



Atlanta Calgary Chicago Houston London New York Singapore

August 8, 2011

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

RE: *Proposed Rulemaking relating to Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies, RIN 3038-AC99*

Dear Mr. Stawick:

IntercontinentalExchange, Inc. (“ICE”) appreciates the opportunity to comment on the Commodity Futures Trading Commission’s (“Commission”) advanced notice of proposed rulemaking relating to the protection of the collateral of individual customers clearing swaps transactions.

As background, ICE operates four regulated futures exchanges: ICE Futures Europe, ICE Futures Canada, the Chicago Climate Exchange, and ICE Futures U.S. ICE also owns and operates five derivatives clearinghouses: ICE Clear U.S., a Derivatives Clearing Organization (“DCO”) under the Commodity Exchange Act, located in New York and serving the markets of ICE Futures U.S.; ICE Clear Europe, a Recognized Clearing House located in London that serves ICE Futures Europe, ICE’s OTC energy markets and operates as ICE’s European credit default swaps (“CDS”) clearinghouse; ICE Clear Canada, a recognized clearinghouse located in Winnipeg, Manitoba that serves the markets of ICE Futures Canada; The Clearing Corporation, a U.S. Derivatives Clearing Organization and ICE Clear Credit, a U.S.-based DCO and Securities Clearing Agency.

ICE recognizes that customers face a degree of “fellow-customer risk” as a part of the traditional clearinghouse model.¹ However, the traditional clearinghouse model has worked well by providing a high level of customer protection while keeping the cost of clearing low. This important balance has served to promote a considerable level of OTC clearing, especially in energy swaps. Thus, it might make more sense for the Commission to carefully consider and weigh the costs and benefits of potential customer-related OTC clearing models

¹ Pursuant to traditional futures clearing models, the amount of “fellow-customer risk” is limited to the amount of initial margin a customer has posted with its Futures Commission Merchant (FCM). As discussed in more detail herein, the ICE Clear Credit model further limits the amount of “fellow-customer risk” to a customer’s pro rata share of its FCM’s net customer-related margin requirement with ICE Clear Credit.



by asset class², as opposed to trying to determine if any potential models should apply to all swaps.

As the owner of ICE Clear Credit, an innovative and active CDS clearinghouse, ICE has a unique perspective on the questions raised by the Commission in its Proposed Rulemaking related to protecting the collateral of customers clearing swaps transactions.

The ICE Clear Credit Customer-related Clearing Model

The ICE Clear Credit customer-related clearing regime is modeled after the traditional futures clearing model that has served ICE's other clearinghouses and the futures industry well for decades. Most importantly, the ICE Clear Credit regime segregates customer collateral from any house/proprietary trading. In other words, ICE Clear Credit is strictly prohibited from utilizing customer collateral to satisfy obligations related to trading by the customer's clearing participant for its house/proprietary account. Thus, in the event that a clearing participant defaults to ICE Clear Credit with respect to a house/proprietary position, all customer collateral is protected (segregated) and may not be used to satisfy the clearing participant's obligation to ICE Clear Credit.

Customer collateral is only "at risk" in the event that a "fellow-customer" at its common clearing participant causes the clearing participant to default to ICE Clear Credit, and in such an event, customer collateral is "at risk" only after ICE Clear Credit has applied a number of significant financial resources of the defaulting clearing participant toward the default.

As stated by the Commission in its Advanced Notice, "fellow-customer risk" is positioned toward the middle of a traditional clearinghouse's default resources waterfall. This is also the case with respect to ICE Clear Credit. Consequently, there are several lines of defense in front of "fellow-customer risk" that significantly reduce the likelihood customer margin will be used as a resource in the event a clearing participant defaults to the clearinghouse. The first line of defense is the margin of any defaulting customer. The second line of defense is the margin of the defaulting clearing participant. As soon as practicable, ICE Clear Credit would liquidate any positions maintained by the clearing participant and apply any available margin collateral to the defaulting customer-related position. The third line of defense is the guaranty fund contribution of the defaulting clearing participant. ICE Clear Credit would apply any available guaranty fund contribution of the clearing participant to the defaulting customer-related position.

