



Subject: ICE response to the CPSS-IOSCO principles for financial market infrastructures consultative report

I have pleasure in submitting IntercontinentalExchange's response to the CPSS-IOSCO consultative report. The response is written on behalf of the entire ICE group, which comprises CCPs in Europe, U.S. and Canada, as detailed in our response. We have responded both to the initial consultative report and also to cover note, dated 10 March 2011.

We are very supportive of the proposed updating, extension and refinement of principles relating to FMIs in general, and CCPs in particular. We believe that the standards achieved by the CCPs within ICE generally meet or exceed the standards set out in the consultative report. We nevertheless believe that documentation of global industry-wide principles is valuable, and that the standards proposed will make a positive contribution to fostering financial stability.

We have set out both general and specific response to the consultative report. You will see that the principal points that we make are the following:

1. While individually these principles seem straightforward, cumulatively they represent a significantly increased burden on CCPs – especially as a lot of compliance with the principles needs to be reviewed and audited by third parties.
2. Some of the principles look rather more like detailed rules and are likely in practice to set a minimum which is also a maximum. This is particularly the case if they become the de facto international standard to measure equivalence.
3. Some of the principles require CCPs to be responsible for things not in their control: an example is Principle 23 requiring CCPs to be responsible for educating users about clearing and ensuring they have understood.
4. Proposed restrictions on collateral are too strict for all FMIs active in every market. We are particularly concerned by the long term implications of this recommendation as the current low interest rate environment is a historical abnormality.
5. Access requirements in Principle 18 – “An FMI should allow for fair and open access to its services, including by direct and, where relevant, indirect participants and other FMIs, based on

reasonable risk-related participation requirements”: this should only be for cash securities given the dangers of interoperability for derivatives, acknowledged also for instance in EMIR.

We stand ready to assist the group in its further development of the Principles, and the assessment methodology.

Yours sincerely,

A handwritten signature in blue ink, appearing to read "Paul Swann".

Paul Swann
President & Chief Operating Officer
ICE Clear Europe

Response of the IntercontinentalExchange (ICE) to the CPSS-IOSCO principles for financial market infrastructures consultative report

Introduction

ICE welcomes the opportunity to respond to the CPSS-IOSCO consultative report. We are very supportive of the proposed updating and refinement of the principles for financial market infrastructures (FMIs). We believe that the standards achieved by the CCPs within ICE generally meet or exceed the standards set out in the consultative report. We nevertheless believe that documentation of global industry-wide principles is valuable, and that the standards proposed will make a positive contribution to fostering financial stability.

Our letter sets out our responses to the consultation report, structured as follows:

- Section 1.** Comments relating to overarching themes
- Section 2.** Responses to particular questions in the cover letter
- Section 3.** Comments relating to particular points in the consultative report not covered in Sections 1 or 2.

ICE's clearing operations comprise the following CCPs across the U.S., Europe and Canada:

- ICE Clear Europe is recognised by the U.K. Financial Services Authority (FSA) and is the designated clearing house for ICE Futures Europe, ICE OTC and European credit default swap (CDS) contracts. ICE Clear Europe is also a CFTC-regulated Derivatives Clearing Organization (DCO) and SEC-regulated Securities Clearing Agency (SCA).
- ICE Clear U.S. operates as a registered Derivatives Clearing Organization (DCO) under the oversight of the U.S. Commodity Futures Trading Commission (CFTC) and is the designated clearing house for ICE Futures U.S.
- ICE Clear Canada is regulated by the Manitoba Securities Commission (MSC) and is the designated clearing house for ICE Futures Canada.
- ICE Clear Credit is a clearing house for North American credit default swap (CDS) markets. ICE Clear Credit is a CFTC-regulated Derivatives Clearing Organization (DCO) and SEC-regulated Securities Clearing Agency (SCA).

We acknowledge the point made in your cover note to the consultative report that at this stage the associated methodology for assessment against the standards has not yet been formulated. Of course, the approach taken to assessment has a significant bearing on the proposals, and therefore our responses in a number of areas. We look forward to discussing the assessment methodology at a later date.

