

TESTIMONY OF SIR BOB REID  
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BEFORE THE COMMODITY FUTURES TRADING COMMISSION  
PUBLIC HEARING ON FOREIGN BOARDS OF TRADE

JUNE 27, 2006

Mr. Chairman, Commissioners and Staff members, my name is Sir Bob Reid and I am the Chairman of ICE Futures. I very much appreciate the opportunity to appear before you today and to share with you our views on how to properly regulate exchanges in today's increasingly global and electronic environment. This issue is one of great importance not only for the Commission and futures market participants, but also for the broader financial community that today operates through markets that are increasingly unbounded by physical or geographic limitations. As Commissioner Lukken recently pointed out in his June 14th speech to the International Swaps and Derivatives Association, the world today is indeed flat, and it is only getting flatter. We commend the Commission for proactively addressing this issue and for providing this forum in which interested parties may express and exchange their views.

We strongly support the Commission's effort to develop specific criteria for determining what constitutes a foreign board of trade and to provide more definitive guidance to foreign exchanges. This process will enhance the ability of exchanges around the world to conduct their operations with clear knowledge of the regulatory regimes to which they are subject. We also believe, however, that it is critically important to ensure that the Commission's approach takes into account the circumstances and needs of global exchanges and markets, and builds into any regulation the requisite flexibility to allow exchanges to operate seamlessly both here in the United States and in other jurisdictions.

The trading of futures is an essential tool in the sophisticated management of risk which has allowed our economies to grow without the violent convulsions of earlier times. The measurement and knowledge of the growth, direction and mechanisms of this vital undercurrent of commercial activity is essential to the macro management of our economies. It is to this end that the regulators should direct their attention. The full knowledge of this activity requires transparency and confidence in the competence and standards of the exchange. The free transfer of information across regulatory boundaries is critical to the management of the global economy. The assurance of the validity of the processes that produce this information is rightly the province of the primary regulator, but should always be open to scrutiny by other national regulators whose economies are impacted by trading activity.

The concept that each exchange be subject to the jurisdiction of one primary regulator has avoided duplication and conflicting regulation that would have made it unduly burdensome and expensive for participants to conduct their trading activities and for the financial markets to have grown and evolved in the manner that they have. Other regulators with an interest in the activities of the exchange can exercise secondary oversight and jurisdiction through consents to jurisdiction, and information sharing, with the correspondent regulator. This is the system that has been in place for many years and that has worked very well. Indeed, we are not aware of a single instance in which problems have arisen with respect to Commission jurisdiction over foreign boards of trade under the current regime, or of circumstances in which the Commission has been unable to obtain information or documents or take action to enforce U.S. laws.

To fully appreciate the wisdom of this approach, one need only consider that ICE Futures products are accessible through trading screens in over 40 jurisdictions around the world. It is important for the Commission to consider not only the potential impact of the Commission asserting jurisdiction but the potential impact of additional regulators asserting jurisdiction around the world. Suddenly, our “flattened world” and “networked economy” would more closely resemble a regulatory labyrinth where fewer market participants would care to venture. This would not be an outcome that would be beneficial to exchanges or the markets as a whole.

In our view, a foreign board of trade should be defined as one that (i) has its principal offices, management and Board of Directors or other governing body in a non-U.S. jurisdiction, (ii) is subject to a comprehensive regulatory regime under the laws of that jurisdiction which the Commission has found to be comparable to the regime administered by the Commission, and (iii) is subject to appropriate information sharing arrangements between regulators. The clarity of responsibility in this system underpins effective supervision and avoids duplication which can be both costly and confusing. Global exchanges and the access to global liquidity offered by them are important factors in achieving the effective management of economic growth. For the reasons set forth below, we believe that many of the criteria being considered by the Commission as a basis for determining that an exchange is subject to registration are unworkable, and will serve only to create a system of duplicative and redundant regulation that restricts global exchange competition and growth, each to the detriment of U.S. interests in the markets. Indeed, we note that if the ICE Futures WTI contract was trading on an exchange floor in London -- which would be equally accessible by U.S. persons, but without the efficiency and monitoring capabilities afforded by electronic trading -- none of these issues or proposed criteria would even arise.

ICE Futures, which formerly operated under the name "International Petroleum Exchange," has been in existence since 1980 and is the largest futures exchange for the trading of energy products outside the United States. Its Brent Crude oil futures contract and Gas Oil contract are the principal benchmarks for these commodities throughout the world. During 2005, over 42 million futures and options contracts were traded in ICE

Futures' global marketplace. ICE Futures has operated as a regulated futures exchange since its inception, presently operating as a "Recognised Investment Exchange," or "RIE," under the United Kingdom Financial Services and Markets Act 2000 (the "FSMA"). This statutory scheme is administered by the United Kingdom Financial Services Authority ("FSA"), which serves as ICE Futures' primary regulator.