² ICE questions whether there has been a general interest by customers regarding individual customer account segregation or whether the driving force behind individual account segregation might be asset class specific (i.e., CDS).



In addition, ICE Clear Credit intentionally designed its CDS-related clearing model to further reduce the amount of “fellow-customer risk.” Specifically, under the ICE Clear Credit model, customers are exposed to “fellow-customer risk” only with respect to the customer’s pro-rata share of the net customer-related margin requirement of its clearing participant. A customer’s pro-rata share of the net of the clearing participant’s customer-related net margin requirement represents a fraction of a customer’s gross margin requirement.³ Whereas, under traditional futures-related clearing models, a customer is exposed to potentially losing the full (gross) value of its margin as a result of another customer’s default.

ICE submits that, with respect to swaps clearing, the net mutualization regime designed for ICE Clear Credit represents an appropriate middle ground between a traditional gross mutualization clearing model and the interest by certain OTC customers in an individual customer account segregation model. ICE also respectfully submits that the customers “calling for” an individual account segregation model have done so without fully appreciating the substantial costs (discussed below) associated with implementing and maintaining such a model. Upon fully understanding the costs associated with individual account segregation, certain customers might determine that it makes more sense to become a direct clearing participant as a means of avoiding “fellow-customer risk.” Such an alternative might be a more viable option in light of the Commission’s recently proposed rulemaking that would prohibit DCOs from setting a minimum capital requirement of more than \$50 million for any entity that seeks to become a clearing member in order to clear swaps.⁴

Potential Systemic Costs Associated with Individual Customer Segregation

ICE cautions that there are potentially significant systemic costs that might be incurred if the Commission decides to fundamentally change how clearinghouses have cleared for decades and require clearinghouses to adopt a model such as Legal Segregation With Commingling. ICE reminds the Commission that the current customer omnibus model is designed, in part, for a significant and practical settlements-related reason. Specifically, the omnibus model is designed to allow for timely settlements during times of market stress. The current laws recognize, as a matter of public policy, the important role clearinghouses provide with respect to the settlement of financial transactions, especially during times of financial stress.⁵

³ ICE Clear Credit holds the difference between a customer’s gross margin requirement and the customer’s net margin requirement (such difference is known as “Excess margin”) strictly on a custodial basis. Such Excess margin may not be applied to another customer’s default, and as a result, such Excess margin is not exposed to “fellow-customer risk.”

⁴ Risk Management Requirements for Derivatives Clearing Organizations, 76 Fed. Reg. (December 16, 2010) (to be codified at 17 C.F.R. pt. 39).

⁵ In its recent release “Risk Management Requirements for Derivatives Clearing Organizations”, the Commission recognizes that Core Principle G, as amended by Dodd-Frank, requires each DCO to have rules



From a practical standpoint, it would be almost impossible for a clearinghouse to accurately reconcile individual customer accounts and their respective customer collateral at the time of a default. A traditional clearinghouse does not maintain individual customer account information and instead would be required to rely on information provided by the defaulting Futures Commission Merchant (“FCM”). At the time of a default, the defaulting FCM is likely to be in a state of chaos and there is little chance that a clearinghouse will know individual customer positions and margin with sufficient certainty. Nor can a clearinghouse assume that margin in the customer omnibus account belongs to any particular customer. Margin held by the clearinghouse could have been advanced by the defaulting FCM or, in the futures world, might belong to a customer participating in another market. Historically, it has taken bankruptcy trustees months after the fact to decipher the individual customer positions and the related margin and marked-to-market (variation) amounts following the default of a FCM. (For a clearinghouse to know individual customer-related margin and variation amounts with certainty, the clearinghouse would need to be directly involved with all initial margin and variation payments from and to each customer. This would effectively disintermediate FCMs from the settlement flows with its customers.)

The fact that a traditional clearinghouse does not have customer-specific information is recognized in the provisions that govern bankruptcy liquidation. (See, Interpretative Statement, No. 85-3, attached as the Appendix to the Advanced Notice.)

