CHAIR

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April 12, 2013

COMMENT

The Honorable Gary Gensler
Chairman
Commodity Futures Trading Commission
1155 21st Street, NW
Washington, DC 20581

Re: RFQs, Voice Brokers, Illegal Rate Rigging & the proposed SEF Rules;
RIN 3038-AD18: Core Principles and Other Requirements for SEFs

Dear Chairman Gensler:

As the CFTC is uniquely aware, international rates like LIBOR have been intentionally, knowingly, and criminally manipulated by dozens if not hundreds of brokers, employees, and supervisors conspiring at many of the largest global banks. There are now numerous reports that similar illegal conduct may have manipulated the ISDAfix rate as well (as the enclosed articles make clear). Frankly, given the evidence already disclosed in connection with the LIBOR investigation and arrests, the only reasonable assumption is that, if a rate can be rigged, it may well have been rigged.

Apart from a shocking indifference to breaking the law, the obvious question is, how can such rampant illegal conduct happen? The short answer is because this market activity is almost all done by telephone among individuals, largely bilaterally. Thus, the reported rate rigging was possible because of the continued use of 19th Century technology, the telephone, rather than by the use of almost universally available 21st Century computer technology.

This is important in connection with the currently pending Swap Execution Facility ("SEF") rules. In those rules, a key question is the minimum number of dealers to whom a Request For Quote ("RFQ") must be submitted if a SEF participant wishes to transact outside of the Central Limit Order Book ("CLOB"). One frequently heard argument for using a low minimum number (such as RFQ-to-2 or RFQ-to-3) is the claim that thinly-traded markets function better under conditions of secrecy and opacity so that participants can avoid having their intentions broadcast and thus receive a worse price. However, the revelation that broker dealers have been manipulating benchmark interest-rate swaps makes it clear that any argument for opacity is highly suspect.

Setting a low minimum RFQ number would therefore be at best unwise. It would perpetuate an opaque, technologically outdated, manipulation-prone system across the entire derivatives marketplace in return for what at best can be considered a potential benefit to a small number of participants in a handful of illiquid sub-markets.

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The creation of SEFs under the Dodd-Frank Act was intended to bring the dark markets into the light, and create a transparent market with a level playing field. A low minimum RFQ number would directly undermine this goal, and would not only preserve, but endorse the ability of brokers to engage in secret bilateral negotiations such as the ones that apparently were at the heart of the alleged manipulation of LIBOR and possibly other markets. Also, like the reported manipulation and rigging in the ISDAfix markets, it would enable delayed reporting/posting of actual transactions, thereby opening another opportunity for illegality.

Given that superior technology is readily available, that outdated technology has been a primary means of illegal conduct, and that the rationale for using the outdated technology lacks merit, the Commission must ensure sufficient market participation to eliminate or reduce the risk of collusion and manipulation by bilateral telephone transactions. RFQ-to-5, or possibly a higher amount, is the obvious way to do that. Anything less would preserve the pre-crisis shadowy marketplace in which manipulation would be far too easy to accomplish. In light of the known rigging of LIBOR and possibly rigging of ISDAfix (and presumably other rates) by the very means and methods a low RFQ requirement would enable here, the CFTC simply cannot ignore the opportunities for fraud, manipulation, and illegality that it would create in the new SEF market space.

Sincerely,

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Commissioner Bart Chilton
Commissioner Scott D. O'Malia
Commissioner Mark P. Wetjen

Enclosures:

"CFTC Said to Subpoena ICAP Brokers, Dealers on Swap Prices", Bloomberg, April 8, 2013.

"Brokers at ICAP in CFTC rate swaps probe", Financial Times, April 9, 2013.

"Swap traders' morning fix under scrutiny", Financial Times, April 9, 2013.

"ICAP Brokers on 'Treasure Island' Said to Reap ISDAfix Rewards", Bloomberg, April 10, 2013.

Bloomberg

CFTC Said to Subpoena ICAP Brokers, Dealers on Swap Prices

By Matthew Leising - Apr 8, 2013

The Commodity Futures Trading Commission has issued subpoenas to ICAP Plc (IAP) brokers and as many as 15 Wall Street banks as part of an investigation into possible price manipulation of benchmark interest-rate swaps, according to people familiar with the matter.

