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WRITTEN TESTIMONY OF CHRISTOPHER EDMONDS
PRESIDENT
ICE TRUST
BEFORE THE SENATE BANKING COMMITTEE
SUBCOMMITTEE ON SECURITIES, INSURANCE AND INVESTMENT

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Chairman Reed, Ranking Member Crapo, I am Chris Edmonds, President of ICE Trust, a limited purpose New York bank that operates as a clearinghouse for credit default swaps. I very much appreciate the opportunity to appear before you today to testify on clearing OTC derivatives.

Background

ICE has a long, successful, and innovative history in clearing, including clearing previously “unclearable” over-the-counter (OTC) derivatives such as energy and credit default swaps. ICE owns and operates five derivatives clearinghouses: ICE Clear US, a Derivatives Clearing Organization (DCO) under the Commodity Exchange Act, located in New York and serving the markets of ICE Clear US; ICE Clear Europe, a Recognized Clearing House located in London that clears ICE Futures Europe, ICE’s OTC energy markets and European credit default swaps (CDS); The Clearing Corporation, a DCO and ICE Clear Canada, a recognized clearing house located in Winnipeg, Manitoba, that serves the markets of ICE Futures Canada. ICE Trust serves as the leading United States



clearinghouse for CDS, having cleared approximately \$11 trillion in gross notional value since it launched on March 9, 2009. Globally, ICE has cleared more than \$18 trillion in credit default swap volume since the financial crisis.

Clearing is the cornerstone of U.S. and global regulators' financial reform efforts. Clearing greatly reduces counter party and systemic risk in the derivatives markets for standardized contracts. As an example, since our service came to market we have reduced the outstanding risk exposure by greater than 90% for the products we offer. In addition, clearing brings transparency, and transparency is a pre-requisite for efficient markets and effective regulation. Increased liquidity from clearing results in lower transaction costs and tighter bid/ask spreads, reducing the cost of hedging price risk and lowering operating costs for businesses. Companies operating DCOs, like ICE, have led this effort and have been very successful in their efforts to clear OTC derivatives.

Clearing Over the Counter Derivatives

ICE's experience in energy and credit derivatives demonstrates that when clearing is offered to a market, the market overwhelmingly chooses to clear its products. While convincing market participants of the advantages of clearing is easy, however, the process of clearing an OTC derivative is difficult. For example, in order to clear an OTC



derivative, the clearinghouse must be able to properly price the contract for an accurate mark to market. Marking-to-market is a process common to clearinghouses whereby a clearing participant's position is priced (marked) on at least a daily basis, and to the extent that the clearing participant has incurred a loss, the clearing participant must pay the clearinghouse the amount of the loss. The daily making-to-market of positions, and the commensurate daily collection of any loss (known as variation margin), is a unique discipline of clearinghouses that reduces systemic risk by eliminating the accumulation of losses. In addition, a clearinghouse must determine the correct size and type of contract that it will clear, balancing the risk management objectives of the clearinghouse with the needs of market participants. Finally, the clearinghouse must model risk for the market in order to determine how to properly set margin rates. We do this by working in concert with our clearing firms, who are required to provide accurate pricing information for OTC products.

For Credit Default Swaps (CDS), which we have cleared since March 2009, we require clearing members to provide accurate and reliable prices on a daily basis. If a clearing member submits a price that is out of line with the prices submitted by other clearing members, the clearing member is subject to being required to enter into a transaction at the out of line price. Requiring clearing members to submit to “executable” prices compels clearing members to carefully price the CDS contract. Furthermore, requiring clearing members to submit accurate and reliable prices limits risk



to the clearinghouse by ensuring that one clearing member can assume another's position in the event of default. Over the past ten years, ICE has gained extensive experience with the clearing process—allowing ICE to grow its business and reduce system risk by finding new markets and product to clear.

Over the next few months, the mandatory clearing and trading provisions of the Dodd/Frank Wall Street Reform and Consumer Protection Act (“Dodd/Frank”) should take effect, and market participants will be forced to clear OTC derivatives as a matter of law. ICE respectfully submits that the regulators responsible for determining which contracts must be cleared should consider any mandate very carefully. Many contracts not cleared now are not cleared for good reasons. Some markets have structural issues where illiquidity makes the contracts difficult to price. Other markets have regulatory hurdles where two or more regulators have different ideas on how the market should operate.