Our conclusion that Section 4d(2) generally allows clearing organizations to treat customer funds as the property of the depositing firm’s customers, collectively, without regard to the respective interests of particular customers, also finds support in the legislative history of the Bankruptcy Reform Act of 1978. In recommending new provisions to govern bankruptcy liquidations of commodity firms, the Commission described the clearinghouse system then (and now) operant in the futures market as one in which “a clearinghouse deals only with its clearing members” and thus “does not know the specific customer on whose behalf a particular contract was entered into by one of its clearing members.” *Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil and Constitutional Rights, House Comm. on the Judiciary, 94th Cong., 2d Sess. 2377, 2395* (Statement of William T. Bagley) (1976). The Commission explained that this system allows a clearing organization to use “whatever funds are on deposit with it on behalf of customers to meet variation margin calls with respect to customers’ trades or contracts” and, following a clearing member default, the defaulting firm’s

and procedures designed to allow for the efficient, fair, and safe management of events during which clearing members become insolvent or otherwise default on their obligations to the DCO. Each DCO must also clearly state its default procedures and ensure that it may take timely action to contain losses and liquidity pressures and to continue meeting its obligations. Section 5b(c)(2)(G) of the CEA.



“original margin deposits are immediately available to offset any losses the clearinghouse might incur” as a result of answering variation margin calls to the defaulting firm. *Id.* at 2397, 2405.

Dodd-Frank – Limitation of Exposure to Potential Losses from Defaults

Eliminating or moving the mutualization of customer margin from a clearinghouse’s waterfall would be inconsistent with the intent of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”). Section 725 of Dodd-Frank amends section 5b(c)(2)(D)(iii) of the CEA to provide that:

Limitation of Exposure to Potential Losses from Defaults – Each derivatives clearing organization, through margin requirements and other risk control mechanisms, shall limit the exposure of the derivatives clearing organization to potential losses from defaults by members and participants of the derivatives clearing organization to ensure that – (I) the operations of the derivatives clearing organization would not be disrupted; and (II) nondefaulting members or participants would not be exposed to losses that nondefaulting members or participants cannot anticipate or control.

In its recent January 11, 2011, Notice of Proposed Rulemaking, the Commission proposes regulation 39.13(f) with language that is virtually identical to the language in section 5b(c)(2)(D)(iii) of the CEA, as amended by Dodd-Frank.

Non-defaulting clearing participants are not in a position to anticipate or control the customer-related clearing losses of a defaulting clearing participant. As noted above, the mutualization of customer margin (in the event that a fellow customer causes a clearing participant to default) falls ahead of the non-defaulting clearing participants’ contributions to the guaranty fund and thus provides a layer of protection to the nondefaulting clearing participants. If the Commission requires individual account segregation it will remove this layer of protection and effectively expose, to a greater degree, nondefaulting clearing participants to losses that they cannot anticipate or control.

The Commission points to the Section 4d(f) use of swaps customer (in the singular) rather than swaps customers (in the plural) as evidence that Congress intended to require DCOs to offer individual customers. This is a fundamental and significant change to swaps clearing resulting from the omission of one letter. The Commission should note that there is no legislative history describing this change, which in all other respects (as the Commission notes) mirrors the existing language in the CEA. As Congress and the Commission are aware, DCOs have cleared swaps similar to futures for over 10 years. As with other parts of



Dodd-Frank, Congress appears to be applying the current futures model on the swaps market. Before making this radical change, the Commission should request that Congress clarify that it meant to legislate this change.

Imposing Individual Account Segregation will Result in a Shift in the Balance of Risk Mutualization within a Clearinghouse that will Significantly Increase Customer Margin Requirements

As noted and discussed above, the initial margin of customers currently serves as a default resource at ICE Clear Credit in the event that a defaulting customer's losses are greater than the financial resources (i.e., margin and guaranty fund) of the customers' defaulting clearing participant.⁶ Again, "fellow-customer risk" or mutualization of customer margin falls behind the first three layers of traditional clearinghouse waterfalls: defaulting customer margin, defaulting clearing participant margin, and the defaulting clearing participant's guaranty fund contribution. However, importantly, "fellow-customer risk" or mutualization of customer margin falls ahead of the non-defaulting clearing participants' guaranty fund contributions.