The CFTC plans to interview about a dozen current and former brokers at ICAP's Jersey City, New Jersey, office as well as dealers that contribute prices used to set the daily ISDAfix swap rates, said three of the people, who asked not to be named because the matter is private. The regulator is probing whether ICAP brokers are colluding with dealers who stand to profit from inaccurate quotes, including failing to update published market prices after trades occur, one of the people said.

The ISDAfix levels, which the Federal Reserve includes in a daily report on money-market rates, are used by everyone from corporate treasurers to money managers to determine borrowing costs and to value much of the $379 trillion of outstanding interest-rate swaps globally.

The CFTC is probing the swaps trading as it works with European regulators in the rate-rigging scandal surrounding the London interbank offered rate. ICAP brokers in London have passed on requests from dealers asking rate-setters at rival banks to make favorable submissions, e-mails released as part of the European probe show. UBS AG, Royal Bank of Scotland Group Plc and Barclays Plc (BARC) have paid $2.6 billion in fines for rigging Libor rates.

'Treasure Island'

Stephanie Allen, a CFTC spokeswoman, said the commission doesn't comment on enforcement issues. Brigitte Trafford, an ICAP spokeswoman, declined to comment.

ICAP, the biggest broker of interest-rate swaps between banks, is paid commissions based on the size of the trades it matches. The firm's rate-swap desk in Jersey City is nicknamed "Treasure Island" because of the size of those commissions, according to three people familiar with the matter. On average, $1.4 trillion of transactions were traded daily on ICAP's systems in 2012, the company said in its annual report.

Like Libor, which is the rate at which banks say they would lend to each other, ISDAfix is derived from a process where 15 banks submit bids and offers for swaps in various currencies and denominations, according to the website of the International Swaps and Derivatives Association, which created the rate in 1998 with the predecessors of Thomson Reuters Corp. and ICAP.

Funding Benchmark

The rates are distributed by Reuters, Telekurs and Bloomberg LP, the parent company of Bloomberg News, according to the ISDA website.

Rate swaps, which investors and companies use to exchange fixed- and floating-rate obligations, involve a series of payments that are determined by rising or falling interest costs over the lifetime of the contract. They last as many as 30 years and are denominated in notional amounts that are used to calculate payments and don't represent money that has changed hands.

The ISDAfix rate and intraday trading levels that ICAP displays on an electronic screen known as 19901 are used by corporate treasurers, asset managers and other market participants as a measure of wholesale funding costs.

About 6,000 companies and financial firms subscribe to the pricing service, according to ICAP. Values published by it are accepted as a legal price by which swaps traders can terminate contracts or to mark the value of positions, according to ISDA.

Manual Prices

One potential source of price manipulation being probed by the CFTC is tied to ICAP brokers not updating the rate-swap price on the 19901 screen after they facilitate a trade between two banks, according to one of the people and a former ICAP broker in the Jersey City rate-swaps group who asked not to be identified for fear of retribution.

ICAP enters those prices manually onto the screen, and dealers tell the brokers not to put trades into the system until all their business in a transaction is done, which skews current market prices, according to the former broker, who said he witnessed such activity first-hand.

The contributors to ISDAfix are Bank of America Corp. (BAC), Barclays, BNP Paribas SA, Citigroup Inc., Credit Suisse AG, Deutsche Bank AG (DBK), Goldman Sachs Group Inc. (GS), HSBC Holdings Plc (HSBA), JPMorgan Chase & Co. (JPM), Mizuho Financial Group Inc. (8411), Morgan Stanley (MS), Nomura Holdings Inc. (8604), Royal Bank of Scotland, UBS and Wells Fargo & Co. (WFC), according to ISDA.

Representatives at the banks declined to comment.

FINANCIAL TIMES

April 9, 2013 12:01 am

Brokers at ICAP in CFTC rate swaps probe

By Tom Braithwaite, Michael Mackenzie and Kara Scannell in New York

The US futures regulator is investigating allegations of manipulation of a popular derivatives benchmark and has issued subpoenas to market participants including ICAP and several global banks, people familiar with the matter said.

ICAP, the interdealer broker, manages a benchmark for interest rate swaps known as the ISDAfix, which is derived from submissions from 16 of the world's largest banks. Before 11am in New York, each bank provides the rate at which it would buy and sell a benchmark swap with a notional value of $50m.

