

Intercontinental Exchange

WRITTEN TESTIMONY OF CHRIS EDMONDS,
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ON BEHALF OF INTERCONTINENTAL EXCHANGE, INC.
BEFORE THE HOUSE AGRICULTURE COMMITTEE

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Introduction

Chairman Scott, Ranking Member Thompson, I am Chris Edmonds, Chief Development Officer for Intercontinental Exchange, or ICE. I appreciate the opportunity to appear before you today, as this Committee looks at the FTX US Derivatives (“FTX”) request for an amended derivatives clearing organization (“DCO”) registration order to permit clearing of margined products through a retail, non-intermediated clearing model.¹

Clearing houses play a critical role in the financial markets that serve the needs of participants around the globe. Policy makers across the world, including this Committee, have an interest in safe and efficient markets. To further the common interest of well-functioning markets and well-regulated clearing houses, we appreciate the opportunity to participate in this hearing as it examines the FTX request to amend its DCO order to offer direct clearing to retail participants for margined derivative products.

Background

Since launching an electronic over-the-counter (OTC) energy marketplace in 2000 in Atlanta, Georgia, ICE has expanded both in the U.S. and internationally. Over the past seventeen years, we have acquired or founded derivatives exchanges and clearing houses in the U.S., Europe, Singapore and Canada. In 2013, ICE acquired the New York Stock Exchange, which added equity and equity options exchanges to our business. Through our global operations, ICE's exchanges and clearing houses are directly regulated by the U.S. Commodity Futures Trading Commission (CFTC), the Securities and Exchange Commission (SEC), the Bank of England, the U.K. Financial Conduct Authority (FCA), the European Securities and Markets Authority (ESMA) and the Monetary Authority of Singapore, among others.

ICE has a successful and innovative history of clearing exchange traded and OTC derivatives across a spectrum of asset classes, including energy, agriculture and financial products. Today, ICE owns and operates six geographically diverse clearing houses that serve global markets and customers across North America, Europe and Asia. Each of these clearing houses is subject to direct oversight by local national regulators, often in close coordination and communication with other regulatory authorities with important interests, and subject to regulations reflective of the G-20 reforms and IOSCO principles.

ICE acquired its first clearing house, ICE Clear U.S., as a part of the 2007 purchase of the New York Board of Trade. ICE Clear U.S. is primarily regulated by the CFTC and is recognized by ESMA and clears a variety of agricultural and financial derivatives. In 2008, ICE

¹ Available at <https://www.cftc.gov/PressRoom/PressReleases/8499-22>.

Intercontinental Exchange

launched ICE Clear Europe, the first new clearing house in the UK in over a century. ICE Clear Europe clears derivatives in several asset classes, including energy, interest rates, equity and credit derivatives, and is primarily supervised by the Bank of England, in close cooperation with the CFTC, the SEC and ESMA. ICE Clear Credit was established as a trust company in 2009 under the supervision of the Federal Reserve Board and the New York State Banking Department and converted to a derivatives clearing organization (DCO) following implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). ICE Clear Credit is primarily regulated by the CFTC and SEC and is also recognized by ESMA and clears a global set of credit default swaps on indices, single names and sovereigns. In 2017, ICE acquired ICE NGX as part of the sale of Trayport. ICE NGX operates a non-intermediated model for clearing of North American energy products and is regulated by the Alberta Securities Commission and the CFTC. ICE also operates ICE Clear Netherlands under the regulatory supervision of De Nederlandsche Bank, Autoriteit Financiële Markten and ESMA and ICE Clear Singapore which is overseen by the Monetary Authority of Singapore.

Clearing Houses Vital Role in the Derivatives Market

The risk-reducing benefits of central clearing have long been recognized by users of exchange-traded derivatives (futures) and the pre-existing regulatory framework and efficacy of the clearing model throughout even the most challenging financial situations made it the natural foundation of the financial reforms put forward over the past decade. Clearing has consistently proven to be a fundamentally safe and sound process for managing systemic risk. Observers frequently point to non-cleared derivative contracts as a significant factor in the broad reach and complexity of the 2008 financial crisis, while noting the relative stability of cleared markets.

As part of the increased use of clearing, clearing houses and market participants have worked to ensure that the clearing process is robust and resilient and supported by adequate financial, risk management, and operational resources. The Principles for Market Infrastructure (PFMI) represent the internationally agreed-to framework for achieving these goals and are intended to ensure that fundamental protections apply internationally and reduce the risk of regulatory arbitrage. National regulators in G-20 jurisdictions have implemented the key aspects of the PFMI into their regulatory frameworks. This process has set an appropriate standard across numerous jurisdictions for the regulation of a clearing house.

The FTX model raises significant questions around risk management, financial resources, investor protections and the collection of margin in a retail non-intermediated clearing model. Retail non-intermediated clearing substantially differs from both the traditional mutualized clearing model and a non-intermediated clearing model restricted solely to commercial and institutional participants. FTX's proposal eliminates sound risk management practices and many customer protections for retail participants, which are key features of the centrally cleared derivatives markets. FTX's proposed structure creates risk-taking incentives that may serve to increase, rather than reduce, the risk to market participants and the global financial system.

In addition, while FTX's current business focuses on digital assets, the proposed framework is not limited to digital assets. The proposed model significantly deviates from the current regulatory framework and the CFTC should evaluate the implications of these changes.