If the mutualization of customer margin is eliminated from the waterfall in the Legal Segregation With Commingling models, or if the mutualization of customer margin is placed at the end of the default resources under the Moving Customers to the Back of the Waterfall model, then the non-defaulting clearing participants who have contributed capital to the guaranty fund will be exposed sooner, and to a greater degree, than they are today. Clearing participants will be uncomfortable exposing their capital to this extent and would likely face increased capital charges as a result of such a change to the waterfall. Accordingly, clearing participants will expect the balance between initial margin requirements and guaranty fund requirements to shift more toward initial margin requirements in order to cover the added risk associated with the removal from, or movement within the waterfall of the mutualization of customer margin. (See below for a detailed risk analysis of the costs associated with shifting the balance of default resources from the guaranty fund to initial margin.)

Changes to Default Management Structure Resulting from Individual Account Segregation

Best-practices for clearinghouses include setting an appropriate ratio between collateralization and mutualization pools, i.e. between initial margin requirements and guaranty fund contributions. The initial margin requirement is intended to provision against low-probability expected losses typically occurring with probability of 1%, i.e. 99% protection, over a selected risk horizon. The chosen risk horizon must reflect the specificities and depth of the centrally cleared market.

⁶ Non-defaulting customers would also have a claim against the bankruptcy estate of the defaulting clearing participant to recover any of the customers' margin that was applied by the clearinghouse to satisfy the defaulting clearing participant's loss.



A major consideration in designing the size of the guaranty fund is the magnitude of potential losses given extreme, but plausible, scenarios. The magnitude of the extreme losses is driven by the risk profile of the cleared financial instrument. CDS instruments present very unique highly asymmetric risk profiles associated with long or short protection positions. The embedded risk of CDS instruments stems from the financial liability of the protection seller upon a credit event.

In general, idiosyncratic (“surprise”) credit events are associated with very low probabilities. ICE Clear Credit’s Risk Management approach, to date, has been to mutualize such losses through a guaranty fund rather than direct collateralization through initial margin requirements. Direct collateralization would lead to very high capital costs that would be detrimental to the CDS market. Table 1 (below) illustrates the impact of incrementally increasing the level of initial margin protection for CDS clearing. The presented results correspond to the currently guaranteed ICE Clear Credit universe of portfolios. “Locking” very significant amounts of funds to provision for low-probability extreme losses will negatively impact the market depth and liquidity, especially in distressed market conditions where market depth is essential.

From a systemic risk point of view, the introduction of a clearinghouse model that features high concentration of initial margin and small guaranty fund is very questionable. The typical clearinghouse waterfall approach features the assessment right which provides the clearinghouse with the ability to “call” for additional funds from non-defaulting clearing participants upon a clearing participant default. In turn, the clearinghouse assessment right yields a second, unfunded, guaranty fund. By increasing the amount of funds attributable to initial margin and reducing the guaranty fund contributions, the clearinghouse is effectively reducing the size of the default funds available to cure a clearing participant default. It is advisable to assume that the extreme scenarios used for guaranty fund size determination might not cover all potential adverse scenarios. As a result, it is appropriate to maintain access to additional default funds through assessment rights.

Further, most clearinghouses have different requirements in terms of collateral assets used to meet initial margin and guaranty fund obligations. Specifically, the guaranty fund assets are more liquid and commonly used as a liquidity pool during default management. Decreasing the guaranty fund size would substantially reduce the liquidity pool available to a clearinghouse. Compensating approaches to maintain a minimum liquidity pool will lead to an increased cost of central clearing. It will yield capital inefficiencies specifically for market participants with limited access to a wide range of accepted collateral assets.



