

**TESTIMONY OF JEFFREY C. SPRECHER  
CHAIRMAN AND CHIEF EXECUTIVE OFFICER,  
INTERCONTINENTALEXCHANGE, INC.  
HEARING OF THE COMMODITY FUTURES TRADING COMMISSION TO  
EXAMINE TRADING ON REGULATED EXCHANGES AND  
EXEMPT COMMERCIAL MARKETS**

**SEPTEMBER 18, 2007**

Acting Chairman Lukken, Commissioners Dunn, Sommers and Chilton, and Staff Members, my name is Jeff Sprecher and I am the Chairman and Chief Executive Officer of IntercontinentalExchange, Inc., or "ICE." We very much appreciate the opportunity to appear before you today to discuss the operations of ICE and to share with you our views on the regulation of trading on exchanges and exempt commercial markets.

Today, ICE operates a leading global commodity marketplace, comprising both futures and over-the-counter ("OTC") contract markets, across a variety of product classes, including agricultural and energy commodities, foreign exchange and equity indexes. ICE provides these important risk management contracts to commercial hedgers, as well as to speculators who provide necessary liquidity to the markets, through an integrated electronic trading platform. We host three separate markets on our electronic trading platform -- ICE's OTC energy market, which operates under the Commodity Exchange Act ("CEA") as an "exempt commercial market," or ECM, and two regulated futures exchanges -- ICE Futures Europe, formerly known as the International Petroleum Exchange, and ICE Futures US, formerly known as The Board of Trade of the City of New York, or NYBOT.

ICE began its existence in 2000 as an OTC execution market. Since that time, ICE has grown significantly, both through organic growth in its markets that has been fostered by ICE's market leading innovation, as well as by acquisition of other exchanges to broaden its product offerings. Today, focusing solely on the breadth of ICE's business (offering both regulated futures markets and unregulated OTC markets on a single electronic platform), or focusing solely on ICE's most liquid OTC contracts (such as the Henry Hub OTC natural gas swap), it is tempting for the casual observer to apply a superficial analysis when considering the appropriate level of regulation for ICE's highly varied markets. After all, if ICE offers regulated futures contracts through part of its business, why shouldn't the same level of regulation apply to all of ICE's contracts, including its OTC markets?

As will be explained in more detail below, such a superficial, top-down analysis is flawed in that it does not consider the highly varied nature of ICE's traded OTC markets, and importantly, how those markets significantly and fundamentally differ from futures contract markets. As I recently testified before Congress, a heightened level of DCM-like regulation, including heightened reporting and a system of position accountability, may be appropriate *for certain of ICE's cleared OTC swap contracts* (those, like ICE's cleared Henry Hub swap contract, that settle on a futures market contract price and that

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are the true economic equivalent of an *actively traded* futures contract). However, applying a standard of “DCM regulation” more broadly to all of the *highly varied swap contracts* traded on ICE, either through application of DCM-like core principles ill-suited for illiquid trading markets, or worse, by eliminating the category of exempt commercial markets altogether as some people have advocated, would be a serious mistake that would not only result in less market efficiency, but ultimately in harm to the constituency that the Commission is charged with protecting – the end users of the markets. In considering this question, it will be important to distinguish between contracts that serve as true pricing benchmarks *and that are actively traded on and subject to the rules of a designated contract market*, on the one hand, and those that *start life as “off exchange” transactions and that are merely cleared through the clearing house of a designated contract market*, on the other hand.

Finally, without proper historical context, it is easy to lose sight of the reasons why ICE was formed, how ICE fits into the context of the broader OTC markets, and how the benefits that ICE has brought to the broader marketplace were facilitated. In the context of this hearing, I will attempt to answer these questions for the Commission, as well as illustrating that a “one-size fits all” level of regulation is ultimately misguided. As I will explain in greater detail below, the marketplace has benefited significantly from the regulatory flexibility embodied in the Commodity Futures Modernization Act of 2000 (the “CFMA”), and through the ECM category of market recognized by Section 2(h)(3) of the Act. In this regard, proper recognition should be given to the Commission, and to those who supported the CFMA – including former Chairman Dr. James Newsome, presently the President of ICE’s primary competitor, the New York Mercantile Exchange, or NYMEX – for the groundbreaking nature of the CFMA and for the real and tangible benefits brought to the marketplace as a result of its adoption.

### ***Background and History***

At the time of ICE’s formation, commercial hedgers had two primary options if they wished to hedge energy price risk – they could seek to hedge their risk through one of *the limited number of futures contracts traded on a DCM* such as NYMEX, or they could work with an investment bank or so-called “voice broker” to negotiate a bilateral swap contract to address their hedging needs in a more tailored fashion. Each of these markets had its benefits and drawbacks.