Section 1. Comments relating to overarching themes

1. Level of detail of proposals

In the introduction to the report, it is stated that the standards contained in the report are in general expressed as broad principles. It is acknowledged that in some cases the principles incorporate a specific minimum requirement.

We are supportive of this approach, and believe that it is appropriate to establish broad principles, which should provide a clear framework, capable of being adapted to particular products and markets, and changing market conditions. We also appreciate that there may be a need in particular cases for more specific minimum guidance to be set out. The problem is that in fact the approach laid out is often not followed in the proposed standards – the text goes well beyond broad principles in most cases.

This granularity has a number of serious implications:

- Reduction in the flexibility of FMIs to adapt to market conditions or particular circumstances. The potential impact will be the reduction of the systemic integrity of CCPs and the aggravation of procyclical effects;
- The greater the degree of specificity, the more likely that the CPSS-IOSCO 'principles' will be regarded as prescriptive statements – ie not just as a minimum requirement, but as a maximum requirement also;
- This is particularly the case given that capital rules relating to banks will inevitably serve in many cases to create pressure for CCPs to adopt no greater than the specified minimum requirements; and
- The effective role of CPSS-IOSCO principles as qualifying conditions for a CCP, for example in determining capital treatment in Basel III, will further exacerbate this effect.

We believe it is far better for the standards to be framed as described in the introduction, as broad principles. Specific requirements should be prescribed only in exceptional circumstances. Subject to a compatible assessment methodology, this approach will allow CCPs to adapt rules, procedures and controls to meet the needs and characteristics of specific products / markets, and provide flexibility to react to changing market conditions. It will also help to avoid the feedback loop described above which will drive FMIs towards an effective 'rules based' approach.

An example of such a scenario could be the imposition of specific measures of the size of default resources. Given the pressure from proposed capital rules relating to default fund contributions, any such specified minimum is likely to become an effective fixed standard, allowing no flexibility to accommodate changing market conditions. Such a fixed standard is unlikely to be the optimal solution for all products and markets, ranging from agricultural and commodities markets to financial derivatives.

2. Interaction with bank capital rules

A number of the standards proposed are based on considerations relating to proposed bank capital rules, rather than considerations relating to systemic risk management at CCPs. In addition, the prescriptive nature of many of the standards described in point 1 above is magnified when taken in conjunction with bank capital rules.

Examples include:

- The stipulation in principle 5 that default fund resources should be pre-funded, thereby not taking into account contingent resources within the default fund. Such resources, whilst presenting challenges relating to bank capital rules, potentially play a part in reducing systemic risk in extreme default situations.
- The proposed restrictions relating to collateral, including letters-of-credit, as set out in principle 5. For commodities markets, such collateral is currently accepted, and from a CCP risk management perspective we believe that under appropriate controls, letters-of-credit should be admissible collateral, as set out in our comments on this point in section 3 of this document.
- References within Basel III to 'qualifying CCPs' as measured against CPSS-IOSCO standards. Such interaction magnifies the danger of prescriptive elements of the standards within the CPSS-IOSCO principles.

It should also be noted in this context that certain proposals in Basel III which have been proposed to tackle, in a narrow context, bank capitalisation considerations can have a negative impact on the systemic integrity relating to CCPs.

3. Cumulation of additional burden on FMIs

A very large proportion of the principles expressed are already undertaken by CCPs such as those within ICE in their normal course of business, through the application of its established and extensive management expertise and according to well-tested management procedures.

Many of the principles specify the formal production of additional documentation and external audit or review of these arrangements. This will add considerably to the cost to CCPs, and consequently to the cost of clearing for the CCPs' users. It will also require a considerable elapsed time to prepare such documentation and to organise and complete reviews and audits as required.

Examples of the formalisation of such analyses, audits and reviews include extensive legal analysis (principle 1), risk committee procedures (principle 2), default test arrangements (principle 2), a range of analyses relating to credit risk (principle 4), independent validation of haircuts (principle 5), assessments of the theoretical and empirical properties of margin models (principle 6), etc.

We estimate that it will take 12 - 18 months for these reviews to be completed.

