March 21, 2011

Mr. David Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street, NW
Washington, DC 20581

RE: *Risk Management Requirements for Derivatives Clearing Organizations*
RIN 3038-AC98

Dear Mr. Stawick:

IntercontinentalExchange, Inc.("ICE") appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("CFTC" or "Commission") proposed rules (the "Proposal") setting forth risk management requirements for derivatives clearing organizations ("DCOs").

As background, ICE operates five derivatives clearinghouses: (1) ICE Clear U.S., a CFTC registered Derivatives Clearing Organization ("DCO") , located in New York and serving the markets of ICE Futures U.S.; (2) ICE Clear Europe, a Recognized Clearing House (and CFTC registered DCO) located in London that serves ICE Futures Europe, ICE's OTC energy markets effected through its exempt commercial market under Section 2(h)(3) of the Commodity Exchange Act ("Act") and also operates as ICE's European clearinghouse for OTC credit default swaps ("CDS"); (3) ICE Clear Canada, a recognized clearing house located in Winnipeg, Manitoba that serves the markets of ICE Futures Canada; (4) The Clearing Corporation, a CFTC registered DCO; and (5) ICE Trust**,** a U.S.-based clearing house for OTC CDS. As the operator of a diverse set of clearinghouses based in three countries, ICE has a practical perspective of the operation of DCOs and the important risk mitigation roles that they serve.

<u>Executive Summary</u>

In the final rules, the Commission should:

- Eliminate the requirement for gross margining or extend the deadline for DCOs to comply with a gross margin requirement;

- Clarify what the Commission means when it states that a DCO shall not adopt restrictive clearing member standards if there are less restrictive requirements that do not “materially increase” risk to the DCO;
- Not preclude an agency or open offer model for clearing swaps by requiring novation in the DCO’s legal structure;
- Not impose a hard concentration limit for settlement banks;
- Not require a DCO to report to the Commission when its Board overrides its Risk Committee;
- Not require every DCOs to conduct an on site review of every clearing member; and
- Conform its business continuity and disaster recovery rules to common financial agency standards.

General Comments on the Proposal

Clearing is the cornerstone of U.S. and global regulators financial reform efforts as a properly structured clearinghouse can potentially reduce counter party and systemic risk in the derivatives markets for standardized contracts. In addition, clearing brings transparency, and transparency is a pre-requisite for greater liquidity, better price discovery, more efficient markets and effective regulation. Increased liquidity 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. A key contributor to this success has been the Commission’s flexible core principles regime, which is now to be replaced by the prescriptive rules proposed in the Proposal.

In general, DCOs already comply with many of the proposed rules in this rulemaking. However, the Commission should ask itself whether there should be only one way to comply with the core principles and whether this single method of compliance should apply to all asset classes in the same way, without regard for their inherent differences. As ICE knows from operating in many markets, rules that apply to commodity derivatives do not necessarily transfer to credit derivatives.

Specific Issues in the Proposal

Gross Margining for Customer Accounts

Proposed rule § 39.13(g)(8)(i) requires DCOs to collect initial margin on a gross basis from each clearing firm’s customer account. As the Commission recognizes, this

will "be a change from current margin practices at certain DCOs."[1] These DCOs use net margining, which some clearing firms believe is more efficient because it allows customer positions to net against one another in the calculation of margin. The Commission's rationale for making this change is the belief that "gross margining of customer accounts would more appropriately address the risks posed to a DCO by its clearing firms…by increase[ing] the financial resources available to a DCO in the event of a customer default."[2] In essence, the Commission's rationale is that customer risk can be mutualized to protect the DCO. This rationale directly conflicts with reasoning behind the Commission's proposed rule *Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies*.[3] In that proposed rulemaking, the Commission proposes to require DCOs to individually segregate customer funds to protect customers from "fellow customer risk."[4] Thus, in one rulemaking, the Commission is concerned about a DCO using customer funds to protect the DCO, and in another, the chief concern is that the DCO have the financial resources available to address the risk posed by a customer default. Moreover, gross margining is unnecessary, as recent history has indicated. Many clearinghouses using net margining did not have any difficulties meeting their obligations during the 2008 financial crisis.

If the Commission decides to require that DCOs use gross margining, it should be aware that converting to a gross margining system is a major operational change for clearing firms and DCOs.

Operational impacts to DCOs and clearing firms include

- **Changes to the Clearing Firm Customer Reporting Timeline**
  Clearing firms will need to apply same day customer closeouts to derive positions prior to the normal end-of-day processing in order to calculate margin. However, in order to do this, the clearing firm must rely on the daily production of the SPAN Array file to determine the tier structures for inter-commodity and inter-contract spreads. Spread tier structures are required to calculate these spreads before they may be submitted to the DCO. This will require reengineering of clearing firm's end of day processing as most firms operationally perform customer closeouts to the DCO the next morning.

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[1] 76 Fed. Reg 3698, 3706 (January 20, 2011).

[2] *Id.*

[3] 75 Fed. Reg, 75162 (December 2, 2010).

[4] *Id.* at 75163.