Futures exchanges such as NYMEX offered *a limited number of highly liquid benchmark contracts* on their exchanges. While these pricing benchmarks offered deep liquidity (and hence a better view of true market price at a given location), they usually did not address the precise hedging needs of the commercial user due to the limited number of contracts traded and the limited number of delivery points of those contracts. For example, a Henry Hub natural gas futures contract is tied to the price of natural gas delivered at the Henry Hub in Tailgate, Louisiana. While relevant, the price of natural gas at the Henry Hub does not define the price of natural gas at all locations around the country for a large number of reasons, ranging from the influence of transportation and storage costs to local supply and demand dynamics. For this reason, futures contracts did

not provide a complete hedge of the commercial user's ultimate price risk. In addition, a physically delivered futures contract had the added problem that if held to expiration (the time through which a commercial user might need to hedge price risk), the holder of the contract could be forced to make or take delivery of the underlying commodity.

Furthermore, NYMEX was, until the introduction of meaningful competition by ICE, overwhelmingly an *open outcry* trading market. The hedger or customer wishing to execute business would call its broker and typically be quoted a wide "bid/ask spread". Customers often did not even get executed in the quoted range due to the time delay inherent in the process, and the absence of firm, executable prices resulted in customers paying more to hedge their price risk –making their businesses more expensive to operate, with costs ultimately either being born by the business itself (resulting in lower operating margins) or by its customers (higher prices being charged to customers). Finally, floor based trading gave traders on the floor who were trading *for their own account* an important time and information advantage in the market.

Alternatively, if the hedger sought to hedge its price risk through use of a bilateral swap contract executed with a dealer (such as an investment bank) or through the services of a voice broker, the hedger faced a number of different trade-offs. On the one hand, the hedger could better tailor the product to its specific hedging needs for, by example, entering into a swap contract that was tied to a delivery point closer to where the commodity would be used. On the other hand, bilateral swap markets tended to be opaque, and the commercial hedger often had little sense of where the true market was and whether it was being charged a fair premium by the dealer or voice broker for shifting the risk in question. Finally, there was no guarantee of fairness in pricing -- different fees and better terms could be charged to different customers -- meaning the small commercial player with limited hedging needs might not be offered the same opportunity as another market participant that transacted a significant volume of business with the investment bank or voice broker. As a result, spreads might be even wider than in the futures market.

I formed ICE to bridge the gap between the existing futures market and the voice brokered swaps market. In addition to offering bilateral swaps tied to individual futures contracts (swaps that were financially settled and could be held to contract expiry), ICE also offered a large number of tailored swap contracts that, like those being offered in the broader OTC swaps market, were better tailored to the delivery locations of users around the country and thus better tailored to the specific hedging needs of the end user. Importantly, ICE offered all of these contracts through a transparent electronic marketplace offering firm, executable prices and employing a strict best bid/best offer trading protocol that did not discriminate between market users (the smallest utility would get the same treatment as the largest investment bank). Furthermore, ICE offered users a view into the "bid/offer" stack so that market participants could for the first time assess the depth of liquidity in a market. In summary, ICE provided market participants with a compelling alternative to the hedging opportunities then being offered by the futures market or by the voice-brokered swaps market. Fundamentally, however, ICE served as an "electronic voice broker," offering its services to the same institutional and

commercial entities participating in the OTC market but allowing them to trade in a more efficient and cost effective manner.

Responding to the needs presented by the downturn in the merchant energy markets in 2002, ICE continued to innovate through its subsequent introduction of “cleared” OTC swap contracts. Following its acquisition of ICE Futures Europe (formerly the International Petroleum Exchange), ICE for the first time had the infrastructure to link to a clearing house and to offer the option of credit intermediation in an OTC swap contract to better provide liquidity to participants in the OTC markets. The elimination of bilateral counterparty credit risk was an important innovation facilitated by the CFMA, which allowing contracts to be cleared through third party clearing arrangements such as the one ICE entered by ICE with a third party clearing house.

### ***Benefits to the Marketplace***

What were the tangible benefits brought to the marketplace? Ultimately, the benefits included more efficient hedging of energy price risk (tighter markets), greater price transparency in all parts of the marketplace (not just at benchmark hubs tied to futures contracts), and vastly improved liquidity through the introduction of more participants (and thus greater price competition) in the markets. These benefits have not been limited to those brought about directly by ICE’s business and its product offerings, but include those resulting from changes to the business models and product offerings of other market participants that responded to the competitive challenge presented by ICE’s business. It is ultimately for others to determine cause and effect, but one cannot ignore the question of whether and how quickly other parts of the market, in some cases dominated by member interests, would have adopted electronic trading and pursued product innovation in the absence of the competition presented by ICE’s markets.

