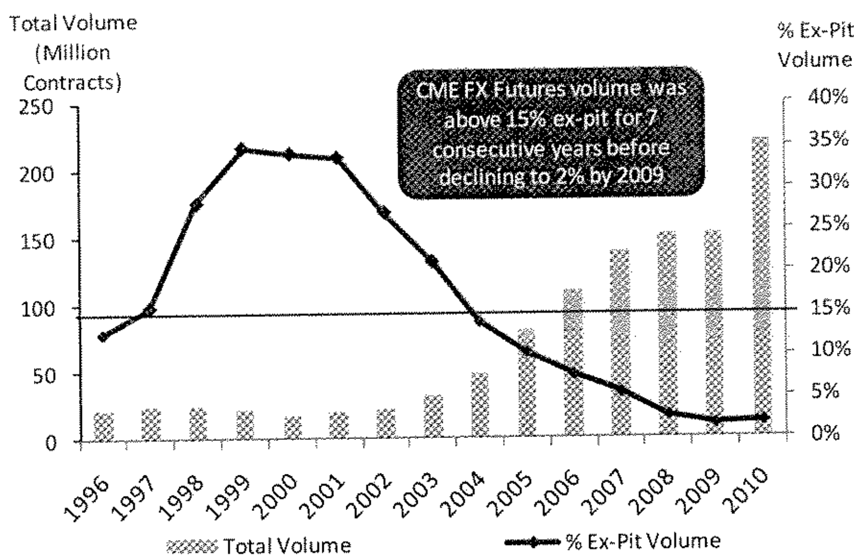


3. **The CFTC's 85% Rule will also force successful, mature and liquid futures contracts off of exchanges and onto SEF or OTC venues.** The CFTC's arbitrary test would cause many existing, liquid and successful contracts to be forced off of exchanges and onto SEF or OTC venues, preventing them from further developing into more liquid and transparent price discovery contracts. For example, in reviewing data for CME Group listed contracts, we determined that approximately 600 futures products will be reclassified as swaps; if we exclude energy and metals products from this number we have identified approximately 80 products that would fail. Within this group of products are several of our highly successful contracts which continue to serve legitimate customer needs.

   The arbitrariness of the proposed 85% Rule is well illustrated by looking at the evolution of CME's highly successful foreign exchange futures market. CME's foreign exchange products were first introduced in 1972 and quickly matured into a successful open outcry market. In the early to mid-1990s, CME's foreign exchange market began to lose momentum as the interbank market became increasingly electronic. In the late 1990s, CME's open outcry volumes had declined and market users began to use EFP transactions in CME FX markets because they did not have access to prices in the interbank market while trading in the pit at CME. As indicated in Table 5 below, between 1997 and 2003, CME FX products – which were then 25 years old, would have failed the CFTC's test, resulting in their delisting and transfer to a SEF or the OTC market had the rule been operative at that time. From 1999 to 2001, these products collectively traded above 30% ex-pit; and only moved within the 85% Requirement at 14% ex-pit in 2004; 10% in 2005; 8% in 2006; 6% in 2007; 3% in 2008; and 2% in 2009 and 2010. On an individual product basis, CME's Pound Sterling futures contract traded non-competitively above the 15% threshold from 1995 through 2004, and the highly liquid Euro futures contract traded more than 15% non-competitively from 1999 to 2003. In 2010 the Sterling and Euro only 1.6% and 0.9% of volume was executed non-competitively, respectively.

