WRITTEN TESTIMONY OF JOHNATHAN SHORT
SENIOR VICE PRESIDENT AND GENERAL COUNSEL
INTERCONTINENTALEXCHANGE, INC.
BEFORE THE SENATE
COMMITTEE ON AGRICULTURE

DECEMBER 2, 2009

Introduction

Madame Chairman Lincoln, Ranking Member Chambliss, I am Johnathan Short, Senior Vice President and General Counsel of the IntercontinentalExchange, Inc., or "ICE." We very much appreciate the opportunity to appear before you today to discuss the reform of financial regulation.

Background

ICE was established in 2000 as an electronic over-the-counter (OTC) market to bridge the transparency void that existed in opaque, bilateral and largely voice brokered OTC swap markets as well as open-outcry futures exchanges, which were largely member-owned organizations with limited product offerings. Since the launch of its electronic OTC energy marketplace in 2000, ICE has acquired and now 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: ICE Clear US, a Derivatives Clearing Organization under the Commodity Exchange Act, 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 and ICE's OTC energy and European credit derivatives markets; and ICE Clear Canada, a recognized clearing house located in Winnipeg, Manitoba that serves the markets of ICE Futures Canada. Finally, ICE operates a limited purpose Federal Reserve regulated bank, ICE Trust, which serves as a clearinghouse for credit default swaps, as

IntercontinentalExchange
2100 RiverEdge Parkway
Suite 500
Atlanta, GA 30328
phone 770 857 4700
fax 770 951 1307
online www.theice.com

well as The Clearing Corporation, which is regulated by the CFTC as a derivatives clearing organization.

Throughout its history, ICE has established a track record of working with both market participants and regulators to introduce new products, heightened transparency and risk intermediation into markets. ICE pioneered the introduction of electronic trading in OTC energy markets, and importantly, the introduction of clearing for OTC energy swap contracts in 2002. Many of these innovations have been adopted by other exchanges for the betterment of the overall market. In addition, in the spring of this year, ICE became the first clearinghouse to clear credit default swaps (CDS), having cleared approximately $4 trillion in notional CDS to date and in the process taking significant risk off of bank balance sheets.

Need for Regulation of Over the Counter Derivatives

Appropriate regulation of OTC derivatives is of utmost importance to the financial system. ICE believes that increased transparency and proper risk and capital management coupled with legal and regulatory certainty are central to OTC market financial reform. Well designed reforms will bring enhanced confidence to these vital markets.

In discussing the need for OTC regulation, it is important to understand the size of the OTC derivatives markets and their importance to the health of the U.S. economy. Derivatives are commonly thought to be esoteric financially engineered products transacted between large investment banks. However, the reality is more complex. For example, as an OTC derivative can encompass anything from a simple forward contract (a promise of delivery in the future) between a farmer and a grain elevator to a highly tailored instrument such as a credit derivative or collateralized debt obligation. Derivatives are central to both the U.S. and global economies, with 94% of the world's 500 largest companies using derivatives to manage their financial risk.[1] These companies are not limited to the financial sector, but span many different sectors, including transportation, health care, manufacturing and technology. Further, use of derivatives is not confined to large corporations, as small utilities and manufacturers, farmers and municipalities also use derivatives to hedge their risk and more efficiently run their operations.

In examining the scope, complexity and importance of the OTC derivatives market, it is clear that financial market regulation must be carefully tailored to bring heightened transparency and risk intermediation to the OTC markets while allowing these markets to continue to perform their important functions within the broader economy.

[1] Study by the International Swaps and Derivatives Association (April 23, 2009). http://www.isda.org/press/press042309der.pdf

Simply banning products, transactions or certain market participants will only create further disruptions in the market and harm U.S. businesses, potentially driving participants to use non-U.S. venues to manage their risk.

Financial regulation must be well defined, flexible and prudential. Flexibility is important, as it allows regulators to respond to future problems, not just yesterday's crises. Prescriptive laws and regulations hamper regulatory flexibility and create gaps in oversight. To be flexible, regulators must also be prudential, understanding their markets and tailoring regulation to ensure market integrity and consumer protection. Congress, the CFTC, the SEC, the Federal Reserve and other regulatory agencies have already made significant progress in examining these important issues. ICE supports congressional legislation that preserves the elements of our existing market and regulatory structures that promote competition and risk management innovation, while protecting against market abuses and lack of oversight.

Clearing and Electronic Trading

Several of the recent OTC derivatives legislative proposals mandate exchange trading and clearing for most, if not all, derivatives transactions. Clearing and exchange trading are generally beneficial to derivatives markets as both promote transparency and efficient execution. However, it is important to understand that clearing and exchange trading are not a panacea, and may not be appropriate for every OTC derivative product or transaction.