- **Changes to the Clearing Firm Position Reporting Requirements and Reconciliation Process**
  To determine gross margins, clearing firms must provide details of their customer's position in the form of "spreads" where the clearing firm maintains their own customer position, according to the inter-month and inter-contract tiers and deltas. These positions must be delivered to the DCO to determine the outright gross positions and the spreads. In turn, the DCO must implement new reconciliation and reporting processes to enable clearing firms to confirm their intended client position levels.
- **Changes to the Margining Systems for the DCO and Clearing Firms**
  The margining technology currently applied by DCOs using net margining does not determine these spreads and must be extended to support gross margin clearing firm customer reporting. Equally, the data submission/input mechanism and margin reporting specifications employed by the DCO must change to allow clearing firms to submit and receive the necessary position and margin data. The clearing firms must implement these enhancements to their bespoke software and/or solicit their third-party middle and back-office service providers to make software updates. Changes to position reporting, reconciliation and margining methodology are challenging technology changes for members and their third-party software vendors and typically take at least 6 to 9 months to fully complete.

Given the depth and breadth of the operational and technology impacts imposed by a change to gross margining, the Commission should allow an implementation period of at least twelve months. A longer implementation period will allow DCOs and clearing firms to adequately test and implement systems necessary for gross margining. Note that lengthening this requirement will not affect the Commission's rulemaking timeline substantially as most, but not all DCOs use gross margining now.[5]

Participant and Product Eligibility

Proposed rule § 39.12(a)(1)(i) states that a DCO shall not adopt restrictive clearing member standards if there are less restrictive requirements that do not "materially increase" risk to the DCO. In essence, the Commission's proposal would require DCOs to dilute current prudent risk management practices. The Commission should state the level of risk should that a DCO can ignore in order to be more inclusive in its clearing member standards. Given the importance of DCOs to the financial system, the Commission should not adopt this prescriptive requirement. Rather, the Commission

[5] For example, ICE Trust and ICE Clear U.S. use gross margining, while ICE Clear Europe uses net margining.

should ensure that minimum financial requirements for clearing membership are sufficient to provide a deep financial cushion in the event of a large customer default or clearing member insolvency as occurred in 2008.

Proposed rule § 39.12(b)(4)(ii) requires a DCO that clears swaps to adopt rules providing that, upon acceptance of a swap by the DCO for clearing, "the original swap is replaced by equal and opposite swaps between clearing members and the DCO."[6] This may imply a "principal" or novation model rather than an "agency" or "open offer" model for cleared swaps. In contrast, U.S. futures markets may clear on an open offer basis, which allows straight through processing. The Commission should not preclude open offer clearing of swaps by requiring the underlying swap to be novated.

Settlement Banks

Proposed rule § 39.14(c)(3)(iii) requires a DCO to impose a concentration limit on its own or its clearing member's settlement banks. In general, limits on asset concentration are useful in limiting risk. However, prescribing concentration limits for settlement banks is unnecessarily prescriptive and expensive for clearing firms and customers, especially if the Commission requires DCOs to adopt individual customer segregated accounts. In that case, a clearing firm may end up with thousands of accounts at different settlement banks, which would cost an average of $900 per year per account, in addition to the expense and inefficiency that would be incurred by multiple wire transfers for each account. When totalled, the redundant settlement bank requirement could be very expensive for customers.

Note that if the Commission determines hard limits are necessary, this may actually increase risk. In order to comply with the limit, a DCO will need to distribute funds across a wide group of banks. As settlement funds increase then the amount of highly rated banks will eventually be consumed by the concentration limits. In the end, DCOs may have to open accounts with lower rated banks: a counter-productive outcome. Finally, limits may act as a constraint on customer choice, if one bank has a large number of settlement customers then there will be natural concentration of settlement flows. In that instance, the DCO may have to direct customers not to use their chosen bank.

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[6] 76 Fed. Reg. at 3702.

Letters of Credit

Proposed Rule 39.15(c)(1) provides that "a derivatives clearing organization may not accept letters of credit as initial margin."[7] The Commission should not adopt a blanket prohibition on letters of credit as they provide members with flexibility for risk management. The Commission should note that the recently proposed CCPS-IOSCO Principles for Financial Market Infrastructure do not prohibit any type of collateral and adopting this requirement will put U.S. DCOs at a disadvantage to foreign clearing houses. The Commission should adopt a more flexible approach and DCOs continue the long standing practice of accepting letters of credit as initial margin.

Governance and Fitness Standards

Proposed rule § 39.25 requires DCOs to report to the Commission when a DCO's Board of Directors overrides the decision of a Risk Committee. The Commission gives very little justification for why it will require corporations to disclose their confidential decision making process, except to cite two general comments from a public roundtable. As ICE has stated in previous comment letters,[8] requiring such disclosure will make overturning a committee decision very unlikely because directors will likely be hesitant to take action that could lead to public disclosure and second-guessing of their decisions or even regulatory action. This in turn could result in committees, which have a narrower, delegated responsibility, asserting greater authority over the affairs of the company than intended by the Commission, or necessarily in the best interests of the company.[9] The Commission's proposed rule could lead to an unchecked committee dominating the DCO.