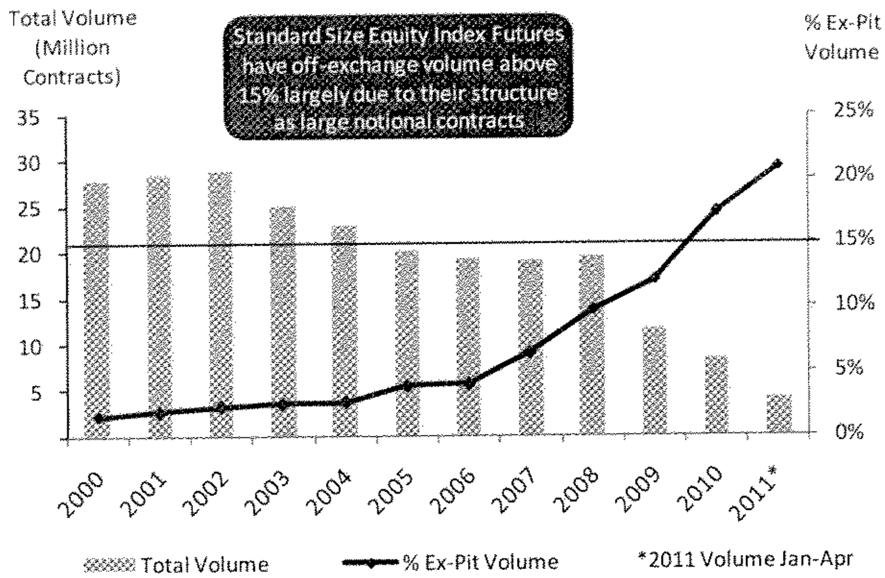
It is doubtful, if the rule had been operative during the early stages of these products' life-cycle that they would have subsequently developed in a fashion where an increasingly large percentage of total transactions were executed openly and competitively rather than through transactions outside the centralized market. Moreover, there is no evidence that price discovery in the central market suffered in any way during the time that central trading fell below 85%. Nevertheless, the CFTC proposals would count as an ex-pit trade that harmed price discovery, a block trade for 100 contracts where the futures commission merchant ("FCM") entered into the trade as a service to its customer and then laid off all the market risk it assumed in a subsequent futures trade in the central market. This common scenario underscores the arbitrary nature of the 85% restriction.

Table 5 CME FX Futures – Total Volume and % of Ex-Pit Volume



Other examples of products that would currently fail the Commission's test include our flagship standard size equity index futures contracts, including S&P 500®, NASDAQ 100®, S&P 400 Midcap®, $10 Dow®, and $25 Dow® futures. Unlike the CBOT 5-year swap futures or CBOT Ethanol futures, these products are very mature and have had robust volume and open interest for years, but would have failed the 85% test in recent years. These contracts have large notional contract sizes designed to appeal to particular customer segments, and, as shown in Table 6, privately negotiated transactions comprise more than 15% of the overall contract volume for these instruments. These standard size equity index futures are part of a broader suite of products, and as the eMini and eMicro futures contracts have gained traction, the standard size contracts continue to serve as a risk management tool for certain customer segments. To better frame the impact of such a rule, CME's standard size S&P 500 contract was, in 2010, the 11th largest equity index futures contract in the world by dollar value of volume traded. In the same year the volume of trading that occurred outside the centralized market accounted for 14.8% of trades in the standard S&P 500 contract. Simply put, the Commission's proposed rule would place the contract, 11th largest in the world, on the brink of delisting. Once again, this is a nonsensical result considering the liquidity and price discovery provided by the associated eMini futures contracts.

Table 6: CME Standard Size Equity Futures – S&P 500, S&P Midcap 400, Nasdaq 100, Dow Jones Industrial Average – Total Volume and % of Ex-Pit Volume



4. **The CFTC's 85% Rule will increase margin requirements by over 200%.** If a product is reclassified as a swap and is required to be traded on a SEF or OTC, under the CFTC's proposals market participants would be required to post more than twice the initial margin than if that same contract were permitted to be traded as a futures contract on a DCM. Specifically, another rule proposed by the CFTC would require a derivatives clearing organization ("DCO") to margin swaps submitted to it for clearing from a SEF or OTC based on losses that might be reasonably incurred over five business days, whereas the DCO would be permitted to margin a contract with identical terms and conditions submitted to it for clearing from a DCM based on losses that might be reasonably incurred over one day. The impact of the interaction of these two rules is remarkable. For example, based on the first six-months of trading in CME Group's standard S&P 500 futures contract, the contract would fail the 85% test by 1.79%. As a result of failing the test, this futures contract would be reclassified as a swap and be required to trade on a SEF or in the OTC market, increasing margin requirements by approximately 224% from $13.8 billion to $30.8 billion. Moreover, based on a recent analysis performed by CME Group, this change in margining would increase the overall collateral requirements for affected contracts by approximately 135%.[4] More specifically, based on a recent review of all CME Group products that would today fail the 85% test and be forced to be reclassified as a swap and traded on a SEF or OTC, market participants would lose approximately $7.6 billion in margin offsets, and overall initial margin payments would more than double from approximately $40 billion to $86 billion, increasing the cost of transacting by over $54 billion. Given the soundness of futures markets and central counterparty clearing historically, and more importantly, during the 2008 financial crisis, this adds unnecessary layers of cost to market participants.