ICE Futures maintains its principal offices, its senior management, and its approximately 70 employees in London. ICE Futures has no U.S. based employees. Since 2001, ICE Futures has been owned by IntercontinentalExchange, Inc., a Delaware corporation with its principal offices in Atlanta, Georgia. Under its recognition principles, the FSA has mandated a degree of separateness between IntercontinentalExchange and ICE Futures in order for ICE Futures to maintain its regulatory status. The Board of ICE Futures consists of a majority of independent Directors, all of whom are approved by the FSA, is chaired by me, and similarly conducts its meetings and other activities outside the United States. ICE Futures has a separate executive and a separate market oversight staff from the parent, and all significant decisions with respect to the operation of ICE Futures are made in the United Kingdom subject to the FSMA and the jurisdiction of the FSA.

ICE Futures is subject to a comprehensive regulatory scheme under the FSMA, which the Commission has already found to be comparable to the scheme in place under the Commodity Exchange Act. See 68 Fed. Reg. 58583 (Oct. 10, 2003) (granting relief to FSA-regulated entities, based on comparability of the regulatory regime and information sharing). The regulatory structure under the FSMA includes, among other things, financial and other fitness criteria for industry participants, reporting and recordkeeping requirements, procedures governing the treatment of customer funds and property, sales practices and other conduct of business standards, provisions designed to protect the integrity of the markets and prohibitions on fraud, abuse and market manipulation. As an RIE, ICE Futures is required under the FSMA to retain specified financial resources, operate its markets with due regard for the protection of investors, ensure that trading is conducted in an orderly and fair manner, monitor positions and movement of positions, maintain suitable arrangements for trade reporting, maintain suitable arrangements for the clearing of contracts, monitor compliance with its rules, investigate complaints with respect to its business, maintain rules to deal with the default of members, cooperate with other regulators through the sharing of information or otherwise, maintain high standards of integrity and fair dealing, and prevent abuse. The FSA is required to monitor the activities of ICE Futures and is authorized to eliminate its recognition status if it fails to meet the statutory standards of the FSMA.

All persons trading on ICE Futures, or executing transactions on ICE Futures on behalf of customers, in or from the U.K., are also regulated by the FSA and are subject to fitness standards, financial requirements and recordkeeping and reporting obligations, as well as antifraud and market abuse prohibitions. Persons trading on ICE Futures from other jurisdictions, either for their own accounts or for customers, are subject to regulation in their home countries. ICE Futures continuously monitors all trading on its markets on a real-time basis and, where necessary or appropriate, conducts investigations into trading activity and initiates disciplinary action against market participants.

Members of ICE Futures are subject to a comprehensive set of rules related to financial condition, business conduct, close out of positions in the event of a default and other matters.

In 1999, the Commission's staff issued the first of a series of no-action letters to ICE Futures that permitted it to provide U.S. persons with direct access to its electronic trading system without ICE Futures becoming registered with the Commission as a designated contract market. Similar letters were issued to other non-U.S. exchanges at or about the same time. Each of these letters was premised on the staff's conclusions regarding the nature and extent of the regulatory regime applicable to the relevant exchange and the exchange's own rules, systems and procedures as a self-regulatory organization. In addition, the Commission has relied on the information sharing agreements in place between the Commission and the local regulator, such as the information sharing agreement between the FSA and the Commission regarding ICE Futures. The Commission has also previously issued orders permitting United Kingdom FCMs to solicit and accept orders for foreign futures transactions from U.S. persons, based on the comparability of the U.K. regulatory regime.

Subsequent to ICE Futures being acquired by IntercontinentalExchange in 2001 and the migration of ICE Futures' electronic trading system to the electronic platform operated by IntercontinentalExchange, ICE Futures requested and obtained from the Commission's staff several updates to the original 1999 no-action letter, pursuant to which the staff confirmed that the relief afforded in 1999 would not be affected by ICE Futures' use of the ICE electronic platform or by the provision of electronic access for the trading of additional futures products by United States persons.

In April, 2005, ICE Futures announced that it would be closing its physical trading floor and that it would thereafter conduct trading exclusively on an electronic basis. Since the closure of ICE Futures' physical trading floor, the Commission's staff has confirmed the availability of the original no-action relief.

