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BEFORE THE HOUSE  
COMMITTEE ON AGRICULTURE

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Chairman Peterson, Ranking Member Lucas, I am Johnathan Short, Senior Vice President and General Counsel of IntercontinentalExchange, Inc., or "ICE." I very much appreciate the opportunity to appear before you today to testify on the Department of Treasury's Over the Counter Derivatives Markets Act of 2009 ("OTCDMA").<sup>1</sup>

***Background***

ICE launched its electronic OTC energy marketplace in 2000. The ICE OTC platform was designed to bridge the void that existed between the voice brokered OTC markets which were bilateral and opaque, and the open-outcry futures exchanges, which were inaccessible or lacked the products needed to hedge in the power markets. Since then, ICE has acquired and operates three regulated futures exchanges through three separate subsidiaries, each with its own governance and regulatory infrastructure. The International Petroleum Exchange (renamed ICE Futures Europe), was a 20-year-old exchange specializing in energy futures when acquired by ICE in 2001. Located in London, it is a Recognized Investment Exchange, or RIE, operating under the supervision of the UK Financial Services Authority (FSA). In early 2007, ICE acquired the 137-year-old "The Board of Trade of the City of New York" (renamed ICE Futures U.S.), a CFTC-regulated Designated Contract Market (DCM) headquartered in New York and specializing in agricultural, foreign exchange, and equity index futures. In late 2007, ICE acquired the Winnipeg Commodity Exchange (renamed ICE Futures Canada), a 120-year-old exchange specializing in agricultural futures, regulated by the Manitoba Securities Commission, and headquartered in Winnipeg, Manitoba. ICE also owns and operates five derivatives clearinghouses, each serving a distinct part of its trading business. These clearinghouses include:

- ICE Clear US, a Derivatives Clearing Organization located in New York and serving the markets of ICE Futures US;
- ICE Clear Europe, a Recognized Clearing House located in London that serves ICE Futures Europe, ICE's OTC energy markets, and the European portion of ICE's credit default swaps clearing initiative;

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<sup>1</sup> Title VII, Improvements to Over-the-Counter Derivatives Markets (August 11, 2009).



- ICE Clear Canada, a recognized clearing house located in Winnipeg, Manitoba that serves the markets of ICE Futures Canada;
- ICE Trust, a U.S.-based CDS clearing house which began clearing CDS transactions in March , 2009, and which to date, along with ICE Clear Europe, has cleared over \$ two trillion in notional value of credit default swaps; and
- The Clearing Corporation, established in 1925 as the nation’s first independent futures clearing house. It provides the risk management framework, operational processes and clearing infrastructure for ICE Trust. The Clearing Corporation also provides clearing services to the Chicago Climate Futures Exchange.

ICE has an established track record of working with market participants to introduce transparency and risk intermediation into OTC markets. We have also worked closely with regulators to improve supervision and access to information from the OTC markets. Along with the introduction of electronic trading to energy markets, ICE pioneered the concept of cleared OTC energy swap contracts. These changes to a traditionally opaque, bilateral market structure were made in response to a crisis in the energy markets in 2002, and have dramatically transformed the way energy derivatives are traded and risks are managed by market participants.

### ***Need for OTC Regulation***

Appropriate regulation of OTC derivatives is of utmost importance to the long term health and viability of our financial system and to our broader economy. The current financial crisis has exposed a significant gap in market transparency and regulation that has allowed systemic risk to grow and for its effects to be felt beyond Wall Street to Main Street. However, in considering the need for OTC derivatives regulation, it is equally important to understand the true size and nature of OTC derivatives markets and their importance to the broader U.S. economy. Derivatives are commonly thought to be complex financial instruments that are only traded between large investment banks and hedge funds. However, derivatives are central to the U.S. and global economy: 94% of the world’s 500 largest companies use derivatives to manage a broad variety of risks.<sup>2</sup> Use of derivatives is not constrained to the financial sector, but cuts across the entire spectrum of business and government, including manufacturing, airline, health care and technology companies, as well as a variety of state and local governmental entities. It also bears emphasizing that derivatives — both futures and

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<sup>2</sup> Study by the International Swaps and Derivatives Association (April 23, 2009). <http://www.isda.org/press/press042309der.pdf>



OTC instruments — could play a central role in any “cap and trade” program to combat climate change.

