CME Group

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VIA ELECTRONIC MAIL

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Department of the Treasury
Office of the Comptroller of the Currency
12 CFR Part 44
Docket No OCC-2011-0014
RIN: 1557-AD44

Board of Governors of the Federal Reserve System
12 CFR Part 248
Docket No R-1432
RIN 7100 AD 82

Securities and Exchange Commission
17 CFR Part 255
Release No 34-65545; File No S7-41-11
RIN: 3235-AL07

Federal Deposit Insurance Corporation
12 CFR Part 3351
RIN: 3064-AD85

Re: Restrictions on Proprietary Trading and Certain Interests in and Relationships with Hedge Funds and Private Equity Funds

CME Group Inc. ("CME Group")[1] appreciates the opportunity to comment on the rules (collectively, the "proposed rule") proposed by the Office of the Comptroller of the Currency, Board of Governors of the

[1] For the record, CME Group is the holding company for four separate Exchanges, including the Chicago Mercantile Exchange Inc. ("CME"), the Board of Trade of the City of Chicago, Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX"), and the Commodity Exchange, Inc. ("COMEX") (collectively, the "CME Group Exchanges" or "Exchanges"). The CME Group Exchanges offer the widest range of benchmark products available across all major asset classes, including futures and options on futures based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products. Moreover, the Exchanges serve the hedging, risk management, and trading needs of our global customer base by facilitating transactions through CME Globex® electronic trading platform, our open outcry trading facilities in New York and Chicago, and privately negotiated transactions. CME Clearing is one of the largest central

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Federal Reserve System (the "Board"), Federal Deposit Insurance Corporation, Securities and Exchange Commission and (in a separate release) Commodity Futures Trading Commission (the "CFTC", and collectively, the "Agencies") to implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), more commonly known as the Volcker Rule.[2]

CME Group acknowledges the difficulty the Agencies face in adopting and implementing an effective rule that would give effect to the prohibitions in the Volcker Rule. With this in mind, CME Group respectfully submits this comment to propose two areas in which the Agencies' proposed rule should be revised prior to adoption: the exemption for market making-related activities and the exemption for permitted investments. We believe that these revisions are necessary in order for the proposed rule to give effect to the statutory language and congressional intent underlying the Volcker Rule. We also intend to provide further comment on this important topic in response to the CFTC's proposal and will provide all agencies with a copy of that further comment when it is filed.

I. <u>Detailed Comments</u>

A. The Agencies' Final Rules Should Unambiguously State that Market Making-Related Activities in Exchange-Traded Futures and Options are Among the Permitted Activities in Which a Covered Banking Entity May Engage.

The Agencies' proposed rule fails to make clear that a covered banking entity's market making-related activities in exchange-traded futures and exchange-traded options on futures (collectively, "exchange-traded futures and options") are among the "permitted activities" exempted from the prohibition on proprietary trading.[3] As proposed, section __.3 of the Agencies' rule text would implement the prohibition on proprietary trading by making it unlawful for any covered banking entity to engage as principal in a purchase or sale of one or more "covered financial positions," which would include positions established in exchange-traded futures and options.[4] In accordance with subparagraph (d)(1) of the Volcker Rule, certain "permitted activities" would be exempted from the general prohibition on proprietary trading by covered banking entities. Among these are a covered banking entity's "market making-related activities."[5] Section __.4(b)(2)(iv) of the Agencies' proposed rule would implement the market making-related activities exemption by making explicit that a covered bank entity's market making-related activities in securities, swaps, security-based swaps, municipal securities and government securities are permitted activities. As drafted, the proposed rule text fails to specify that a covered banking entity's market

counterparty clearing services in the world; it provides clearing and settlement services for exchange-traded contracts and over-the-counter ("OTC") derivatives contracts through CME ClearPort®. The CME ClearPort® service mitigates counterparty credit risks, provides transparency to OTC transactions, and brings to bear the exchange's market surveillance monitoring tools.

2 Dodd-Frank Wall Street Reform and Consumer Protection Act § 619, 12 U.S.C. § 1851.

3 §__.4(b) of the proposed rule.

4 The proposed rule includes "a contract of sale of a commodity for future delivery, or option on a contract of sale of a commodity for future delivery" among the covered financial positions. §__3(b)(3) of the proposed rule.