[4] The overall increase in margin requirements for this collective group of products is approximately 135% rather than 224% because our clearing house currently margins many of these products for greater than 1-day liquidation.

Referring again to the various contracts supporting price discovery in natural gas, as depicted in Table 1, the 85% Rule would result in the following anomaly. NYMEX's cash-settled NN contract would fail to meet the test and be reclassified as a swap contract on a SEF – notwithstanding the fact that it is economically equivalent to and priced off of NYMEX's highly liquid, physically-delivered NG contract. As such, it would be subject to 5-day margining. In contrast, ICE's cash-settled LD1 contract, which is also economically equivalent to and prices off of NYMEX's NG contract would be eligible to trade on a DCM and receive 1 day margining. Given more than double margin requirements on the reclassified NN contracts, it is likely that customers will simply stop trading NN and migrate instead to ICE's LD1 contract. This example underscores the arbitrariness of the proposed 85% rule and the absence of any public benefit. It also again highlights the error in evaluating each instrument on a stand-alone basis where a given contract, which functions as a second-order derivative, accurately reflects the real-time, daily and final settlement price of a price discovery contract that meets the 85% test (e.g., NYMEX's NG contract).

5. **The CFTC's 85% Rule will create market risk and adverse tax and regulatory consequences for market participants holding "reclassified contracts."** The proposed 85% Rule requires that if a contract fails this centralized market trading threshold, market participants can either (i) trade for liquidation only or (ii) convert their futures open interest to swaps open interest. Both options have adverse consequences for market participants holding open interest in contracts that fail this arbitrary test.

   Market participants that must trade for liquidation only will face increased market risk as a result of this rule. Specifically, liquidity in the relevant market will be drained as a result of both other market participants' converting their open interest to swaps open interest and the absence of new participation in the market. In other words, it will be much more costly for those that trade for liquidation to ultimately get out of their positions because reduced liquidity likely will increase the bid-ask spread.

   Market participants choosing to convert their futures open interest into swaps open interest likely will experience adverse tax consequences. Specifically, futures contracts receive 60/40 tax treatment under the tax code. Swaps traded on a SEF or OTC do not. Many market participants value strongly the 60/40 tax treatment they receive trading futures products. For those that do, being forced to trade swaps on a SEF would result in an overall increase in the cost of doing business. For example, for an individual trader in the highest tax bracket, the trader would potentially net only $.65 on $1 of gain after federal income taxes at today's rates on a swap trading on an SEF. An economically equivalent future trading on a DCM would be marked to market for tax purposes and would net $.77 on the same $1 of gain. For an equivalent transaction, market participants lose 15% of their after-tax gains because they have been forced trade swaps instead of futures.

   Moreover, many market participants likely will qualify as "swap dealers" ("SDs") or "major swap participants" ("MSPs"). Qualifying as such comes with significantly enhanced regulatory requirements, resulting in what likely will be a substantial increase in the cost of doing business. Specifically, the CFTC is proposing capital requirements of $20 million plus additional amounts to cover (i) counterparty credit risk and (ii) additional market risk exposure.[5] Registration and detailed compliance obligations also would be imposed.

[5] This term refers to the additional amount of capital that must be maintained for the total potential market risk associated with such swaps and any product used to hedge such swaps, including futures, options, other swaps or security-based swaps, debt or equity securities, foreign currency, physical commodities, and other derivatives. The CFTC is proposing to include swap transactions and related hedge positions that are part of the SD's swap activities in the OTC derivatives credit risk requirement and market risk exposure requirement, and not swap positions or related hedges that are part of the SD's commercial operations.

6. **The CFTC's 85% Rule will limit the development of open and competitive price discovery markets by limiting access to "reclassified contracts" only to ECPs.** In order to trade swaps on a SEF or OTC, one must qualify as an ECP. ECPs include, among others, persons that are acting for their own account and are either: (a) a financial institution; (b) a commodity pool with total assets of $5M, (c) an entity with assets exceeding $10 million or having a net worth of $1 million and entering into the contract for purposes of managing the entity's risk; (d) an ERISA plan that has total assets exceeding $5 million, (e) a futures commission merchant, (f) a floor broker or trader, or (g) an individual with amounts invested on a discretionary basis, the aggregate of which is in excess of $10M or $5M and entering into the contract for purposes of his or her own risk management.[6]

   Limiting access to those market participants that do not qualify as ECPs is detrimental both to contracts forced off exchange as well as to market health, whereby liquidity and factors contributing to market depth and quality are lost with participants unable to transact. Moreover, it seems unfair and illogical to deny market participants that do not qualify as ECPs the ability to utilize the same risk management tools for their legitimate business purposes available to, generally speaking, wealthier market participants. In fact, this rule has the potential to lock non-ECPs out of price discovery markets altogether.