ICE generally supports the clearing principles of Dodd/Frank. ICE believes, however, that the best path to meet this goal is to allow clearinghouses and market participants to find the best way to clear markets within defined principles, as opposed to promulgating prescriptive rules for clearinghouses. Many of the proposed rules attempt to design a perfect market. Attempts at such market design are not very likely to work and may delay implementation of clearing services. At the very worst, these efforts may



destroy liquidity in certain markets. The best way to quickly achieve the clearing objectives of Dodd/Frank is to make sure those unnecessary regulatory hurdles and other impediments are removed and to give clearinghouses and market participants the freedom to create cleared OTC markets.

For example, one key regulatory hurdle to clearing is cooperation between regulators. Many OTC derivatives, like CDS, have characteristics of securities and commodities. Close regulatory cooperation between the CFTC and SEC is necessary, and required by law, in order to make sure that market participants have legal certainty. This is particularly important in regards to portfolio margining — allowing security-based and commodity-based derivatives to be held in the same account and margined together. Historically, the CFTC and SEC have had little success creating portfolio margining. After the implementation of Dodd/Frank, the absence of a clear and economical portfolio margining regime will discourage CDS clearing.

Regulation of Clearinghouses

Appropriate regulation of clearinghouses is of utmost importance to the financial system. Pursuant to Dodd/Frank, clearinghouses will be a key part of the efforts to decrease systemic risk in the derivatives markets. In order to accomplish this important mission, clearinghouses must be open and transparent, while exercising proper risk



management controls. However, given the scope, complexity and importance of the OTC derivatives, “one size fits all” regulation will not work. Flexibility is important, because regulators must be able to anticipate and respond to future problems — and not just yesterday’s crises. Prescriptive laws and regulations will hamper flexibility and create regulatory gaps. To be flexible, regulators must be prudential, understanding their markets and tailoring regulation to ensure market integrity and consumer protection.

Regulators need clear lines of jurisdiction. Regulators need to provide certainty that they have the power to take actions to uphold the public good. Likewise, market participants need the certainty that their business transactions will not be held to conflicting standards of conduct. Further, regulatory certainty reduces the possibility of regulatory arbitrage, or long-term damage to the U.S. financial sector in a highly competitive global environment.

The need for certainty extends beyond U.S. borders. It is vital to recognize that the OTC derivatives markets are global: most large companies in the developed world use derivatives, and they conduct these transactions with U.S. counterparties. Thus, U.S. regulators must work with international regulators from a common set of regulatory principles. Right now, Dodd/Frank has created significant uncertainty over whether a transaction will be subject to U.S. regulation or foreign regulation. This lack of clarity may begin to have an impact on markets, drying up liquidity and hampering regulatory



reform efforts because market participants are unsure which laws apply. Therefore, harmonizing regulatory systems across countries and giving market participants is of utmost importance.

Timing of Implementation

Earlier this month, the CFTC and SEC held a roundtable to hear views on the implementation of Dodd/Frank. Dodd/Frank's effective date is July 16th or at least 60 days after a final rulemaking, if one is required. As the CFTC and SEC have come to realize, the legislation cannot (effectively or practically) take effect all at once.

ICE believes that regulators should pursue an aggressive timetable to implement most sections of Dodd/Frank as soon as possible. While Dodd/Frank requires an enormous effort from both market participants and regulators, the cost of uncertainty is much higher. ICE has suggested to regulators that they pursue a three-phase implementation plan. Phase 1 would implement transparency initiatives, including the important swap reporting and swap data repository regulations. Phase 2 would implement the mandatory clearing and trading requirements, building on the transparency created by Phase 1. Phase 3 include everything else, such as non spot month-position limits, which could constrain the mandatory trading and clearing requirements. This



timeline is similar to what other organizations are suggesting, such as the Managed Fund Association.

Flexibility is central to meeting these implementation goals. Regulators have an immense burden to implement Dodd/Frank. Creating a one size fits all prescriptive system of regulations will only increase that burden, as regulators will be required to continually consider exemptions for markets that do not quite fit the regulator's model. Likewise, market participants will have an easier time meeting implementation goals if they have the freedom to meet the goals of Dodd/Frank without radically changing their operations to meet prescriptive rules.

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. 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 and clearing activity on our markets. We have also worked closely with Congress and regulators at home and abroad to address the evolving 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.