5 § 619(d)(1); 12 U.S.C. § 1851(d)(1).

making-related activities in exchange-traded futures and options also would be among the permitted activities exempted from the prohibition on proprietary trading.

Given the long list of other regulated financial instruments in the market-maker exemption, we assume the omission of exchange-traded futures and options was inadvertent. However, this omission threatens to create unnecessary confusion about the scope of permissible market making-related activities and could lead to less liquidity and more price volatility in important exchange-traded markets. To avoid these adverse economic impacts, we strongly recommend-that the final text of section __.4(b)(2)(iv) should explicitly provide that market making-related activities in exchange-traded futures and options are among the permitted activities in which a covered banking entity may engage.[6]

The statutory text plainly includes market making-related activities in exchange-traded futures and options as one of the permitted activities exempted from the prohibition on proprietary trading.[7] Subparagraph (d)(1)(B) of the Volcker Rule allows covered banking entities to purchase, sell acquire or dispose of the financial instruments described in subparagraph (h)(4) in connection with market making-related activities, and the instruments listed in subparagraph (h)(4) include securities, derivatives, exchange-traded futures, options on any of the foregoing instruments, and any other security or financial instrument that the Agencies determine by rule.[8] The proposed text of section __.4(b)(2)(iv) would faithfully implement the statutory text with respect to securities, swaps and security-based swaps, but would inexplicably omit exchange-traded futures and options from the list of acknowledged instruments for which market making-related activities are permitted.

We believe the statutory text is clear and unambiguous, and the omission of exchange-traded futures and options from section __.4(b)(2)(iv) would cause covered banking entities to be uncertain at best as to the status of their market making-related activities in exchange-traded futures and options. In the absence of regulatory certainty, most of these would-be market makers will be forced to curtail their market making-related activities in order to avoid unintentional violations of the Volcker Rule.

Indeed, the Financial Stability Oversight Council itself acknowledged that "[b]roadly gauged restrictions on proprietary trading may deter [otherwise] permitted market making...activities."[9] As mentioned above, a decrease in market making-related activities in exchange-traded futures and options markets would diminish the liquidity of exchange-traded futures and options contracts. Reduced liquidity in exchange-

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6 Unlike the other market making exemptions in proposed section __.4(b)(2)(iv), the market making exemption for exchange-traded futures and options cannot be tied to a registration status because the exchange-traded futures and options market has no corollary to the dealer registration requirements in the securities, swaps and security-based swaps markets.

7 § 619(d)(1)(B); 12 U.S.C. § 1851(d)(1)(B).

8 *Id.* § 619(h)(4); 12 U.S.C. § 1851(h)(4).

9 Fin. Stability Oversight Council, *Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds* (Jan. 18, 2011), *available at* http://www.sifma.org/uploadedfiles/issues/regulatory_reform/volcker_rules/fsoc%20volcker%20section%20619%20dodd-frank%20study%20final%201%2018%2011%20rg.pdf.

traded futures and options would make hedging activity more difficult or more costly or force market participants to hedge their risks using other less optimal or appropriate derivative instruments.[6]

B. The Agencies Should Clarify that Treasury Futures and Options are Permitted Investments Under Section 619(D)(1)(A).

Treasury futures and options on such products are essentially a purchase or sale (albeit deferred) of an obligation of the United States. This is because one can stand for delivery on such contracts, in which case one is "purchasing [an] obligation of the United States." Thus, under the plain language of the Dodd-Frank Act, Treasury futures and options on such products are already included as permitted investments under (d)(1)(A). Accordingly, the Agencies should clarify this in the final rules.

C. If the Agencies Disagree that Treasury Futures and Options are Permitted Investments Under Section 619(D)(1)(A), then the Agencies Should Use the Exemptive Authority in Section 619(D)(1)(J) to Add Treasury Futures and Options on Treasury Futures to the List of Permissible Proprietary Trading Activities for Covered Banking Entities.