Finally, proposed rule § 39.13(b) requires the Board of Directors of a DCO to approve the written policies, procedures and controls that establish the DCO's risk management framework. The Commission should clarify that the DCO's Risk Management Committee can also be involved in approving these policies. This clarification would also be consistent with proposed rule § 39.13(c), which requires the DCO's Chief Risk Officer to make "appropriate recommendations to the DCO's Risk Management Committee or Board of Directors, as applicable, regarding the DCO's risk management function.

[7] *Id.*

[8] http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=31101&SearchText=

[9] Note ICE continues to believe that DCOs should have the flexibility to have a risk committee that serves in an advisory capacity.

Risk Management

Proposed rule § 39.13(g)(8)(ii) requires DCOs to require clearing members to collect greater than 100% of DCO initial margin requirement for "non-hedged" positions. In current practice, the duty of determining a hedge or non-hedged position typically falls upon the futures commission merchant ("FCM"). The DCO's initial margin determination is the amount it needs to protect the clearinghouse. As the FCM has complete visibility into their customer's positions, they are best able to determine how much to charge above the initial margin requirement. The CFTC should not place this requirement on the DCO, but should address this with FCMs through another set of rules.

Proposed rule § 39.13(h)(5) requires DCOs to adopt rules to require clearing members to maintain written policies and procedures regarding risk management, and to "review the risk management policies, procedures, and practices of each of its clearing members on a periodic basis and document such reviews." The Commission asks whether it should mandate that DCOs conduct onsite reviews of clearing members. Many firms are clearing members of multiple DCOs. If every DCO were required to conduct reviews of each of its clearing members, certain clearing members would likely have multiple DCOs on their premises conducting reviews for much of the year. Thus, continual on-site risk reviews by multiple DCOs could become overly burdensome for clearing members. The Commission should address this through the current Designated Self Regulatory Organization structure.

Business Continuity and Disaster Recovery

Maintaining operations is of utmost importance to ICE, both from a market integrity and a financial standpoint. ICE invests substantially in its back-up systems and spends substantial effort on its business continuity and disaster recovery programs. ICE supports many of the Commission's proposed rules governing business continuity and disaster recovery standards. However, the Commission should consider the expense and necessity of certain proposed rules.

For example, proposed rule § 39.30(a) requires Systemically Important Derivatives Clearing Organizations ("SIDCOs") to set a recovery time recovery objective ("RTO") of no later than two hours following any disruption. ICE designs and builds it systems to be highly available and has a significant and ongoing commitment to business continuity and disaster recovery preparedness. Business continuity best practices use analysis of the business processes and requirements to determine recovery time objectives; however, this rule is overly prescriptive by not recognizing that, depending on

the clearing organization's daily schedule, it may be able to meet its obligations for the business day with a longer RTO. While the SEC's *Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System* does reference an "overall goal of achieving recovery and resumption within two hours after an event" that is only in the context of the primary emphasis of having core clearing and settlement organizations recover and resume their operations "within the business day on which a disruption occurs."[10] Additionally, the two hour goal is directed a very specific set of financial markets and the paper goes on to say that "[f]irms that play significant roles in the *other critical financial markets* (italics added) should strive to achieve a four-hour recovery time capability for clearing and settlement activities in order to ensure that they will be able to meet a within the business day recovery target." By adopting the most aggressive time goal of a two-hour RTO, the rule does not capture the spirit of the *Interagency White Paper*'s same business day objective. Assigning an RTO to a SIDCO instead of assigning the objective the RTO is intended to achieve adds significant cost to a SIDCO's business continuity program but does not necessarily increase overall resilience of the financial system.

In addition, the definition of a "wide-scale disruption" in proposed § 39.18(a) does not specify a minimum time that such a disruption must be accommodated. The level of cross-training and redundant personnel required could be significantly higher if the "unavailability of the population in the relevant area" that must be accommodated is for total loss of personnel instead of temporary period. The Commission should state a maximum time that must be accommodated. ICE recommends one week to allow relocation of personnel outside the affected area.

Finally, proposed rule § 39.18(j)(2) requires that"[t]esting shall be conducted by qualified, independent professionals." The Commission elaborates that "[s]uch qualified independent professionals may be independent contractors or employees of the derivatives clearing organization, but shall not be persons responsible for development or operation of the systems or capabilities being tested." As a normal procedure, the personnel charged with designing or operating the systems test the recovery and business continuity processes. Management reviews the process through its governance process and by internal audit. The Commission should clarify that a qualified, independent professional should review testing of systems or capabilities rather than conduct the actual tests.

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[10] http://www.sec.gov/news/studies/34-47638.htm

Conclusion

We appreciate the opportunity to comment on the proposed rules. Please do not hesitate to contact the undersigned if you have any questions regarding our comments.

Sincerely,

R. Trabue Bland
Vice President and Assistant General Counsel
IntercontinentalExchange, Inc.