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BEFORE THE HOUSE OF REPRESENTATIVES
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 discuss 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 Bank, the Commodity Futures Trading Commission ("CFTC"), and the Securities Exchange Commission on these efforts that are vital to the health of our financial markets. Importantly, ICE has a history of working with OTC market participants to introduce transparency and risk intermediation into markets, having been a pioneer in the introduction of transparent electronic trading into the energy markets and having introduced cleared OTC energy swap contracts into its markets in 2002 in response to a market crisis in the energy markets – a freezing of credit and transactions – much like the crisis faced today in the broader financial markets.

Background

ICE was established in 2000 as an electronic over-the-counter (OTC) market. Since that time, ICE has grown significantly, both through its own market growth fostered by ICE's product, technology and trading innovations, as well as by acquisition of other markets to broaden its 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 a separate 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 US), a CFTC-regulated Designated Contract Market (DCM) headquartered in New York specializing in agricultural, foreign exchange, and equity index futures. In late 2007, ICE acquired the

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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 three clearinghouses: ICE Clear US, a Derivatives Clearing Organization under the Commodity Exchange Act, located in New York and serving the markets of ICE Clear US; ICE Clear Europe, a Recognised Clearing House located in London that will serve ICE Futures Europe and ICE's OTC energy markets; and ICE Clear Canada, a recognized clearing house located in Winnipeg, Manitoba that serves the markets of ICE Futures Canada.

Finally, and of importance to this discussion, ICE recently acquired Creditex Group. Founded in 1999, Creditex is a global market leader and innovator in the execution and processing of credit derivatives. Creditex operates a hybrid model of voice and electronic execution, and was the first to successfully launch electronic trading for credit default swaps in 2004. In the last few years, Creditex has worked collaboratively with market participants on three important initiatives which directly address calls by regulators, most notably the Federal Reserve Bank of New York, for improved 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 allow orderly settlement of CDS contracts referencing Fannie Mae, Freddie Mac and Lehman Brothers. Also in 2005, Creditex launched its subsidiary, T-Zero, which is now the industry standard for trade transmission and same-day trade matching. The platform addresses recommendations by the President's Working Group earlier this year for flexible and open architecture, ambitious standards for accuracy and timeliness of trade matching errors and operationally reliable and scalable infrastructure. In recent months, Creditex has also worked collaboratively with industry participants to launch a platform to allow efficient compression of offsetting CDS portfolios of major dealers. The platform reduces operational risk and provides capital efficiency.

Credit Derivatives and the Importance of Credit Derivatives Clearing

ICE has earned a reputation as an innovator in introducing clearing and transparency to the energy derivatives markets. ICE was the first to introduce clearing to the power markets, which were the domain of voice brokered, bilateral transactions. Voice brokered transactions offer limited transparency and cater to the largest customers. Now, the energy markets are predominately cleared with the attendant benefits of mitigation counterparty credit risk and related systemic risk that can flow from the failure of a large trading counterparty that has bilateral agreements with a large number of market counterparties. Of equal importance, regulators such as the CFTC and the Federal

Energy Regulatory Commission ("FERC") were provided with important market and individual trading information that has allowed each agency to better understand, monitor, and discharge their respective regulatory obligations with respect to these vital markets. In its last State of the Markets Report, FERC remarked ICE "provides the clearest view we have into bilateral spot markets."[1]

Like energy derivatives, credit derivatives serve an important role in the broader financial markets, allowing parties to shift credit risk, such as the downgrade in a company's debt, or insure against a default in connection with a credit instrument. A common type of credit derivative is the credit default swap, in which the buyer agrees to make a payment or series of payments to the seller. In return, the seller agrees to pay the buyer should a specified credit event occur. Presently, the credit market is very similar to the way energy markets worked earlier this decade; most transactions are bilaterally executed through brokerage firms. This is not a transparent or efficient way for a market to operate. Critically, the bilateral nature of the market leaves participants exposed to counterparty risk. In times of great financial distress, like the present, this risk can have systemic implications. When financial counterparties do not trust each other, and are unable to hedge their credit risk, they then stop lending to each other and the credit markets freeze.

The question before us today is how to bring appropriate transparency to the credit derivatives markets, as well as how to appropriately mitigate counterparty credit risk and resulting counterparty default risk that can have implications in the broader financial markets when a large market counterparty defaults on its obligations. ICE believes that the mutual goals of transparency and mitigation of counterparty credit risk and systemic risk can be achieved through the introduction of clearing and appropriate reporting obligations to regulators.