Intercontinental Exchange

If the FTX proposal is approved, clearing houses could apply this model to other markets such as traditional agriculture or energy commodities. The CFTC must consider the implications of the proposed model as a policy matter for all products and markets. Innovation cannot supersede the primary functions of futures markets for price discovery and hedging. The FTX proposal raises many questions and concerns. As such, the CFTC should use its rulemaking process to propose and fully vet any necessary modifications to the current rules to fit a retail non-intermediated market structure.

Cross-Border Regulation and Equivalence

Cross-border oversight and regulatory deference to home country regulators is essential to well-functioning markets. The CFTC and global regulators have worked together to implement relevant laws, standards, and policies that further the goal of financial stability and resilience, while minimizing supervisory duplication and conflict. Global regulators have recognized third-country clearing houses as equivalent allowing market participants to continue accessing global markets. ICE does not believe the FTX proposal fully satisfies the PFMI and Commission regulations and as such, the CFTC should carefully consider the cross-border implications of approving a clearing model that fails to satisfy the PFMI. Other jurisdictions including the European Union (“EU”) and the United Kingdom (“UK”) rely on compliance with the PFMI to determine whether a jurisdiction has comparable or equivalent regulation. The current recognition of US clearing houses in the EU and UK is based on this determination of equivalence. It is critical that any action by the CFTC not jeopardize the existing foreign equivalence determinations applicable to U.S. clearing houses.

Current Regulatory Framework

The FTX proposal raises significant questions regarding compliance with the PFMI and CFTC regulations. Specifically, the FTX proposal does not fully meet PFMI standards and CFTC rules for credit risks, sufficient financial resources to cover participant exposure, liquidity risks, default management, governance, and customer protections. Under the FTX proposal, the clearing house does not evaluate and monitor the credit risk of its participants. FTX does not have credit standards for participants nor are participants required to meet any minimum capital or asset requirements. The clearing house does not conduct any due diligence on a participant’s ability to perform its obligations and the FTX proposal does not indicate that FTX would review individual participants financial reports. The clearing house would solely rely on margin provided by the participant and the automated close-out methodology. This approach removes a fundamental protection existing in other clearing models where the clearing house can look to the financial strength of the participants in addition to the posted margin. Moreover, the proposed auto-liquidation process would manage capital-related risks other than through participant capital requirements, as required.

Moreover, there are fundamental differences between the traditional clearing house model and the FTX model related to the treatment of losses in a portfolio. Currently, clearing houses operate a “pay as you go” model, meaning losses are settled at least once a day. This model allows participants to maintain their positions notwithstanding negative market moves. Conversely, the FTX model is a “go as you pay” model. In this model, when a participant’s collateral is eroded below a prescribed threshold, FTX liquidates the position and the participant’s participation is stopped. The FTX participants lose their positions when the

Intercontinental Exchange

market moves against them, and they are liquidated at adverse prices. ICE notes the risks to the market and other participants when a clearing house is forced to automatically liquidate and the potential for a cascading downward spiral, especially in relatively illiquid markets.

In addition, the financial resources supporting the clearing house are key to the management and mitigation of credit risk and to ensuring the safety, soundness and robustness of the clearing system. The cover 1/cover 2 standard is designed for clearing arrangements with institutional clearing members. This standard, in addition to the FTX proposed cover 3 alternative, is not suitable for a retail non-intermediated clearing model based on the large number of small retail market participants. Such an approach would include a small proportion of a DCO's exposure to a participant default against which to make a reasoned assessment of appropriate financial resource requirements. Nonetheless, it is essential that each clearing organization be subject to a robust financial resource standard - particularly when the participants at risk of a default by the clearing house are individual retail investors.

Moreover, FTX proposes to allow itself to use customer funds for FTX operations and replace the funds at some point in the future. The FTX proposal states that in some cases margin provided by users may be used for liquidity purposes or haircut due to losses caused by other users. This approach is inconsistent with the approach taken by other clearing houses in default management where margin of a non-defaulting member is not subject to use in the default by another member. It is also inconsistent with the general principles under Section 4d of the Commodity Exchange Act and CFTC regulations which prohibit funds of one customer to be used to cover obligations of another.

Comparison to Other Non-Intermediated Models

ICE has significant experience with non-intermediated clearing arrangements through its ICE NGX clearing house. ICE NGX operates a sophisticated commercial market, offering clearing services to producers, marketers and utilities in the physical energy markets of North America. Commercial and institutional participants utilize the ICE NGX markets to manage risk associated with a physical energy business. ICE NGX has been clearing physical energy products for over 20 years and has a history of managing volatility and participant defaults. ICE NGX has a risk profile that differs substantially from the FTX proposal and has numerous features and protections that are not present in the FTX proposal. ICE NGX participation is restricted to commercial market participants that meet minimum financial requirements. ICE NGX can also call for additional collateral and there is no auto-liquidation function. Participants in cleared physical markets are also required to have the capability to make and take delivery of underlying energy commodities, which discourages pure speculative trading firms from participating. The ICE NGX commercial non-intermediated model includes robust risk management and financial protections that comply with CFTC regulations and the internationally-agreed standards applicable to clearing houses. The FTX proposal does not share many of these features and raises issues that differ from those of existing institutional non-intermediated arrangements.

Conclusion

Intercontinental Exchange

ICE has always been, and remains, a strong proponent of open and competitive markets with appropriate regulatory oversight. As an operator of global futures and derivatives markets, ICE understands the importance of ensuring the utmost confidence in financial markets. To that end, the FTX proposal raises significant policy issues as well as questions about compliance with the PFMI and Commission regulations that warrant further analysis. The approval of the FTX proposal could undermine the internationally agreed to framework and Commission regulations intended to achieve the goal of a robust and resilient clearing process.

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