4. Scope of analysis and responsibilities of CCPs

There are a number of instances in the report of FMIs being required to analyse and assume responsibility for activities outside their control. In a number of cases FMIs are expected to produce external reports on such matters.

This will remove important aspects of market discipline and cause undesirable ambiguity over responsibilities. It will also further increase costs at CCPs. In addition, there is a risk that the extensive formal review and production of documentation by FMIs with such a broad scope of extended responsibilities will lead to moral hazard. Given the central position of CCPs in the market structure this will have serious repercussions.

Examples include:

- In principle 23, a requirement for CCPs not just to provide transparency and training, but to assess whether users have absorbed and understood.
- In principle 14, CCPs are required to have segregation and portability arrangements that protect customer positions and collateral to the greatest extent possible under applicable law. This is a substantial increase in the scope of responsibilities of CCPs beyond ensuring the orderly operation of markets in times of stress. This responsibility was previously undertaken largely through client money regulations.
- In principle 17, a responsibility to identify, monitor and mitigate the risks FMIs pose to other FMIs.
- In principle 1, highly onerous requirements to analyse legal arrangements and potential conflicts in the jurisdictions of every major financial centre globally.

5. Relationship between a CCP, its members and indirect participants

In a number of instances the consultative report sets out requirements of CCPs in relation to its indirect participants, or to all participants including indirect participants. CCPs typically operate on the basis of a principal-to-principal relationship with its clearing members. Indirect participants operate through clearing members, and it is with their clearing members with which they have legal relationships and financial obligations. The risk of failure of indirect participants is borne by the clearing member with which the indirect participant has a relationship. This is key to the successful operation of a CCP. There are a number of far-reaching implications of this structure, the most important of which, in the context of the CPSS-IOSCO Principles are the following:

- There are limitations on the extent to which a CCP can, or should, aim to control or govern actions of indirect participants. This is particularly relevant to principles 18 and 19 relating to participation, as well as to principle 23 relating to disclosure of rules and key procedures.
- It has important implications for the way in which segregation is arranged, as set out in the comments relating to principle 14, covering segregation and portability.

Section 2. Responses to particular questions in the cover note to the consultation report

1. Principle 4: Credit risk

a) “Cover 1” vs “Cover 2” vs flexible approach

We support a flexible approach, for the reasons set out in Section 1. In particular, we believe that “Cover 1” should be the minimum level of protection provided, with a determination being made by the CCP, through its Risk Committee, as to additional protection appropriate. Such determination should be reviewed regularly based on all relevant factors, including those set out in point (b) below.

For example, for ICE Clear Europe, energy futures markets are typically highly liquid, even in stressed market conditions. In addition, positions are held by a relatively wide range of types of market participants, and the risk of contagion in the event of a default is relatively low. Subject to other considerations, these factors lead to the suitability of “Cover 1”. In contrast, the credit default swap (CDS) market is an OTC market which has relatively lower liquidity, and the nature of the market is such that liquidity could be particularly impacted in stressed market conditions. There is also less diversity of types of participants, most major position holders being major global banks, and the risk of contagion in the event of a default is higher than the energy markets. Subject to other considerations, these factors lead to the suitability of “Cover 2”.

In our view it is important that CCPs determine risk policies such as these on the basis of market risks and conditions, and product characteristics, and not on the basis of commercial competitiveness. It is primarily for these reasons that we are supportive of measures included in the proposed CPSS-IOSCO principles concerning risk management processes at CCPs. An additional measure which could be considered is for CCPs to make a regular clear statement to its participants concerning key policies adopted in relation to credit risk, to promote transparency and permit participants to perform appropriate due diligence.

b) Relevant product / market characteristics

Potentially, all the product / market characteristics listed could be relevant in an assessment of the stress testing scenarios to adopt, as well as factors such as market volatility, market / product characteristics, relationship with related markets, and extent to which the market is divided geographically and/or between different CCPs.

A number of the factors listed will be taken into consideration in other measures and controls at a CCP. For example, the factor of OTC vs exchange-traded is a potentially relevant factor for these purposes, but would also be taken into account in other factors such as close-out periods.

