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WRITTEN TESTIMONY OF JOHNATHAN SHORT  
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INTERCONTINENTALEXCHANGE, INC.  
BEFORE THE HOUSE  
COMMITTEE ON AGRICULTURE

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***Introduction***

Chairman Peterson, Ranking Member Goodlatte, 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 role of credit derivatives in the financial markets and ICE's efforts, along with other market participants, to introduce transparency and risk intermediation into the OTC credit markets.

ICE is proud to be working with the Federal Reserve System, the Commodity Futures Trading Commission ("CFTC"), and the Securities Exchange Commission ("SEC") on these efforts that are vital to the health of our financial markets. Importantly, ICE has a history of working with over-the-counter ("OTC") market participants to introduce transparency and risk intermediation into markets. We pioneered the introduction of transparent OTC energy markets nearly a decade ago, moving trading from telephones to screens. In 2002, we introduced clearing into the OTC energy markets in response to the credit and counterparty risk crisis that were then gripping the energy markets — much like the crisis confronting global financial markets today. With the formation and launch of ICE Trust ("ICE Trust"), which I will detail in a few minutes, ICE is leveraging its expertise in OTC clearing and making significant investments to transform the OTC credit derivatives market into a regulated, centrally cleared marketplace that will be open, independent, transparent and efficient.

***Background and Progress Report***

As outlined in previous testimony, to clear credit default swaps ("CDS"), ICE will form a limited purpose bank, ICE Trust. ICE Trust will be a New York trust company and a member of the Federal Reserve System. It will therefore be subject to regulatory and supervisory requirements of the Federal Reserve System and the New York Banking Department.

ICE has agreed to purchase The Clearing Corporation ("TCC") and has garnered the support of nine banks: Bank of America, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, J.P.Morgan Chase Bank, Merrill Lynch, Morgan Stanley and UBS.



Currently TCC provides clearing services for global futures exchanges and OTC markets and since early 2007 has been working with leading industry participants, regulators and industry associations on a global initiative to clear CDS indices, tranches and single name instruments.

The nine banks using the ICE CDS clearinghouse will novate and capitalize their positions with a new and completely separate bulk fund. The guaranty fund for index contracts alone has been estimated to be in excess of \$1 billion. The total level of funding and collateral could rise considerably as initial and variation margin levels are determined and as new types of credit transactions move into the clearinghouse.

It is important to note that one of the defining features of the ICE Trust CDS clearing solution — and one that we believe is import to its success over the long term — is the independence of ICE Trust management from its clearing membership. The management of ICE Trust will be vested in an independent board of directors. Initially, the board of directors of ICE Trust will consist of seven members, four of whom are independent in accordance with the requirements of the New York Stock Exchange listing standards, the Exchange Act, and ICE’s Board of Director Governance Principles. Within six months of its initial constitution, the Board of Directors will increase to nine with the addition of two new independent directors.

In this vein, ICE Trust has also been holding regular meetings with buy-side participants to insure their representation in the clearinghouse solution. Feedback from these meetings has allowed ICE Trust to tailor its governance to allow buy-side participants to have a voice in the management of the clearing house through an advisory board. ICE Trust believes it is very important that its clearing solution be open to all participants, and thus obtaining buy-side support is very important.

ICE Trust will also be an open platform: other suitable trading platforms will be able to use ICE Trust’s clearing facilities. Because TCC and Creditex are integrated with the Depository Trust and Clearing Corporation (DTCC) warehouse, our solution will have the ability to support all existing and future CDS trades, regardless of when or where the trades were executed. Ultimately, the goal is to insure that the greatest amount of trades are centrally cleared in order to decreased counterparty risk and increase transparency.

### ***Regulation of Credit Derivatives Clearing***

As stated in our earlier testimony, appropriate, effective regulation of credit derivatives is essential for the efficient operation of capital markets and the financial system. Presently, credit default swaps are largely exempt from regulation by the CFTC and the SEC. Since the beginning of the credit crisis in 2007, however, the Federal



Reserve Bank of New York (“New York Fed”) has progressively taken steps to address the unique market structure and systemic risks inherent in the credit market. As recent events demonstrate, the credit markets are intricately tied to the banking system, and many of the largest credit derivative market participants are banks subject to regulation by the Federal Reserve.