If the Agencies disagree that Treasury futures and options are permitted investments under Section 619(d)(1)(A), then we strongly recommend that the Agencies' final rule include Treasury futures and options on Treasury futures (collectively, "Treasury futures and options") among the permissible instruments that a covered banking entity may purchase, sell, acquire or dispose of without violating the prohibition on proprietary trading. Section __.6(a) of the proposed rule, which implements subparagraph (d)(1)(A) of the Volcker Rule, would recognize that trading in a variety of government obligations is one of the permitted activities exempted from the prohibition on proprietary trading.[7] While United States Treasury securities are one of the government obligations that would be a permitted investment under proposed section __.6(a), if the Agencies choose to narrowly interpret subparagraph (d)(1)(A), Treasury futures and options would not be similarly exempted.[8] In their respective releases, the Agencies have asked whether an additional exemption should be adopted to allow covered banking entities to engage in proprietary trading in derivatives that reference an enumerated government obligation – we believe Treasury futures and options warrant an additional exemption.

Subparagraph (d)(1)(J) of the Volcker Rule gives the Agencies broad authority to exempt any activity from the general prohibition on proprietary trading, but only in very narrow circumstances.[9] To use the exemptive authority in subparagraph (d)(1)(J), the Agencies must determine that the activity "would promote and protect the safety and soundness of the banking entity and the financial stability of the

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6 As proposed, section __.4(b)(2)(iv) would require a covered banking entity to be registered as a dealer, swap dealer, security-based swap dealer, a municipal securities dealer or a government securities dealer (or exempted from any of the aforementioned, as applicable). Since these registration categories are inapplicable to the futures markets, we believe that this should not be a requirement to qualify for the exemption, or the Agencies should clarify that this is only a requirement where such registration categories are applicable.

7 § 619(d)(1)(A); 12 U.S.C. § 1851(d)(1)(A).

8 *Id.*

9 § 619(d)(1)(J); 12 U.S.C. § 1851(d)(1)(J).

United States."[10] For the following reasons, we respectfully submit that trading in Treasury futures and options meets this high threshold and, for these reasons, trading in such instruments should be included among the permitted investments in section __.6(a).

1. **Differential Treatment of the Market for Treasury Futures and Options Would Threaten to Disrupt the Market for Treasury Securities.**

As the Agencies well know, maintaining a strong market for Treasury securities is essential to the financial stability of the United States. Treasury securities are a critical component to finance the operations of our federal government. Backed by the full-faith and credit of the United States, Treasury securities are regarded as nominally riskless and are highly liquid investments – the average daily trading volume in Treasury securities, as of 2010, was in excess of $528 billion.[11] Further, the secondary market for Treasury securities is critical to the Federal Reserve Board's open market operations. Treasury securities are a primary instrument by which the Federal Open Market Committee (the "FOMC"), through the Federal Reserve Bank of New York, seeks to implement broad-based monetary policy for the United States.

In order to maintain a strong market for Treasury securities, it is important to have an equally strong market for Treasury futures and options. These two markets are intricately intertwined, as Treasury futures and options have, for most market participants, become highly substitutive with particular Treasury securities (this is most true with "off-the-run" or seasoned Treasury securities, as they are generally the optimal securities for delivery into the futures contract). In fact, recent academic literature has identified instances in which the trading activity in the Treasury futures markets has contributed significantly to price discovery in the cash market for certain Treasury securities.[12]

The deep relationships between these corollary markets and the highly substitutive nature of these instruments greatly benefits and strengthens the market for Treasury securities. For example, the present unrestricted interaction between Treasury securities and Treasury futures and options markets ensures homogeneity in the Treasury yield curve. This is because if a particular Treasury security should encounter stress, Treasury futures and options serve as a ready alternative to those market participants who seek to avoid the costs associated with the stresses in the market for that Treasury security. The substitutive nature of these products helps to maintain orderly Treasury securities markets by providing an outlet to relieve any supply and demand imbalances in Treasury securities. This outlet allows market participants to "smooth" potential disruptions to the yield curve.

Similarly, Treasury securities may experience price discrepancies arising from imbalances between the demand and supply of a particular Treasury security, which leads to price distortions (sometimes referred

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10 *Id.*

11 Government Accountability Office website: http://www.gao.gov/special.pubs/longterm/debt/ownership.html

12 "The Microstructure of the U.S. Treasury Market" Bruce Mizrach and Christopher J. Neely, Federal Reserve Bank of St. Louis, December 2007, revised April 2008; "Price Discovery in the Treasury Futures Market" Michael W. Brandt, Kenneth A. Kavajecz, Shane E. Underwood, The Journal of Futures Markets, 2007 Wiley Periodicals, Vol. 27, No. 11, 1021-1051 (2007).

to as a “squeeze”). If such a scenario were to occur today, banks would likely use Treasury futures and options markets to accomplish their business goals while avoiding the negative price exposure. (They can do this because a Treasury futures contract, which makes a basket of securities eligible for delivery, is more difficult to squeeze than any individual Treasury security.)