The Commission and its staff, therefore, have repeatedly reviewed the regulatory and self-regulatory regime that governs ICE Futures and have concluded that it provides a level of regulation and protection comparable to those afforded by the CEA and Commission regulations. Moreover, the Commission has information sharing agreements in place with the FSA that have recently been expanded after the launch of ICE Futures' WTI crude futures contract, and ICE Futures has agreed to provide the Commission with any information, and any access to books and records, that it requires in order to perform its obligations under the CEA and Commission regulations. In our view, these are the principal factors that should be considered in determining whether it is necessary for the CFTC to exert jurisdiction with respect to a foreign board of trade offering screen access to customers within the United States. Indeed, in the current global environment, we do not believe that this determination can be made on any other basis.

To restate our position, the determination as to whether an exchange is a foreign board of trade should be made on the basis of (1) the jurisdiction in which it is organized and in which its principal offices and executive management are located, and where Board meetings are held and decision-making is based; (2) whether it is subject to the jurisdiction of and regulation by a foreign regulatory authority under a regime that the Commission has found to be comparable to that administered under the CEA, and (3) the existence of appropriate information sharing arrangements between regulators. Moreover, with respect to the "comparability" of the regulatory structure, the Commission should, as it has in the past, rely on the general comparability of the regulatory scheme (and such factors as the objectives of the regulatory regime, the resources of the regulator, its history of effective oversight, protection of investors and maintenance of orderly markets, including detection and prevention of manipulation and other market abuses), rather than specific rules and regulations. Having clarified our position on what is the best way forward, it may be helpful to address the other criteria that the Commission has identified in its recent release as possible bases for making the foreign board of trade determination.

First, let us examine the proposition that the location of systems or servers could determine the regulatory locus of an exchange. Systems and servers are an administrative back office function that may be -- and often is -- outsourced to third parties for a variety of reasons (such as cost, convenience or systems quality). Outsourcing of technology functions to third parties that are better positioned to perform them is a major trend in today's flattened world, but is hardly a basis for asserting regulatory jurisdiction over a market. If ICE Futures chose to outsource its technology to Mumbai, should its markets suddenly become subject to primary regulation by an Indian regulatory authority? These decisions should have no bearing on the foreign board of trade determination. Indeed, we note that the Chicago Board of Trade maintained servers in London and Paris for over a year, but was neither subjected to English or French jurisdiction nor exempted from CFTC jurisdiction. Moreover, it would likely be impossible to make the determination based on the locations of servers or other systems in any event, because servers and systems are often dispersed throughout the world and may be moved from time to time.

Second, the source of trading volume is likewise a problematic basis upon which a foreign board of trade could become subject to U.S. jurisdiction. For ICE Futures, as with many exchanges, trading volumes are sourced from a wide range of countries, including the United Kingdom, other countries in Europe and Asia, and the United States. Depending on a wide variety of factors, the source of trading volumes can ebb and flow across countries, and across arbitrary thresholds. It would seem imprudent to base regulation on a standard that can vary across time. For example, would an exchange become subject to regulation in the United States if it crossed a trading volume threshold one month, but fall outside U.S. jurisdiction in the following month if trading volumes subsided? What if primary trading volume in Brent crude futures (with a delivery point at Sullum Voe in the North Sea) shifted to the United States due to a significant disruption in U.S. domestic supply? These are only a few examples of why the source of trading volume is a problematic basis upon which to assert jurisdiction. Regulators in all

of the jurisdictions from which ICE Futures sources trading volume may protect their participants by regulating those who are offering and selling the traded product within their jurisdiction and by requiring these activities to comply with the regulations of the local regulator. This home country regulatory approach has often involved the implementation of information sharing agreements or other cooperative undertakings between local regulators and regulators with authority over the relevant exchanges. These arrangements have been effective and durable. The concept that the primary regulatory function should be diffused across the individual markets or embark on a peripatetic pursuit of the dominant market is to pursue the Holy Grail without the help of the esoteric code.

Moreover, even if it were determined that the location of trading volume is a relevant consideration for this purpose, it is often not possible to determine the source of trading volume. In an era of global, electronic trading, with market participants trading through a variety of technology providers, traders could be located in any part of the world, regardless of their principal residences or places of business. In addition, based on available technologies, traders in one location can pass their trades to a different location and have them entered into the exchange from that second location. For example, non-US market participants often trade on US and non-US exchanges through US-based brokers. In these situations, the exchange cannot know the actual source of the trading volume. However, this issue should not drive the determination of regulatory jurisdiction and, for these reasons as well, trading volume cannot realistically be considered in determining what is a foreign board of trade.