The probe by the Commodity Futures Trading Commission marks a widening of the multi-pronged international investigation into the rigging of a variety of interest rates, most prominently the London interbank offered rate, or Libor. Traders have expressed concerns that interest rate swaps are vulnerable to manipulation in a similar way as Libor.

Interest rate swaps play a crucial role in helping companies and investors protect themselves against changes in interest rates. The global interest rate swap market had a notional size of $379tn as of June 2012, the Bank for International Settlements said. Total outstanding US dollar swaps are $164tn.

Instructions to appear at interviews with the CFTC have been received by multiple market participants, the people familiar with the matter said. Subpoenas do not represent an allegation of wrongdoing.

The CFTC and the 16 banks declined to comment. The International Swaps and Derivatives Association, which helped established the benchmark, said: "ISDA received a subpoena related to ISDAfixand has provided information in response to the CFTC's request. We are co-operating fully."

ICAP said on Monday that it is involved in the administration of part of the ISDAfix process, and is co-operating "with the CFTC's wider inquiry into this area.

"ICAP maintains policies that prohibit any of the behaviour that has been alleged in the media," it said. It had no knowledge of the allegations beforethe media speculation, and is investigating them. "Until those investigations are complete we will not make any further comment."

The subpoenas were first reported by Bloomberg News.

In an interest rate swap, counterparties exchange a floating-rate cash flow, typically based on Libor, for a fixed-rate cash flow, derived from the Treasury bond market.

Since the late 1990s, ISDAfix has played a role in helping traders settle trades on interest rate swaps before they expire. The benchmark is also used to settle interest option trades at expiration and for some other complex structured products.

A report into Libor last year by Martin Wheatley, head of conduct at the UK's Financial Services Authority, said participants in other markets had expressed concerns about other benchmarks including ISDAfix.

In the past, both ICAP and ISDA have insisted the process used to calculate ISDAfix involves strict oversight and controls.

But traders and rival interdealer brokers have long maintained that large banks with positions have sought to influence swap prices just before the 11am fix, in order to gain more attractive levels.

Interdealer brokers, which act as middlemen for banks' over-the-counter trades, are under investigation in Libor. ICAP has placed several people on leave in connection with that probe. Two brokers from RP Martin, another interdealer broker, have been arrested by the UK's Serious Fraud Office.

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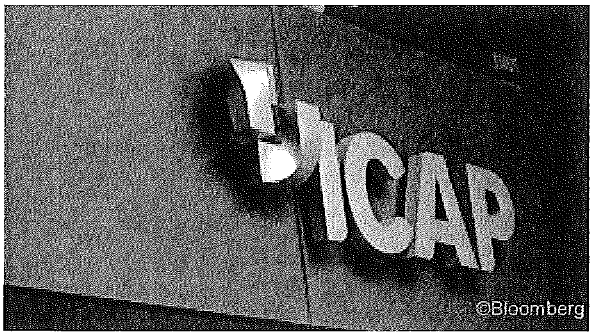
FINANCIAL TIMES

April 9, 2013 7:22 pm

Swap traders' morning fix under scrutiny

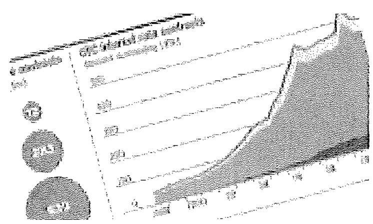
By Michael Mackenzie, Tom Braithwaite and Kara Scannell in New York



For two decades, one electronic page on trading terminals has dominated the shadowy world of interest rate swap trading between banks and their clients.

Known as 19901, its legacy page number from the defunct Telerate era, it retains a crucial role in the $164tn US swap dollar market, which is now attracting regulatory scrutiny.

The going rate



The growing size of the OTC derivatives markets

Every day before 11am in New York, 16 banks provide the rates at which they would buy and sell a benchmark swap. The rates are collated to provide the ISDAfix, named for the International Swaps and Derivatives Association.

For the past decade, ICAP, the largest interdealer broker, has published the page, using the prices supplied by banks that transact swaps. That means traders are keen to do business with ICAP because they want the screen to reflect their trades.

So lucrative is the business for ICAP that its brokers call its rate-swaps desk in Jersey City by a more catchy sobriquet: "Treasure Island."