To address these issues, on November 14, the President’s Working Group on Financial Markets (“PWG”) announced its policy objectives for the OTC Derivatives Market. In the policy statement, the PWG outlined four objectives for OTC derivatives markets: (1) Improve Market Transparency and Integrity for Credit Default Swaps, (2) Enhance Risk Management of OTC Derivatives, (3) Strengthen OTC Derivatives Market Infrastructure, and (4) Continue Cooperation among Regulatory Authorities. ICE supports the PWG’s policy objectives, and as outlined below, ICE believes its credit default swaps clearing solution, ICE Trust, will help regulators achieve these objectives.

### ***Improving Market Transparency and Integrity for Credit Default Swaps***

The first policy objective of the PWG is to improve market transparency and integrity for credit default swaps. Specifically, the PWG calls for public reporting of prices, trading volumes, and aggregated open interest. Further, the PWG states that regulators should have access to trade and position information housed at central counterparties and central trade repositories. ICE will satisfy these objectives through direct regulation by the Federal Reserve, and through adoption of appropriate clearing house rules.

The Federal Reserve Act authorizes the Federal Reserve System and the New York Federal Reserve to require reporting from ICE Trust, and to conduct examinations of ICE Trust as it sees fit. The Federal Reserve has this authority because it establishes the terms under which ICE Trust will become a member bank. The Federal Reserve also has statutory authority to require reports and conduct examinations of any affiliate of ICE Trust. We expect that the Federal Reserve will require detailed reports on a regular basis concerning all aspects of the operations of ICE Trust. As the Federal Reserve reviews our membership application, we will work with the agency, as well as other regulators, to ensure that we provide requested and required data, including public reporting.

In the case of the current market structure for credit default swaps, the *absence* of this kind of information has contributed to uncertainty in the credit derivatives marketplace. ICE fully supports reporting of consolidated CDS market information because we know transparency will improve public confidence and market effectiveness. Our experience has taught us that central clearing combined with timely and appropriate information disclosure will substantially improve market safety and soundness, while



preserving OTC market participants' ability to innovate and create new risk management products.

Oversight by the Federal Reserve System will ensure that ICE's cleared credit derivatives model is transparent and fully regulated from the inception of its operation. The Federal Reserve System has played a central role in addressing both the current credit crisis and issues related to credit derivatives within the broader market. Indeed, since its founding in 1913, the U.S. central bank has had primary responsibility for maintaining the stability of the financial system and containing systemic risk in financial markets.

### ***Enhanced Risk Management of OTC Derivatives***

The second policy objective of the PWG is to enhanced risk management of OTC derivatives. Among the specific objectives, the PWG calls for consistent risk management standards for regulated entities that transact OTC derivatives instruments, including best practices for market participants with respect to risk management.

To meet these objectives, Federal Reserve regulatory requirements include minimum capital requirements, governance requirements, membership requirements, margin requirements, a satisfactory guaranty fund, and operational safeguards, all with a view to satisfying internationally recognized clearing standards. As a limited purpose bank, ICE Trust will be subject to regular examination by the Federal Reserve and the New York Banking Department, among other regulatory bodies as appropriate in the normal course of operations and will be required to satisfy reporting requirements.

ICE Trust will offer clearing services to its membership. Membership will be open to all market participants that meet the clearinghouse's financial criteria, and, importantly, third parties unable to meet membership criteria will be able to clear through members of the clearinghouse. Like other clearinghouses, ICE Trust will review each member's financial standing, operational capabilities (including technical competence), systems and controls, and the size, nature and sophistication of its business in order to meet comprehensive risk management standards with respect to the operation of the clearinghouse.

ICE Trust will require members to report various specific other matters to the clearinghouse including: where the member ceases to hold sufficient capital or breaches any applicable position limit; if the net worth of such member reduces by more than 20% from that shown on the latest financial statement filed by it with the clearinghouse for any reason; the failure to meet any obligation to deposit or pay any margin when and as required by any clearinghouse of which it is a member; failure to be in compliance with



any applicable financial requirements of any regulatory authority, exchange, clearing organization or delivery facility; the insolvency of the member or any controller or affiliate of that member; any default affecting it.