Of the factors listed, it is likely that the most directly relevant would be the number and type of market participants, market concentration, market volatility, market / product characteristics, relationship with related markets, and extent to which the market is divided geographically and/or between different CCPs.

2. **Principle 7: Liquidity risk**

a) “Cover 1” vs “Cover 2” vs flexible approach

We support a flexible approach, as set out above in relation to credit risk. In particular, we believe that “Cover 1” should be the minimum level of protection provided, with a determination being made by the CCP, through its Risk Committee, as to additional protection appropriate. Such determination should be reviewed regularly based on all relevant factors, including those set out below.

The example set out in Section 1 relating to credit risk is relevant also for liquidity risk. The factors that would lead to “Cover 1” being appropriate for markets such as the energy market, and “Cover 2” being appropriate for markets such as the CDS market are applicable to liquidity risk as well as credit risk.

As set out in our response in relation to credit risk, it is important in our view that CCPs determine risk policies such as these on the basis of market risks and conditions, and product characteristics, and not on the basis of commercial competitiveness. It is primarily for these reasons that we are supportive of measures included in the proposed CPSS-IOSCO principles concerning risk management processes at CCPs. An additional measure which could be considered is for CCPs to make a regular clear statement to its participants concerning key policies adopted in relation to credit risk, to promote transparency and permit participants to perform appropriate due diligence.

b) Relevant product / market characteristics

As set out in our response in relation to credit risk, we believe that all the product / market characteristics listed could potentially be relevant in an assessment of the stress testing scenarios to adopt, as well as factors such as market volatility, market / product characteristics, relationship with related markets, and extent to which the market is divided geographically and/or between different CCPs.

A number of the factors listed will be taken into consideration in other measures and controls at a CCP. For example, the factor of OTC vs exchange-traded is potentially relevant for these purposes, but would also be taken into account in other factors such as close-out periods.

Of the factors listed, it is likely that the most directly relevant would be the number and type of market participants, market concentration, market volatility, market / product characteristics, relationships with related markets, and extent to which the market is divided geographically and/or between different CCPs.

3. Principle 14: Segregation and portability

The consultative report proposes that CCPs should be required to have “segregation and portability arrangements that protect customer positions and collateral to the greatest extent possible under applicable law...”. This is an extremely onerous and far-reaching requirement. Furthermore, it is a substantial increase in the scope of responsibilities of CCPs beyond ensuring the orderly operation of markets in times of stress. This responsibility was previously undertaken, to a more reasonable degree, largely through client assets regulations in MiFID, and their equivalents in other jurisdictions, applying to clearing members and other stages of client money arrangements. In addition this requirement goes further than, and is not consistent with, other proposals in this area, including the latest Basel III proposals, as well as proposals included within EMIR and Dodd-Frank.

We believe that CCPs and clearing members should fully segregate house business and customer business. In addition, in the event of a default, a CCP should have clear procedures to handle non-defaulting customer positions, via liquidation or transfer to alternative clearing members in a prioritised and timely manner. These methodologies are proven, well documented and have stood the test of time.

We also believe that indirect participants should be provided with the ability to opt for an enhanced form of segregation, and there should be transparency over risks and costs of different levels of segregation. Such enhanced forms of client segregation and portability need to be practical, robust in a default situation, available on reasonable commercial terms, and consistent with relevant legal frameworks including in particular insolvency laws. It is also a requirement that clearing members continue to provide customers with important services such as collateral transformation and liquidity arrangements. Further work is necessary to develop such enhanced forms of client segregation and portability which meets these requirements. We believe it would be helpful for CPSS-IOSCO principles to set out clearly the objectives which reasonably can be achieved through such an enhanced form of client segregation and portability, allowing the industry to formulate effective responses to meet these objectives.

4. Principle 15: General business risk

We believe that equity capital of 6 months’ expenses provides more than adequate cover for an orderly wind-down allowing for close out or transfer any positions a CCP may have in its books.

5. Principles 18 to 20: Access & interoperability

a) Principle 18: Access

We believe that CCPs should put in place, and publish, objective criteria for each class of direct participation. These criteria should be established with the primary purpose of ensuring the systemic integrity of the CCP and fulfilling its risk management objectives, and should be justifiable on this basis.