Now some of those brokers at ICAP and traders among the 16 global banks that submit rates have been subpoenaed by the Commodity Futures Trading Commission as it investigates claims of possible market manipulation.

Both ISDA and ICAP said they were co-operating with the CFTC. ISDA added that has hired Oliver Wyman to help advise on what modifications it needs to make to its oversight of the fixing process for swap rates. The banks declined to comment.

This world of tight relationships between dealers and their brokers is coming under intense pressure after regulators uncovered abuse in the setting of a different interest rate gauge: the key global floating rate benchmark known as the London interbank offered rate, or Libor.

Investigation by international regulators has produced large fines and management upheaval at banks starting with Barclays. Other institutions are expected to settle with regulators in the coming months.

But the ISDAfix probe shows that regulators' concern extends well beyond Libor into crucial if obscure benchmarks. It will also shine a light on interest rate swaps, a crucial area of the derivatives market that plays a key role in helping companies and investors protect themselves against sudden changes in interest rates.

ISDA has previously described the ISDAfix as a "transparent, readily available value to which parties to a transaction can refer as a settlement rate".

Even as the CFTC was sending subpoenas to market participants last November, the trade association wrote to the European Commission to argue for the benefits of its benchmark. "Without such a benchmark, it might be necessary to go through the process of calling a number of active dealers for quotes in order to settle transactions," ISDA wrote.

After it hired Oliver Wyman to review the process on Tuesday, Steven Kennedy, head of strategy and communications at ISDA, said: "We understand that best practices have emerged via the Wheatley Report and we want to make sure that the ISDAfix is in accord with those practices."

The Wheatley Report was produced last year by Martin Wheatley, now chief executive of the new Market Conduct Authority in the UK. His was the main UK government-ordered report into lessons learnt from the Libor scandal. But it also identified explicitly ISDAfix as an area of concern.

Dennis Kelleher, president at Better Markets, says the Libor-rigging scandal shows that banks are willing to manipulate benchmark interest rates given the billions of dollars at stake. "It is laughable how – in the computer-driven 21st century – that the securities industry is still using old technology," he says.

ISDA began the 11am fix in 1998 as market participants, seeking to unwind old swap trades or settle an option contract for a swap about to expire, sought a fixing rate that all could agree to follow. The methodology adopted for the fix was based on the Libor-setting process, subsequently revealed to have been rigged by some banks across a range of currencies.

The ISDAfix formalised the custom of dealers supplying swap rates for an 11am fixing in New York each trading day, with ICAP reaping the benefit to the chagrin of its rivals.

While swap rates tend to track underlying Treasury yields, they can fluctuate independently of government bonds. This is very noticeable when companies sell debt and want to swap their fixed payments for a lower floating rate via the swap market.

The nature of swap trading means a small difference in pricing does matter given the large notional size of trades that can start at $100m and rise to $1bn and more between banks and their clients. In this world, a hundredth of a percentage point matters. A difference of a quarter or half a tick in a fixing is very important. For example, for a $100m 10-year swap trade, each basis point change amounts to a plus or gain of about $93,000.

In depth

Libor scandal

Regulators across the globe probe alleged manipulation by US and European banks of the London interbank offered rate and other key benchmark lending rates

Given the stakes and the highly competitive ego-driven world of traders, there has long been talk in the market that some of the larger banks seek to influence swap rates ahead of customer deals. Often, ahead of the fixing, swap prices can fluctuate sharply, with a trade from a bank required to change the mid-level of the swap before 11am.

ISDA and ICAP established trading protocols for the fixing process and have insisted the process used to calculate the ISDAfix was fair and beyond reproach. But the concern is that banks may have got around those guidelines in the same way they circumvented the Libor process.

In a statement, ICAP said: "It maintains policies that prohibit any of the behaviour that has been alleged in the media."

The probe also raises questions over the role of brokers in setting rates and encourages the acceleration of rate-setting based on computerised trading and transparent prices from the broader market.

"I can't see how 19901 can exist – they will have to change how it works," says a broker.

Bloomberg

ICAP Brokers on 'Treasure Island' Said to Reap ISDAfix Rewards

By Matthew Leising - Apr 10, 2013

ICAP Plc's (IAP) U.S. interest-rate swap desk, which regulators are investigating as part of a price-manipulation probe, paid its brokers as much as $7 million a year at the market's peak, earning the group the nickname "Treasure Island," said two people familiar with the matter.