ICE Trust will adhere to the "Recommendations for Central Counterparties" ("RCC") developed jointly by the Committee on Payment and Settlement Systems ("CPSS") and the Technical Committee of the International Organization of Securities Commissions ("IOSCO") which set out standards for Risk Management of a central counterparty ("CCP"). These recommendations are broadly recognized and have been used by national regulators and other clearinghouses for self-assessment.

Following these guidelines, ICE Trust will establish a guaranty fund sufficient to meet costs associated with the cost of closing out an insolvent member's liabilities that exceed the financial resources (cash and collateral) held in the account of the insolvent member. Each member will be required to contribute to the guaranty fund in an amount which is adjusted to reflect the volume of activity and risk they hold within the clearinghouse. The value of the guaranty fund will be sufficient in aggregate to meet the largest single modeled stress-test loss of the largest two members in excess of the margin requirement of that member. Portfolio stress-testing will use scenarios to cover market risks exceeding a confidence level of 99.9%.

The ICE Trust guaranty fund will be for CDS positions only and will not serve as a collateral deposit for any other commodity contracts. We believe the best solution for containing the financial risks associated with credit derivative markets is to completely separate them from other derivative markets.

### ***Strengthened OTC Derivatives Market Infrastructure***

The third policy goal of the PWG is to strengthen the OTC derivatives market infrastructure. This objective includes ensuring that all market participants have open and fair access to key infrastructure components and that exchange or similar platforms for standardized CDS contracts should be encouraged. Finally, the PWG states that regulators should encourage improvements to operational infrastructure, including improvements to post-trade automation, frequent portfolio compression and enhanced standardized documentation.

ICE's clearing solution squarely addresses this objective by addressing the OTC CDS market as it exists today. By bringing a CDS clearing solution to the existing market structure, ICE's solution can quickly address the existing systemic risk that is resident in the market. Of equal importance, ICE has critical domain knowledge and expertise to bring to its clearing solution as a result of its acquisition of Creditex Group, Inc. ("Creditex"). Creditex is the global market leader and innovator in providing



infrastructure to the credit default swap markets. In the last few years, Creditex has worked collaboratively with market participants on three important initiatives to improve operational efficiency and scalability in the credit derivatives market.

In 2005, Creditex helped to develop the ISDA Cash Settlement Auctions, which are the market standard for credit derivative settlement and have been used in recent weeks to facilitate the orderly settlement of CDS contracts referencing Fannie Mae, Freddie Mac, Lehman Brothers, Landsbanki (Europe's first credit event auction) and many others. In addition, Creditex and Markit, a credit derivative pricing service, designed a compression solution to reduce the overall notional size and the number of outstanding contracts in credit derivative portfolios. Since August, Creditex and Markit have completed the compression of \$1.036 trillion in notional value of CDS transactions, greatly reducing the risk to the financial system.

Finally, Creditex's subsidiary, T-Zero, provides critical infrastructure for trade transmission and same-day trade matching. The platform addresses recommendations by the PWG earlier this year for flexible and open architecture, ambitious standards for accuracy and timeliness of trade matching errors and operationally reliable and scalable infrastructure.

Importantly, ICE US Trust will be open to other appropriate market "front end" and "back end" solutions that fit the needs of market participants. As noted earlier, other suitable trading platforms will be able to use ICE Trust's clearing facilities. Because TCC and Creditex are working with the Depository Trust and Clearing Corporation ("DTCC") warehouse, our solution will have the ability to support all existing and future CDS trades, regardless of when or where the trades were executed.

### ***Cooperation among Regulators***

The final policy objective of the President's Working Group is continued cooperation among regulators. Specifically, the PWG states that regulators that have jurisdiction over OTC markets should cooperate and ensure that they have adequate enforcement authority. ICE fully supports this recommendation and believes that CDS clearing will help achieve its goal. ICE Trust's principal regulator will be the Federal Reserve, but it stands willing to work with any regulator to make sure that the CDS market is open, transparent and regulated.

### ***Conclusion***

ICE has always been and continues to be a strong proponent of open and competitive derivatives 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. To that end, we have continuously worked with regulatory bodies in the U.S. and abroad in order to ensure that they have access to all relevant information available to ICE regarding trading activity on our markets. We have also worked closely with Congress to address the regulatory challenges presented by derivatives markets and will continue to work cooperatively for solutions that promote the best marketplace possible.

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