ICE's Proposed Solution

ICE has announced an agreement in principle with leading credit market participants, Markit, Risk Metrics and the Clearing Corporation to introduce a clearing solution to address this problem. Founded in 1925, the Clearing Corporation is an independent clearinghouse, owned by some of the largest derivatives dealers, including many of the largest credit derivatives brokers. The Clearing Corporation has been a leader in devising a credit derivatives clearing solution. With its Creditex subsidiary and its partnership with the Clearing Corporation, ICE believes it can offer a clearing solution uniquely tailored to the credit derivatives market.

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[1] Federal Energy Regulatory Commission, 2007 State of the Markets Report, pg. 9 (Issued, March 20, 2008).

To clear credit default swaps, ICE will form a limited purpose bank, ICE US Trust. ICE US Trust will be a New York trust company that will be a member of the Federal Reserve System, and therefore will be subject to regulatory and supervisory requirements of the Federal Reserve System and the New York Banking Department.
ICE US Trust will meet the statutory requirements for a multilateral clearing organization, or MCO, as a State member bank. As an MCO, ICE Trust, pursuant to section 409 of the FDIC Improvement Act, will be allowed to be a clearinghouse for OTC derivatives.

ICE US Trust will offer its clearing services to its membership. Membership will be open to market participants that meet the clearinghouse's financial criteria, and third parties unable to meet membership criteria will be able to clear through members of the clearinghouse. ICE US 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. In order to supplement ICE US Trust's own monitoring processes, members will have a general obligation to immediately notify ICE US Trust of any infringement of its rules or applicable laws or of any financial or commercial difficulty on the part of themselves or any member and, as soon as practicable thereafter, give the ICE US Trust full particulars of the infringement or difficulty.

Members of ICE US Trust will be required 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 capital of such member reduces by more than 10% 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; any breach by it of the Rules; any breach by it of any applicable law; or any action taken against it (including a fine, censure, warning, default proceeding, disciplinary proceeding, investigation, suspension or expulsion).

ICE US 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 firms for self assessment.

Following these guidelines, ICE US Trust will establish a Guaranty Fund sufficient to meet costs associated with the cost of closing out a 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 a member 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%.

In addition, ICE will make available its T-Zero service to facilitate same-day trade matching. T-Zero is a credit default swap trade processing service launched by Creditex in 2005. T-Zero is the market standard for CDS affirmation, novation consent, routing and straight through processing. T-Zero's ability to deliver timely and accurate trade information across the marketplace and to multiple users will be leveraged to effectively support ICE US Trust. T-Zero currently supports every major CDS trading house at some level as well as three interdealer brokers.

Regulation of Credit Derivative Clearing

Appropriate regulation of credit derivatives is of utmost importance to the financial system. Presently, credit default swaps are largely exempt from regulation by the Commodity Futures Trading Commission and the Securities Exchange Commission. Also, as recent events demonstrate, the credit markets are intricately tied to the banking system, with many credit derivative market participants being banks that are subject to regulation by the Federal Reserve.

Given the central role that the Federal Reserve has played in addressing both the current credit crisis and issues related to credit derivatives within the broader market, ICE proactively sought to ensure that it's clearing model would be subject to direct regulation by the Federal Reserve. ICE chose its model in order to ensure that its credit derivatives markets will be transparent and fully regulated from the inception of its business. Regulatory requirements will include minimum capital requirements, membership requirements, margin requirements, a satisfactory guaranty fund, and operational safeguards, all with a view to satisfying the internationally recognized clearing standards. As a limited purpose bank, ICE US Trust will be subject to examination by the Federal Reserve and New York Banking Department in the normal course of operations.

Finally, ICE understands that Congress may choose to enact additional financial market reforms in the coming Congress to broaden the purview of regulation of credit derivatives. In the event of such reform, and any decision to vest jurisdiction of credit derivatives with any particular regulator, ICE US Trust will stand ready to work with all appropriate regulators to ensure that its clearing operations are robust, that the trading of credit derivatives through its clearing house is transparent, and that each relevant regulator has all information that it needs to carry out its mission. ICE is willing to work towards any oversight solution that insures that these markets are properly regulated.

Conclusion

ICE has always been and continues to be a strong proponent of open and competitive markets in the 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.