Third, the location of the delivery point for a product is a poor basis upon which to make the foreign board of trade determination. As one might expect in a global marketplace, many of the principal commodities on which contracts are traded are themselves completely fungible and interchangeable. Crude oil is a fungible commodity. For example, delivery obligations under a NYMEX WTI contract may be satisfied by delivery of WTI, U.K. Brent and Forties, Norwegian Oseberg, Nigerian Bonny Light and Qua Ilboe, and Colombian Cusiana. Moreover, a majority of the crude oil delivered into the United States and refined into end products does not come from Cushing, Oklahoma, the delivery point for the WTI crude oil contract, but is imported from approximately 100 countries in all parts of the world, and may be delivered in various locations within the United States. In addition, the overwhelming majority of futures contracts are not settled by delivery of the physical commodity, but instead are traded out of prior to contract expiry, and many, like ICE Futures' WTI contract, are cash settled.

The logic of the delivery point as being a consideration on the foreign board of trade determination has inherent flaws. What we are trying to regulate is a commercial activity centered in a domestic exchange and this should be influenced solely by the adequacy of the regulatory process and information flow between regulators, not by the location of the product either at loading point or delivery destination.

If the Commission were to rely on criteria such as trading volume or delivery point in determining whether an exchange is a foreign board of trade, this would result in

fragmentation in the regulation and operation of exchanges, which would be cumbersome and unworkable. An exchange might be subject to the Commission's jurisdiction with respect to some products and to the jurisdiction of other regulators for other products. Furthermore, if a foreign board of trade were to become subject to Designated Contract Market (DCM) registration by virtue of its U.S. trading volume in certain contracts, it would be required under the Commodity Exchange Act to clear those contracts through a U.S. Derivatives Clearing Organization (DCO). This, in turn, would make it difficult to achieve cross-margining of products (which is a significant consideration for trading parties from the standpoint of capital efficiency), or would force the exchange to clear all of its products through the DCO to achieve this goal, which might be prohibited by its home country regulator.

Fourth, and finally, the fact that a contract traded on a foreign board of trade is priced against futures contracts traded on a U.S. designated contract market is also irrelevant. The prices of contracts on global commodities are all intertwined regardless of their price basis. Prices of contracts traded on U.S. DCMs are used worldwide for many purposes; indeed, that is the reason prices are required to be made public and U.S. courts have held that use of such prices is permissible. There is no reason to single out the use of DCM prices for trading of contracts listed on foreign boards of trade and to base jurisdiction on this factor alone. Certain U.S. DCMs today base their key contracts on settlement prices that are determined in foreign markets – perhaps most notably the Eurodollar contract traded on the Chicago Mercantile Exchange, which is settled against London interbank offered rate as determined by the British Bankers Association -- and there appears to be very little need for regulation by the foreign regulator given the CFTC's primary role in regulating DCMs.

We understand that one of the principal issues being considered by the Commission is the potential need for market surveillance and the role of speculative position limits. In this regard, however, we note that the contracts traded on ICE Futures that are based on WTI or other commodities deliverable in the U.S. are all cash-settled, and the Commission itself has acknowledged that there is less of a need for market surveillance in connection with cash settled contracts. For this reason, the Commission has stated that "[t]he size of a trader's position at the expiration of a cash-settled futures contract cannot affect the price of that contract because the trader cannot demand or make delivery of the underlying commodity. The surveillance emphasis in cash-settled contracts, therefore, focuses on the integrity of the cash price series used to settle the futures contract." (CFTC Website, [www.cftc.gov](http://www.cftc.gov), June 21, 2006) Therefore, the cash-settled contracts offered by ICE Futures, which are settled against settlement prices on a U.S. DCM, do not raise the surveillance concerns that exist in connection with physically delivered markets. Moreover, ICE Futures provides the FSA with reports of large positions in its cash-settled futures contracts, which are available to the Commission pursuant to the information sharing agreements that are currently in place.

In the politically sensitive area of high energy prices, it is tempting for the public to believe that regulation can in some way affect and even control price movements. This misapprehension has obvious dangers, and clarity on this point would be a wise outcome

of these deliberations. For the reasons stated above, we believe that the current regime is the most workable, and that burdening the markets with additional layers of unnecessary regulation will ultimately lead to a result (less efficient markets) with consequences that are the opposite of those hoped for by the public. We therefore urge the Commission to adopt an approach based on the criteria we have outlined above, and appreciate the opportunity to present our views today.