If Treasury futures and options are not included as permitted investments under proposed section __.6(a), the differential treatment of these otherwise highly substitutive instruments will have detrimental effects to both markets. Restrictions on covered banking entities’ trading in Treasury futures and options could decrease liquidity in Treasury futures and options and simultaneously increase activity in the market for Treasury securities. Facing increased restrictions on trading activity in Treasury futures and options, covered banking entities would be less likely to use Treasury futures and options as substitutive instruments for Treasury securities. Such a reduction in trading activity would diminish the beneficial impact that Treasury futures and options currently have on disruptions to the yield curve and Treasury security squeezes.

We believe these unintended consequences would undermine congressional intent in allowing permissible investments to be exempt from the prohibition on proprietary trading. For these reasons, we believe that including Treasury futures and options as permitted investments under section __.6(a) is justified under subparagraph (d)(1)(J) of the Volcker Rule.[13]

2. Primary Dealers Need Unrestricted Access to the Market for Treasury Futures and Options to Ensure the Orderly Operation of The Market for Treasury Securities.

The orderly functioning of the market for Treasury securities is dependent upon banks that serve as primary dealers. These primary dealers assume enormous responsibilities. First and foremost, a primary dealer serves as a trading counterparty to the Federal Reserve Bank of New York in its implementation of U.S. monetary policy. This necessitates that the primary dealer: (i) participate consistently as counterparty to the Federal Reserve Bank of New York in its execution of open market operations to carry out U.S. monetary policy pursuant to the direction of the FOMC; and (ii) provide the Federal Reserve Bank of New York’s trading desk with market information and analysis helpful in the formulation and implementation of monetary policy. A primary dealer is also required to participate in all auctions of Treasury securities and to make reasonable markets for the Federal Reserve Bank of New York when it transacts on behalf of its foreign official account-holders.[14] Failure to participate in either of these activities could result in the Federal Reserve Bank of New York withdrawing the bank’s primary dealer status.

The responsibility of a primary dealer bank to stand ready at a moment’s notice to transact as a counterparty with the Federal Reserve Bank of New York in its vital role to implement United States monetary policy necessitates that the primary dealer has unfettered access to all related markets almost instantly. To manage this responsibility, primary dealer banks rely heavily on the market for Treasury futures and options.

[13] § 619(d)(1)(J); 12 U.S.C. § 1851(d)(1)(J).

[14] Federal Reserve Bank of New York website: www.newyorkfed.org/markets/pridealers_policies.html

Under the proposed rule, covered banking entities that are primary dealers would face onerous restrictions in accessing the Treasury futures and options markets, which may inhibit them from effectively executing their duties as primary dealers and diminish the covered banking entity's overall safety and soundness. For example, a primary dealer might establish a short hedge position in Treasury futures or options in anticipation of taking Treasury securities into inventory in an impending auction. Should the primary dealer be awarded a smaller share of the auction than anticipated, it might face difficulty in authenticating its entire short hedge position in Treasury futures or options as "hedging activity," as would be required by section __.5(b) and (c) of the proposed rule. In reaction to this potentially negative regulatory exposure, covered banking entities that are primary dealers may choose, in subsequent auctions, to either hedge significantly less or bid for significantly fewer Treasury securities than they would if Treasury futures and options had been included as permitted investments under section __.6(a).

We believe these consequences would create more, not fewer, risks to the safety and soundness of these covered banking entities and would weaken the market for Treasury securities. This perverse result would be contrary to the intent of the Volcker Rule. For these reasons, we believe that including Treasury futures and options as permitted investments under section __.6(a) is justified under subparagraph (d)(1)(J) of the Volcker Rule.[15]

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CME Group thanks the Agencies for the opportunity to comment on this matter. We would be happy to discuss any of these issues with staff of the Agencies. 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 Bart Chilton
Commissioner Jill Sommers
Commissioner Scott O'Malia
Commissioner Mark Wetjen

[15] § 619(d)(1)(J); 12 U.S.C. § 1851(d)(1)(J).

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