ICE believes that increased transparency and proper risk and capital management, coupled with legal and regulatory certainty, are central to OTC market financial reform and to restoring confidence to these vital markets. In this regard, the current Treasury proposal embodied in the OTCDMA contains many provisions that will benefit the derivatives markets and the broader economy as a whole. However, several key points in the legislation warrant further scrutiny and consideration by Congress in order to strike the proper balance between needed market reform and maintaining the usefulness of OTC derivatives to the broader economy.

#### *Mandating Clearing and Electronic Trading*

The OTCDMA recognizes the benefits of exchange trading and clearing by requiring all standardized swaps to be exchange traded and cleared. The OTCDMA instructs the CFTC and the SEC to define the term “standardized” as “broadly as possible after taking into account” factors as (i) which terms of the trade, including price, are disseminated to third parties; (ii) the volume of transactions; (iii) the extent to which the swap is similar to other swaps that are centrally cleared; (iv) whether the swap is similar to other swaps in ways that are of economic significance; and (v) other factors that the Commodity Futures Trading Commission (“CFTC”) and the Securities and Exchange Commission think relevant.<sup>3</sup> This broad definition is designed to capture most derivative transactions.

Clearing and electronic execution and trade processing are core to ICE’s business model. As a result, ICE would clearly stand to benefit commercially from legislation that required all derivatives transactions conducted in the U.S. to be cleared and traded on exchanges or electronic trading facilities. However, the mandated electronic trading and clearing provisions of the OTCDMA may result in significant unintended consequences by attempting to force transactions that are not readily amenable to clearing into clearinghouses, or by forcing commercial market participants – including those who would rather, for a price, outsource their risk management to an OTC swaps dealer – to incur the cost and expense of trading in standardized contracts that may not perfectly fit their risk management needs. In addition, many commercial market participants will be forced to post significant cash collateral to margin cleared positions when they historically have been able to use illiquid assets to back OTC bilateral swap positions that they have entered into with swaps dealers.

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<sup>3</sup> OTCDMA, Section 713(a).



The critical factors for efficient clearing include not only the standardization of products, but also the availability of adequate pricing and market liquidity. Pricing is essential for the clearinghouse to mark open positions to market on a daily basis and to properly margin positions, which protects both the clearinghouse and market in the event of a clearing participant default. The depth of market liquidity and number of clearing participants or intermediaries impacts margin and guaranty fund calculations, as well as the ability to efficiently mutualize risk across enough clearing participants to make clearing economically viable. Where market depth is poor, margin and risk mutualization cost is very high and can make it uneconomic from a market perspective for a product to be cleared given the necessary conservatism on the part of a clearinghouse.

Thus, while ICE certainly supports clearing and exchange trading of as many standardized contracts as possible, there will always be products which are not sufficiently standardized or which do not possess sufficient market liquidity for clearing to be practical, economic or necessary. Pursuant to the OTCDMA's broad definition of "standardized swap", many thinly traded instruments will be submitted for clearing and traded on exchange. This could increase risk to clearinghouses and to the financial system in general.

Finally, forcing all derivatives transactions and all market participants to trade through exchanges and to clear through clearinghouses will greatly increase cost to commercial companies and ultimately to consumers. Currently, many commercial entities address their risk management needs through trading with swaps dealers. The swaps dealers offset the risk they undertake through internal offsets, trading with other swaps dealers, or through trading on exchanges. Under these arrangements the commercial entities have the flexibility to post illiquid collateral (such as a pledge of hard assets or a pledge of future production) that could not be accepted by a clearinghouse. Forcing these transactions into clearinghouses will cause these companies to post their most liquid assets, impairing their ability to operate efficiently. This will put U.S. firms at a severe disadvantage to foreign competitors.

Instead of forcing all derivative transactions to be exchange traded and cleared, Congress should focus on the segments of the markets where risk is greatest, like the inter-dealer and major swaps participant derivatives market. Mandating that inter-dealer and major swaps participant trades be cleared would eliminate the bilateral counterparty risk that was central to the liquidity crisis that occurred last year, and achieve many of the risk reduction and transparency objectives that Treasury is seeking without impacting clearinghouse risk management and the competitiveness of U.S. commercial businesses. This step could be supplemented with enhanced prudential regulation of swaps dealers or major swaps participants that would allow regulators to ensure that such entities do not engage in trading conduct with other parties that poses any systemic risk.