7. **The CFTC's 85% Rule would adversely impact the CME ClearPort® offering, increasing systemic risk and reducing liquidity in U.S. energy futures.** The CFTC's requirement that 85% of the volume of any futures contract listed for trading by a DCM trade via open outcry or on a CLOB would severely disrupt large portions of the market for illiquid energy futures contracts. The ability of producers and consumers to effectively hedge their energy risks will be significantly curtailed. The 85% limitation seems to be directed at shutting down the highly successful CME ClearPort® offering in energy rather than accomplishing a legitimate purpose of DFA.

   The notice of proposed rulemaking states: "The Commission believes that rather than seeking 4d orders for off-exchange products, certain DCMs have resorted to listing those products as futures despite their unlikely prospects for central marketplace trading, to achieve the same results as the Section 4d process to the possible detriment of the centralized market." (DCM Proposal at 90588, n. 95.) The Commission fails to explain the "detriment" to the centralized market nor does it offer any suggestion that any positive impact of its proposal is even remotely likely. The Commission's characterization of NYMEX's "ClearPort®" offering in the energy space ignores the significant risk mitigation value that this offering brings to the marketplace and market participants, including the contribution ClearPort makes to the price discovery process in the NYMEX suite of energy products.

   ClearPort® is a clearing technology that provides, among other things, capabilities for transactions executed in the first instance outside our centralized market to be cleared. NYMEX first offered this service to the OTC energy market in 2002 in response to demands for the elimination of trading counterparty credit risk in the wake of Enron's bankruptcy and the ultimate implosion of the energy merchant sector due to counterparty risk/credit concerns. At that time, Enron was counterparty to a significant volume of trades in the OTC energy space through its "Enron On-line" marketplace. This ClearPort offering reduces systemic risk by making a regulated clearing house the counterparty to every trade submitted for clearing. This innovative offering utilizes a transaction expressly permitted by the CEA – the exchange of futures for swaps ("EFS") – to bring OTC transactions into the clearing house so that customers ultimately hold a cleared futures position that, among other things, provides the customer greater protection in the event of a FCM bankruptcy and makes it easier in many markets for the customer to liquidate his or her position. Despite agreeing to permit the EFS transaction and allowing it to flourish in the energy markets for years, the Commission of late has taken the position that such transactions do not serve a legitimate business purpose because they harm price discovery. We, and many market participants, strongly disagree for the obvious reason

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[6] A full list of entities and persons that qualify as ECPs can be found at Section 1a(18) of the Commodity Exchange Act. This term is subject to further definition by the CFTC through the rulemaking process.

that most of the contracts cleared are not yet sufficiently liquid to be supported on a double sided auction CLOB. In consequence, the Commission's proposed 85% Rule would force many of our energy contracts off our exchange and onto a SEF or into the OTC market; another proposed rule would ban the EFS transactions employed by so many energy market participants.

Once again, the CFTC presumes that any EFS transaction, block trade or directed RFQ detracts from price discovery on the central market. This is inaccurate; the CFTC is taking a snap shot approach to price discovery rather than making an accurate and realistic appraisal of the entire process. Let's consider the example of a typical ClearPort trade – one party wants to manage a price risk, the other party is willing to assume it. If the product is as unique as are most ClearPort products, there is no likelihood that a party will find a useful quote waiting for him on the CLOB. Market makers are typically not equipped to expose themselves to the sharply discontinuous and imbalanced batching of orders that characterize illiquid markets of quoting illiquid products would essentially constitute a business of waiting to get picked off.

Under DFA, Clearport will employ a block trading process, which will bring information on all block trades to the market quickly. In addition to the publication of the block price, many market makers in the less liquid ClearPort products will off-set the risk by using standardized futures contracts traded on the CLOB. It would be typical for a dealer to enter into a ClearPort trade in Jet Fuel – with current open-interest of 50 million barrels – and hedge that risk immediately with a heating oil futures position on GLOBEX or another of the products in the NYMEX energy suite. In that instance, the ClearPort trade directly results in more price discovery on GLOBEX, not less, as the CFTC has apparently presumed.