Mandated Clearing and Exchange Trading

Clearing and electronic execution and trade processing are core components of ICE's business model and 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, provisions that mandate electronic trading and clearing may result in significant unintended consequences by attempting to force transactions that are not readily amenable to clearing into clearing houses, 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.

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 clearing house to mark open positions to market on a daily basis and to properly margin positions, which protects both the clearing house 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 clearing house.

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, prudent, economic or necessary. Pursuant to broad definition of "standardized swap" in many of the proposed bills, exchanges and clearing houses could be forced to offer many thinly traded instruments. This could actually increase risk to clearing houses and to the financial system in general.

Finally, forcing all derivatives transactions and all market participants to trade through exchanges and to clear through clearing houses 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 clearing house. Further, forcing these transactions into clearing houses 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 and other regulators are seeking without impacting clearing house 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.

Risk Management

Under the current regime, clearing houses handle risk management under the supervision of their respective regulator. However, some of the proposed bills pending before Congress could inhibit the clearing house's ability to control and manage risk.

Clearing houses have been some of the few institutions that have operated well in the financial markets during this time of crisis. Clearing houses perform a vital risk management function in margining derivative positions and performing real time risk management for their customers. Forcing clearing houses to take contracts from other clearing houses or to provide margin offsets with other clearing houses 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 clearing houses, 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 clearing houses might not have been very different from interconnected banks, with problems in one competing clearing house impacting other clearing houses.

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.

Competition

Financial reform of the over the counter derivatives markets should protect and encourage competition. The derivatives markets, especially the exchange traded derivatives markets, are very competitive. This competition has spurred great innovation

in these markets, including new product development, electronic trading and clearing. U.S. firms have benefited through lower bid/ask spreads, lower transaction fees, and a greater ability to hedge risk. However, several proposals before Congress could inhibit competition and innovation in the derivatives markets.

Position Limits

Every financial reform proposal pending before Congress gives the CFTC the authority to set aggregate position limits across all markets: OTC, exchanges, and foreign boards of trade for contracts linked to a contract traded on a designated contract market. This is important because the current position limit regimes, both CFTC-administered and exchange-administered, are obsolete. The regimes have not been updated for many years, even though the size of the futures markets has changed considerably.

However, to change the current system into an effective regime, Congress and the CFTC should be careful to protect competition by setting aggregate limits across markets and leaving market participants with the choice to "spend" that limit in the venue of their choice. Some proposals pending before Congress would require exchanges to set position limits according to relative market size. These proposals would allow an exchange with a large percentage of market share to have a higher position limit than an exchange with smaller market share, which would only work to limit competition by inhibiting the development of liquidity in a competing market and locking in the relative market share of incumbent exchanges. New entrants to the market would never be able to attract sufficient liquidity to their markets given the lower position limits. Importantly, setting position limits as a percentage of an exchange's open interest would be contrary to the CFTC's statutory mandate to promote competition among exchanges and seek to regulate the futures markets by the least anticompetitive means available. Congress should ensure that the any new position limit regime treats all exchanges equally and preserves competition.

Appropriate Regulation

Financial reform should strike an appropriate balance in regulating the derivatives markets to ensure competition. In striking this balance, regulation should be sufficiently flexible to accommodate future changes in the derivatives markets. ICE believes that a broad set of core principles governing markets would allow regulators to work towards the common goal of protecting market integrity and reducing systemic risk.

Core principals allow financial regulators to be flexible and prudential. Flexibility is important, as it allows regulators to respond to changing market dynamics and anticipate future problems rather than living by prescriptive regulations that were

designed to address yesterday's markets and yesterday's problems. To be flexible, regulators must also be prudential, with an intimate understanding of their markets and market participants. This depth of knowledge is required to tailor effective regulation to ensure market integrity and consumer protection.

In addition, financial reform measures must endeavor to avoid dual regulation. Given the financial crisis, it may be tempting to have multiple regulators for every financial institution. However, it is important to note that several of the OTC derivatives markets at the heart of the financial crisis were in regulatory "gray areas" between two or more regulators. Regulators need certainty that they have the power to take actions to uphold the public good, which may be more difficult if jurisdiction is shared among multiple regulators. Likewise, market participants need the certainty that their business transactions will not be held to conflicting standards of conduct. Conflicting or duplicative regulation will only hamper regulators and needlessly complicate financial regulations.

Conclusion

ICE has always been and continues to be a strong proponent of open and competitive financial 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 markets and welcomes the ability to work with members of Congress on this important debate.

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