### ***One Size of Regulation Does Not Fit All Markets or Contracts***

The problem with “one size fits all” regulation can best be illustrated by contrasting the historic nature of futures markets (limited number of actively traded benchmark contracts, all transactions executed through a broker who can trade for its own account or that of a retail customer) with the ECM OTC swaps markets (large number of niche products, many illiquid and thinly traded, principals only trading). Recognizing the importance of futures pricing benchmarks to the general public (a DCM is obligated to publish its prices to be used by the broader market), and in recognition of the potential for conflicts of interest due to members trading for their own accounts alongside business transacted on behalf of customers, some of whom were retail customers, DCM core principles were developed to facilitate regulation of the markets by the DCM, which acted as a self regulatory organization. The typical high level of liquidity in benchmark contracts make application of core principles such as market monitoring and position accountability and limits feasible and appropriate.<sup>1</sup>

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<sup>1</sup> This answer does not change because the futures market, in addition to offering its highly liquid and actively traded benchmark contracts, also offers less liquid contracts that are thinly traded and primarily used as a vehicle for converting OTC swap transactions *traded off exchange and not*

Suggesting that these same DCM core principles, which were developed with the futures exchange model in mind, should apply to all OTC swap contracts traded on an ECM market, is attempting to fit the proverbial square peg in a round hole. While some level of additional reporting and a system of position accountability may be appropriate for certain contracts – specifically, *those that settle on a futures market contract price and that are the true economic equivalent of a contract actively traded on a regulated futures market – most of the energy swap contracts traded on ICE are niche OTC products* that trade in *illiquid markets* that are not amenable to the application of DCM core principles. For example, how would an ECM actively monitor an illiquid swaps market in an attempt to “prevent manipulation” where price changes can be abrupt due to the limited liquidity in the market? How would an ECM swaps market administer accountability limits in a market that has only a handful of market participants? Should the ECM question when a single market participant holds 50% of the liquidity in an illiquid market when the market participant is one of the few providers of liquidity in the market? It is important to analyze these questions not in isolation, but in the context of market participants having alternatives such as OTC voice brokers through which they can conduct their business. Importantly, such OTC voice brokers can even offer their customers the benefits of clearing through use of block clearing facilities offered by NYMEX itself (and also by ICE). Faced with constant inquiries by the ECM related to legitimate market activity, and facing no such monitoring when it transacts through a voice broker, market participants might choose to conduct their business elsewhere. It is for these and other reasons that Congress and the Commission have developed the carefully calibrated two-tier regulatory structure applicable to DCMs and ECMs. We believe that the judgments made by Congress and the Commission were and remain prudent and should generally be maintained.

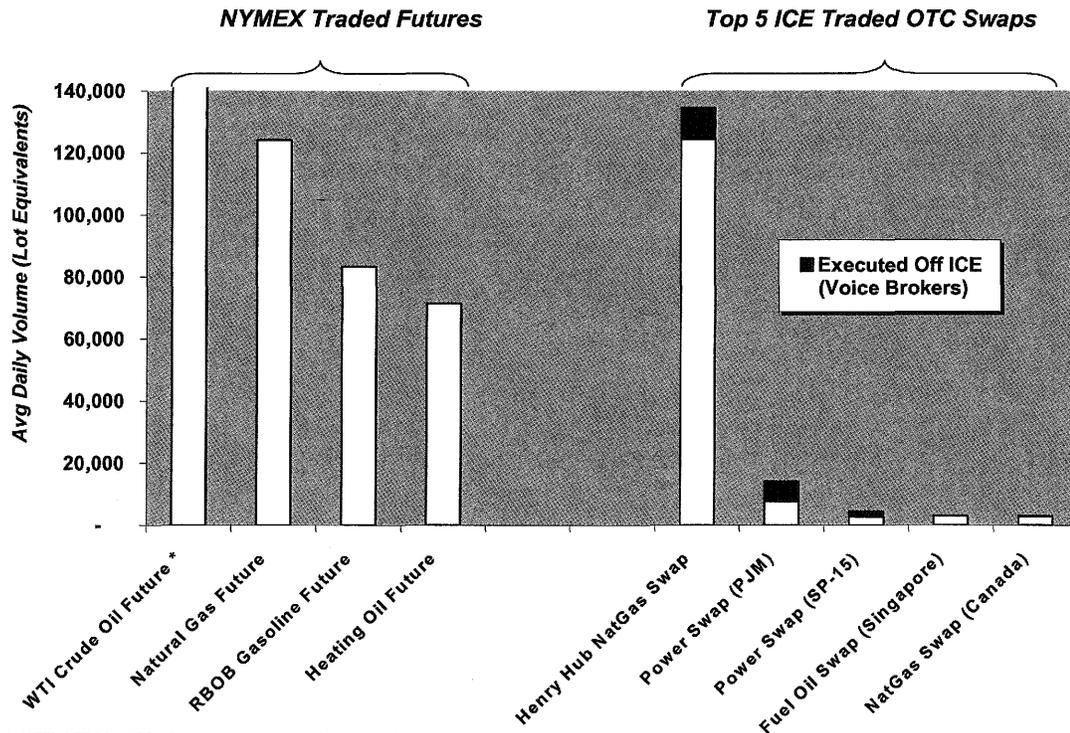
The resulting harm to the marketplace from reversing these judgments could be two-fold. If liquidity is taken from the market, commercial users who rely upon niche market to hedge their particular risk will likely find hedging to be more expensive, with less market participants competing to take the commercial participants price risk. In addition, if the real time bids and offers that market participants place in ICE’s markets are eliminated from the information available to the CFTC, the regulator may have greater difficulty in assessing what real market conditions are at a particular location due to absence of bids and offers representing “market sentiment”. As a result, it may be more difficult for the regulator to determine whether certain actions taken in that market are proper market activity or attempts to engage in manipulative conduct. This lack of comparative information could have the perverse effect of making it *more difficult* for regulators to bring enforcement actions against true wrongdoers in the marketplace.