	99.00%	99.50%	99.75%	99.90%
CP A	1.00	1.20	1.49	1.87
CP B	1.00	1.28	1.68	2.34
CP C	1.00	1.38	2.26	4.12
CP D	1.00	1.38	2.13	3.73
CP E	1.00	1.25	1.62	2.28
CP F	1.00	1.46	2.38	4.35
CP G	1.00	1.41	2.21	3.95
CP H	1.00	1.39	2.15	3.73
CP I	1.00	1.36	1.93	3.21
CP J	1.00	1.26	1.68	2.51
CP K	1.00	1.73	3.36	6.35
CP L	1.00	1.42	2.40	4.26
CP M	1.00	1.41	2.29	3.81
CP N	1.00	1.73	3.27	5.49
Average:	1.00	1.40	2.20	3.71

Table 1. Risk-related cost estimate for Full Physical Segregation model: Impact of increasing the statistical risk quantile used for initial margin computations. The numbers in the table represent the scaling of initial margin as a function of the chosen level of protection. Currently, ICE Clear Credit uses a 5-day 99% risk quantile. If the risk quantile is increased to 99.5%, the average initial margin increase will be about 40%, i.e. scale factor of 1.4. In order to achieve the overall clearinghouse desired protection level of 99.90%, the initial margin requirements will increase approximately 3.7 times. (The corresponding guaranty fund size would be approximately equivalent to the sum of the minimum guaranty fund contributions.)

Implementation and Administrative Costs

As noted in our previous comments, individual customer segregation would require significant operational and administrative changes at ICE Clear Credit involving (depending on the model): trade processing systems; compliance processes and systems; risk management processes, methodologies and systems; and treasury processes, systems and accounts. The required changes will result in significant initial and ongoing costs and would take considerable time to implement.

DCO Treasury-related Costs

A model requiring individual segregation of each customer's collateral at all levels would present many challenges relating to a DCO's treasury operations. The areas affected would include: bank settlement and custody accounts; collateral managements systems; investment return options; and balancing/reconciliation and reporting.



The proposed model would fundamentally change the way margin cash and collateral are held at a DCO today. Today, ICE Clear Credit maintains an omnibus account arrangement that records cash and collateral in a sub-ledger “collateral management system” for each clearing participant by regulatory account origin (house and customer omnibus). Cash accounts and custody accounts are opened for each regulatory account origin and the margin is held comingled within each of the respective accounts. In other words, all customer-related margin for a clearing participant is held in that clearing participant’s customer account origin. Maintaining records for thousands of accounts across multiple banking relationships would be very difficult and expensive for a DCO to manage.

In addition, most DCO collateral management systems are not designed to handle thousands of individual accounts. These systems are designed to handle a few hundred accounts and would have to be stress tested if more were required. In addition, these systems produce individual reports to clearing participants. The proposed model would likely require the DCO to produce individual account statements of collateral held for each of the clearing participant’s clients. It is possible that a completely new system would have to be put in place to handle the volume of accounts and transactions. (Estimated cost is millions of dollars).

A DCO’s clearing participants are accustomed to receiving a return of interest on cash they post as margin. Under the Full Physical Segregation model, it would be impossible to invest cash that is held in individual demand deposit accounts and such accounts do not pay interest. This would fundamentally change the economics of the cost of clearing for FCM’s and their clients.⁷

Optional Adoption of Individual Customer Segregation

The Commission’s proposal asks whether individual segregation should be an option for participants. In response, ICE believes that DCOs should have the option of whether to offer this as a service to customers. If participants truly desire individual customer segregation at any price, then the DCOs that offer the service will have a competitive advantage. Conversely, DCOs that offer futures style segregation could offer that service and market participants could weigh the cost benefit analysis themselves. In addition, allowing individual customer segregation as an option would allow OTC product classes with well established clearing, energy for example, to operate as they have for the last decade without this disruptive change.

⁷ Today, ICE Clear Credit holds cash margin in its Federal Reserve account and the Federal Reserve Bank (FRB) and the FRB pays interest on those deposits. ICE Clear Credit passes the interest (less costs) back to its clearing participants. However, the Federal Reserve does not accommodate multiple accounts.