ClearPort trades also promote other public interests. In their dissent to the 85% Rule and the proposed rule to ban the EFS transactions employed in the NYMEX energy space which make the execution of the transaction contingent upon being accepted for clearing, Commissioners Sommers and O'Malia noted that for the past decade, ClearPort transactions have provided significant regulatory and public benefit, particularly in the energy space:

> Over the past decade, a long list of non-standardized, illiquid contracts in the energy sphere have been executed off-exchange and cleared on-exchange through the exchange of futures for swaps (EFS) mechanism. The availability of clearing for these contracts added a level of safety, soundness and transparency to the marketplace that did not exist before. If the Commission had not permitted these contracts to be listed for clearing through the EFS process it is highly doubtful that the level of clearing that exists today for these contracts would have been achieved, and highly likely that this activity would have remained opaque to market participants and regulators. (75 FR 80636.)

The 85% rule would have the ultimate effect of moving at least 490 of our listed energy products off the NYMEX DCM and onto a SEF or into the OTC market. The open interest for these products is approximately 36.6 million contracts. The overall transaction volume for these products for the first 6 months of 2011 was approximately 65 million; trading outside the centralized market accounted for 77% of that volume. This entire market would be forced outside the auspices of NYMEX as a result of the 85% Rule. Significantly, we believe that at least 350 contracts within this group likely would not be subject to the trading and clearing mandate, which means these markets would be pushed into the OTC space. No regulatory or public benefit would be achieved by this result.

As stated in our comment letter in response to the Commission's rule proposal, to the extent that there is an unstated philosophical issue with the continued use of the EFS transactions currently employed in bringing OTC energy trades into the clearing house, we may allow market participants to achieve the same result by adopting block trading rules which will have the added benefit of providing post trade price reporting. Specifically, subsection (b)(iii) of Core Principle 9 states that the rules of DCMs may permit "a futures commission merchant, acting as principal or agent, to enter into or confirm the execution of a contract for the purchase or sale of a commodity for future delivery if that contract is reported, recorded, or cleared in accordance with the rules of the contract market or [DCO]." Subsection (b)(iii) grants DCMs discretion in setting block thresholds so long as such thresholds do not undermine any price discovery that may be occurring in the centralized market. The validity of such ex-pit transactions is underscored by CEA § 4(a), which expressly prohibits any person to execute or even offer to enter into a futures contract unless such transaction is "conducted on or subject to the rules of a board of trade which has been designated or registered by the Commission as a contract market." 7 U.S.C. § 4(a) (emphasis added). Congress certainly was aware of this language in Section 4(a) of the CEA when it passed DFA and chose not to eliminate it from the Act. Thus, there is no basis for the Commission to do so through the rulemaking process.

V. Conclusion

In enacting DFA, Congress intended to bring a significant portion of transactions in the OTC market into regulated clearing houses and onto SEFs or DCMs. In modeling the new swaps regulatory regime on the existing futures regulatory framework, Congress believed that if we experienced substantial market turmoil again, the swaps market would demonstrate the strength and stability evidenced by the futures markets during the 2008 financial crisis. It certainly defies logic to conclude that Congress intended for the CFTC, through the rulemaking process, to remove markets and market participants from the regulated futures markets and force them into trading reclassified swaps on SEF or OTC venues.

As highlighted in the discussion above, the CFTC's proposed rule requiring more than 85% of a contract's volume to trade in the centralized market in order to be able to be listed for trading on a DCM is clearly harmful to the market and should be abandoned. With no regulatory or public benefit resulting from this proposed rule, the Commission is not justified in imposing such substantial costs on market participants, competitively disadvantaging DCMs and potentially increasing systemic risk to the financial system.

As the Commission knows, every market is different and the value of the core principles regime is that it allows registered entities the flexibility to tailor rules to fit the characteristics of the various markets it hosts. A one-size-fits-all regulatory approach – whether in assessing whether a DCM complies with Core Principle 9 or whether a "swap" product is appropriately margined – is bad regulatory policy and bad for markets. CFTC rules or guidance in this area should focus on whether a DCM evidences good faith efforts to support competitively traded markets, where appropriate. Such an approach is consistent with the principles-based regulatory policy that Congress preserved for DCMs and extended to other registered entities through DFA.