### *Fungible Clearing for Swaps*

The OTCDMA includes a provision that requires clearinghouses to “prescribe that all swaps with the same terms and conditions are fungible and may be offset with each other.”<sup>4</sup> This provision would force clearinghouses to treat standardized swaps as fungible with positions held other clearinghouses and offer risk offsets against positions held in other clearinghouses. This could make proper risk management by clearinghouses extremely difficult, and inadvertently increase systemic risk – the very thing that clearinghouses are intended to eliminate under the OTCDMA.

Clearinghouses have been some of the few institutions that have operated well in the financial markets during this time of crisis. Clearinghouses perform a vital risk management function in margining derivative positions and performing real time risk management for their customers. Forcing clearinghouses to take contracts from other clearinghouses or to provide margin offsets with other clearinghouses could present significant systemic risk issues, making it more difficult to track positions and counterparty risk exposure, and creating significant problems in the event of a default of a major market participant. To understand this risk, consider what would have happened in the real world Lehman Brothers default scenario if Lehman’s positions had been spread across ten different clearinghouses, none of whom may have had the full risk picture and all of whom might have been dependent on the risk management practices of the weakest link in the “offset” chain. In this regard, interconnected clearinghouses might not have been very different from interconnected banks, with problems in one competing clearinghouse impacting other clearinghouses.

Many important problems would need to be overcome to make fungible clearing and margin offsets workable. For example, what if rules at each clearinghouse are not exactly the same with respect to a default, which clearinghouses’ rules would have precedent? What if one clearing house chose to adopt more stringent margin requirements than the minimum legally required – would it have to provide a margin offset for positions held at a second clearinghouse that only chose to adopt the minimum margin standards that are legally required?

It is important to note that fungible clearing is currently allowed, but not forced upon futures clearinghouses, pursuant to Core Principle E of the Commodity Exchange Act. Thus, clearinghouses have the ability to create netting and offsetting arrangements with other clearinghouses on a voluntary basis, with appropriate risk management considerations in mind. Congress should eliminate the fungibility requirement from the OTCDMA before passage.

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<sup>4</sup> OTCDMA, Sections 713(a), 753(a).



### *Foreign Boards of Trade*

The OTCDMA gives the CFTC greater authority over foreign boards of trade. Foreign Boards of Trade will need to register with the CFTC in order to provide electronic access to U.S. participants. In order to register with the CFTC, the foreign board of trade must adopt position limits for contracts that are linked to a contract traded on a U.S. DCM.<sup>5</sup> The OTCDMA goes further than linked contracts, however, and gives the CFTC the authority to set position limits on **any contract** traded on a foreign board of trade that is offered to U.S. market participants.<sup>6</sup>

While placing position limits on U.S. market participants trading in contracts **linked to** a contract traded on a U.S. exchange is appropriate, allowing the CFTC to place position limits on foreign exchange contracts that have no nexus or “linkage” to U.S. traded contracts presents serious issues. For example, if a foreign exchange offered access to U.S. market participants to a contract that was not linked to a U.S. traded contract, under the OTCDMA the CFTC rather than the foreign exchange regulator would set position limits. The provision would allow the CFTC to set aggregate position limits on traditionally sovereign contracts such as German bonds or Asian currencies. This would be unacceptable to the foreign government regulating a market, would invite retaliation by foreign regulators against U.S. exchanges, and would impede regulatory cooperation among governments in what is today a global financial market. Congress should eliminate this provision from the OTCDMA since it does not pertain to the stated goals of the proposal.

### *Conclusion*

ICE has always been and continues to be a strong proponent of open and competitive markets, and of appropriate regulatory oversight of those markets. As an operator of global futures and OTC markets, and as a publicly-held company, ICE understands the importance of ensuring the utmost confidence in its markets. Subject to the foregoing considerations which should be addressed by Congress in any final legislation, the OTCDMA offers many improvements to the existing regulatory framework in enhancing market transparency and eliminating elements of systemic risk from the financial system.

Mr. Chairman, thank you for the opportunity to share our views with you. I would be happy to answer any questions you may have.

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<sup>5</sup> OTCDMA, Section 725. ICE’s London-based subsidiary, ICE Futures Europe, complies a similar requirement through its “no-action” letter.

<sup>6</sup> OTCDMA, Section 723.