Proposed Rule 22.3

Finally, the Commission should note that Proposed Rule 22.3 can be read to preclude a DCO from applying variation or mark-to-market margin provided to the DCO by a FCM for the account of a cleared swap customer to the DCO's obligation to credit variation or mark-to-market margin to the clearing member on the other side of the trade. Under the proposed rule, "Cleared Swap Customer Collateral" would appear to include variation or mark-to-market margin posted with respect to a cleared swap for or on behalf of a cleared swap customer.

The proposed rule does not specify the circumstances under which a DCO may use Cleared Swap Customer Collateral, although proposed Rule 22.3, together with proposed Rule 22.15, provide that Cleared Swap Customer Collateral may not be used to margin, guarantee or secure the obligations of other cleared swap customers in respect of cleared swaps. Proposed Rule 22.3 should be amended to clarify that a DCO that has received Cleared Swap Customer Collateral may use such collateral to satisfy the obligations of the DCO to provide variation or mark-to-market margin in favor of other clearing members (including, if applicable, for the account of a cleared swap customer of another clearing member as applicable). This would in effect be limited to Cleared Swap Customer Collateral constituting variation or mark-to-market margin (as opposed to initial margin).

By way of illustration, a new subsection of Rule 22.3(e) could be added that provides as follows:

- (e)(2) A derivatives clearing organization may withdraw and apply such share of Cleared Swap Customer Collateral provided to it in respect of Cleared Swaps as in the normal course of business of the derivatives clearing organization shall be necessary to margin, guarantee, secure or settle the obligations of the derivatives clearing organization in respect of variation or mark-to-market margin for offsetting Cleared Swaps with a member of the derivatives clearing organization.

Without such an amendment, clearinghouses could effectively be prohibited from clearing much of the OTC swaps market as it transacts today. Such a result would be in direct conflict with Dodd-Frank that was enacted to facilitate and promote the clearing of the OTC Swaps market. ICE Clear Credit and ICE Clear Europe have successfully cleared more 20 trillion in notional value of credit default swaps since they launched utilizing the marked-to-market margin process that is a fundamental term of the underlying OTC swap contract. As recently noted by Darrell Duffie, a professor of finance at Stanford University and a member of the Federal Reserve Bank of New York's financial advisory roundtable, "counterparty risk in the over-the-counter derivatives market is going down decidedly. The financial system is safer because of higher capital and cash requirements for banks, increased collateral, or



margin, for swaps and the use of clearinghouses.”⁸ In fact, ICE Clear Credit and ICE Clear Europe recently held more than a combined USD 20 billion as collateral for the credit default swaps they currently clear.

Conclusion

ICE submits that the significant and various costs that would be incurred associated with the proposed rulemaking, (including implementation, administrative, regulatory and compliance, increases in initial margin and systemic costs) would, to a degree, at each level of the marketplace (customer, FCM, and DCO), far outweigh any benefit. In addition, ICE submits that the Commission’s recently proposed Large Trader reporting and stress testing regulations (39.13(h)(2) and 39.13(h)(3)) should serve to mitigate “fellow-customer risk.” Accordingly, ICE suggests that it would be more prudent and practical for the Commission to allow the traditional omnibus (mutualized) clearing model to be applied to customer-related swaps transactions.

If the Commission nevertheless determines to fundamentally change how clearinghouses have cleared customer-related transactions historically, ICE recommends that the Commission allow for sufficient time for FCMs and DCOs to analyze, develop and implement the necessary systems and processes relating to any clearing model that the Commission might ultimately prescribe.

We appreciate the opportunity to comment on this rulemaking.

Sincerely,

A handwritten signature in black ink that reads "Kevin R. McClear". The signature is fluid and cursive, with the first name "Kevin" and last name "McClear" clearly legible.

Kevin R. McClear
General Counsel
ICE Clear Credit LLC

⁸ See, e.g., Matthew Leising, CREDIT SEEN SAFEST SINCE 2008 AS CLEARINGHOUSES CONTROL SWAPS, Bloomberg, (August 4, 2011).