Concerning indirect participants, we believe that it is inappropriate and ineffective for CCPs to attempt to establish criteria, for the reasons set out in section 1, sub-section 5. We believe that the primary responsibility for ensuring the suitability and eligibility of indirect participants should rest with the clearing members through which the indirect participants clear. It may be appropriate for CCPs to set out guidance for its clearing members relating to minimum criteria to be established relating to indirect participants.

b) Principle 20: Interoperability

It is generally recognised that interoperability between CCPs for derivative products potentially presents systemic risk issues. Such issues, arising particularly as a result of the creation of imbalances between CCPs, should be examined and the systemic risk implications resolved, before such interoperability arrangements for derivative products be further developed.

6. Adoption and implementation of the principles

As set out in Section 1, a large proportion of the principles expressed are already undertaken by the CCPs operated by ICE in their normal course of business, through the application of its established and extensive management expertise and according to well-tested management procedures. Accordingly, in practical terms, we believe that ICE is already compliant with the spirit of the substantial majority of the principles. However, many of the principles require the formal production of additional documentation and external audit or review of these arrangements. It will require considerable elapsed time to prepare such documentation and organise reviews and audits as specified. Accordingly, we believe that to be fully compliant with the proposed principles will take a minimum elapsed time of 12 - 18 months.

Section 3. Comments relating to particular points in the consultative report not covered in Sections 1 or 2

1. Principle 1: Legal risk

As identified in Section 1, the specific requirements set out in principle 1 are extremely onerous, for the following reasons:

- The scope of ‘relevant jurisdictions’ set out in paragraph 3.1.4. For a major organisation such as ICE, this could be construed to include all significant financial centres globally.
- The task of achieving a high degree of legal certainty concerning enforceability and addressing any conflict-of-law issues in each such jurisdiction, as specified in principle 1, would be an extremely onerous and expensive exercise.
- Whilst the importance of ensuring a proper legal basis is completely understood, the requirements set out in principle 1 are overly ambitious.

2. Principle 2: Governance

We are in favour of clear and transparent governance arrangements, and accordingly supportive of the standards set out under principle 2. We would point out that the remit of the risk committee is more focussed than that of the board, and that qualifications for board membership are therefore clearly different from qualifications for risk committee membership. Consequently, we do not believe that the specific requirements relating to the make-up of the risk committee, particularly the requirement for the risk committee to consist of a majority of board members, reflect principles of good governance. The fact that these provisions are also inconsistent with provisions included within EMIR will cause additional difficulty, particularly for ICE Clear Europe. We also believe that the risk committee should include a senior CCP executive whose responsibilities include risk management at the CCP, as a voting member. This person would we believe assist the risk committee in their focus on the relevant issues, and reflect the fact that CCPs have their own capital at risk in the event of a default.

3. Principle 5: Collateral

We agree with the need to take into account, monitor and control wrong-way risk. The requirement to ‘avoid wrong-way risk by not accepting collateral that would likely lose value in the event that the participant posting the collateral defaults’ is, however, impractical. In the event of a major default there would be loss of value to a very wide range of collateral. It is more appropriate to require CCPs to monitor wrong-way risk and use controls such as collateral haircuts to limit its impact.

Irrevocable standby letters-of-credit are currently an important form of collateral (particularly amongst non-financial institutions) in markets such as commodities. We believe that provided CCPs specify the conditions and circumstances of admissibility,

covering aspects such as permissible terms, payment deadlines & specific events which trigger the calling of the letter-of-credit, admissible banks, limits and concentration risks, etc., irrevocable standby letters-of-credit constitute a secure form of collateral for margin purposes. For example, such letters-of-credit at specified banks, under internationally accepted standard terms for documentary credits, within defined parameters, limits and controls, are likely to be appropriate for an energy company which makes use of letters-of-credit extensively for physical oil transactions.