The critical difference between NYMEX’s benchmark futures contracts and the vast majority of ICE’s OTC swap contracts can best be illustrated by actual data related

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*subject to any oversight during the price formation process*, into cleared futures through use of the DCM’s clearing facilities.

to the trading volumes in such contracts. The graph below visually illustrates this difference, and suggests why DCM regulation is appropriate for NYMEX’s contracts, but with the possible exception of ICE’s Henry Hub OTC swap, would not be appropriate for ICE’s other contracts:



As can be seen from the chart above, ICE’s Henry Hub swap contract is *far and away* ICE’s most significant contract in terms of trading volume. ICE traded contract volumes *drop off dramatically* after the Henry Hub natural gas swap, illustrating the niche nature of most of ICE’s OTC swap contracts. Note also that some of that contract volume results from transactions that are actually executed in the OTC voice broker market and then “blocked in” to ICE for clearing processing. It is significant to compare and contrast the limited trading volumes in the ICE swap contracts with the *significant trading liquidity* in NYMEX’s four benchmark energy contracts, each of which have enough volume to warrant the application of core principles such as market monitoring and accountability.<sup>2</sup> Also, it is important to note that the contracts listed above are the *top five* contracts by trading volume in ICE’s OTC market – *and ICE offers over 400 unique financial swap contracts*, and this number does not take into account hundreds of

<sup>2</sup> In addition, it is important to note that the fourth and fifth highest volume OTC swap contracts offered by ICE are a Singapore fuel oil swap and a Canadian natural gas basis swap – contracts that do not have a United States delivery point focus. Attempting to apply DCM like principles to such OTC swap contracts, which are often traded by entities outside of the United States, could result in trading volume reverting to the opaque voice brokered part of the market.

cash and forward physical energy contract markets that are typically viewed as outside of the CFTC's oversight mandate. Viewed in this context, one can easily understand the issue with attempting to apply DCM-like principles to a large number of illiquid swap markets, almost all of which have analogs in the OTC voice brokered market.

Finally, while ICE has indicated its willingness to be subject to additional reporting of contracts and a system of position accountability for *cleared OTC contracts that settle on the settlement price of the designated contract market* (and thus represent the true economic equivalent of the futures contract), ICE presently reports such information to the CFTC pursuant to the CFTC's special call authority.

### ***Conclusion***

ICE has always been and continues to be a strong proponent of open and competitive markets in energy commodities and related derivatives, and of appropriate regulatory oversight of those markets. As an operator of global futures and OTC markets, and as a publicly-held company, ICE understands the importance of ensuring the utmost confidence in its markets. To that end, we have continuously worked with the Commission and other regulatory agencies in the U.S. and abroad in order to ensure that they have access to all relevant information available to ICE regarding trading activity on our markets and we will continue to work with all relevant agencies in the future.

However, in prescribing regulation, it is important to consider the fundamental nature of the market in question, and avoid engaging in a superficial, "one size fits all" analysis that would unduly burden the efficient operation of markets and potentially stifle innovation and competition in the process. In short, *the level of regulation should fit the market in question* – both in terms of the users who can access the market, as well as the amenability of the markets to active monitoring and the prevention of manipulative activity (as opposed to the detection of such activity after the fact and the subsequent punishment of wrong doers for attempting or engaging in such activity).

The goal of regulation fitting the characteristics of the market in question has been ably achieved under the principles-based regulation embodied in the CFMA, and calls to blindly apply DCM core principles to illiquid markets, or to eliminate the ECM category of marketplace entirely, are both misguided and counterproductive. The CFMA has allowed for greater competition and heightened transparency, and has provided the CFTC with a deeper view of the OTC markets than they would have otherwise had.

Thank you for the opportunity to share our views with you on these important issues. We look forward to continuing to work with the Commission and the staff. I would be happy to answer any questions you may have.