4. Principle 13: Participant-default rules and procedures

We are supportive of the need to periodically validate and test default arrangements. However the requirement specified in paragraph 3.13.7 to periodically test participant-default procedures with 'all relevant parties' is an extremely onerous and expensive requirement. It would require very extensive, large scale international tests. Encouraging active participation from all relevant parties would be virtually impossible without regulatory compulsion. Whilst the importance of testing is fully appreciated, it is proposed that a more practical unit-based testing methodology be applied.

In addition, we agree totally with the point expressed in paragraph 3.13.5 to the effect that an FMI should have sufficient discretion to implement default procedures in a flexible manner. The requirement that a CCP indicate in its rules and procedures the particular situations when management can exercise discretion will reduce such discretion to known circumstances. In practice it is likely that CCPs will need to include scope for discretion in unpredictable circumstances, and it is important that such discretion be permitted.

5. Principle 18: Access and participation requirements

As set out in section 2, we believe that CCPs should put in place, and publish, objective criteria for each class of direct participation. Principle 18 makes reference in addition to access by other FMIs. For CCPs we presume this refers to interoperability, and on that basis this principle should not apply to derivatives. There is a general recognition of the systemic risk issues raised by CCP interoperability for derivatives. For example, EMIR only proposes interoperability arrangements for transferable securities and money-market instruments. In any case, links between FMIs is covered in principle 20.

Principle 18 also requires open access to 'other market infrastructures (for example, trading platforms)'. Provision of access to trading platforms raises a range of technical, operational, market efficiency, and systemic risk issues. (This was recognised in the discussion of this subject in the framing of EMIR regulations, for example, as a result of which access provisions are currently only being put forward in relation to OTC derivatives (ie not for listed derivatives)). We recommend that Principle 18 should be focussed on access and participation requirements for clearing members, leaving competition matters to the relevant competition authorities.

6. Principle 19: Tiered participation arrangements

As set out in point 5 of section 1, CCPs typically operate on the basis of a principal-to-principal relationship with its clearing members. Indirect participants operate through clearing members, and it is with their clearing members with which they have legal relationships and financial obligations. The risk of failure of indirect participants is borne by the clearing member with which the indirect participant has a relationship. Accordingly, it is the responsibility of direct participants to perform due diligence on their clients and monitor their activities. Furthermore, it would be impractical for most indirect participants to participate directly as clearing members of CCPs: they rely on the services of clearing members for a range of services, including liquidity, collateral transformation, expertise, interfaces with CCPs and technology.

For these reasons, whilst it may be possible for a CCP to perform a periodic review in outline terms of the general risks of indirect participation, an extensive review of specific threats would be difficult for a CCP to conduct, and would be limited in value given the necessity of indirect participation in practice.

7. Principle 20: FMI links

As set out in section 2, it is generally recognised that interoperability between CCPs for derivatives would introduce a significant degree of additional systemic risk. We therefore presume that principle 20 relates to transferrable securities and money-market instruments. The degree of applicability of principle 20 to CCPs such as ICE is therefore limited.

Nevertheless, we believe that this section of the standards would be substantially more effective by being more principles-based, rather than setting out specific requirements. A particular weakness of the approach of setting out such specific requirements is that a linkage which adopts a different methodology from previous such linkages could potentially avoid coverage by such specific requirements, or alternatively be constrained in a manner which is unintended. Such weaknesses would be less applicable to a principles-based approach.

8. Principle 22: Communications procedures and standards

It is clear that the use of relevant internationally accepted communication procedures and standards facilitates efficiency in many cases. Nevertheless, there needs to be a test of critical mass of the communications in question and cost-effectiveness of using such international standards.

9. **Principle 23: Disclosure of rules & key procedures**

It is impractical for CCPs to be responsible for identifying ‘those participants that do not adequately understand its rules, procedures and risks of participation’, as set out in paragraph 3.23.4. A more practical requirement is for an FMI to meet the following standards:

- Provide training and documentation for key clearing functions, rules, procedures and risks;
- Bring to participants’ attention instances of lack of understanding where they manifest themselves; and
- Require, under its rules / procedures, clearing members to monitor their clients’ activities and take steps to rectify any perceived lack of understanding within the clearing member or at any of their clients.