The team of about 20 in the company's Jersey City, New Jersey, office made $100 million to $120 million annually for ICAP around 2008 and 2009, said the people, who asked not to be named because the details are private. The group benefits from a move 11 years ago that put the firm in control of the computer screen used by the industry to price swaps in much of the $379 trillion market, one of the people said.

That screen has become the focus of the Commodity Futures Trading Commission, which subpoenaed about a dozen current and former ICAP brokers and as many as 15 dealers to determine if they're colluding to create inaccurate quotes that would boost bank profits. About 6,000 firms subscribe to the screen, and prices set daily by the trades ICAP arranges are used by corporate treasurers and money managers to value positions.

"Brokers who can work in markets that aren't transparent continue to enjoy oversized profitability," Mark Williams, a former Federal Reserve bank examiner who teaches risk management at Boston University, said in a telephone interview.

Matching Dealers

London-based ICAP, the biggest broker of interest-rate swaps between banks, is paid commissions based on the size of the trades it matches. The Treasure Island brokers bring together dealers over the telephone and then enter the transactions manually into the screen, known as 19901.

The firm paid brokers in the Americas on average 61 percent of the revenue they generated in the six months ended in September, ICAP said in a Nov. 14 presentation. The firm pays brokers who use its electronic trading systems about 10 percent to 15 percent of revenue they generate, one of the people said.

Guy Taylor, an ICAP spokesman in New York, declined to comment. ICAP said in an April 9 statement it maintains policies prohibiting price manipulation and is cooperating with the CFTC's wider inquiry.

The control the Treasure Island brokers exert over the 19901 screen, and the pay that follows, diminishes the chances of them going to a competing inter-dealer broker, according to an ICAP competitor who asked not to be identified because of the lack of authorization to speak publicly.

$7 Million Salary

The top three to five brokers on the desk made $5 million to $7 million annually during the best years, while four to five earned $3 million to $4 million and the least-productive brokers took home $1 million to $2 million, one of the people familiar with the compensation said.

ICAP displaced Tullett & Tokyo Liberty Plc as the provider for rate-swap prices on the 19901 screen in 2002, according to Risk magazine.

"That screen makes or breaks a lot of profit and loss, so clearly there's a lot of opportunity for influence," David Kelly, the director of financial engineering at Calypso Technology Inc. in New York, who helped design the underlying analytics of the 19901 screen in the early 2000s, said in an interview this week.

The CFTC is probing the process of setting swaps prices and trading of the derivatives as it works with European regulators in the rate-rigging scandal surrounding the London interbank offered rate.

Libor Probes

ICAP brokers in London passed on requests from dealers asking Libor-setters at rival banks to make favorable submissions, e-mails released as part of the European probe show. UBS AG, Royal Bank of Scotland Group Plc and Barclays Plc (BARC) have paid $2.6 billion in fines for rigging Libor rates.

ICAP is being investigated in the Libor case by Britain's Financial Services Authority and Canada's Competition Bureau.

"I'm pleased that the FSA and other regulators are investigating this thoroughly and rooting out any wrongdoing so that the industry can, in time, heal and move on and learn from it and be better for it," Michael Spencer, ICAP's chief executive officer, said on a Feb. 7 conference call.

Like Libor, which is the rate at which banks say they would lend to each other, ICAP brokers derive benchmark prices known as ISDAfix from a process where 15 banks submit bids and offers for interest-rate swaps in various currencies and denominations, according to the website of the

International Swaps and Derivatives Association. The industry group created the rates in 1998 with predecessors of Thomson Reuters Corp. and ICAP.

Legal Prices

ISDAfix values are accepted as a legal price by which swaps traders can terminate contracts or to mark the value of positions, according to ISDA. The Fed includes them in a daily report on money markets.

The contributors to ISDAfix are Bank of America Corp. (BAC), Barclays, BNP Paribas SA, Citigroup Inc., Credit Suisse Group AG (CSGN), Deutsche Bank AG (DBK), Goldman Sachs Group Inc. (GS), HSBC Holdings Plc (HSBA), JPMorgan Chase & Co. (JPM), Mizuho Financial Group Inc. (8411), Morgan Stanley (MS), Nomura Holdings Inc. (8604), Royal Bank of Scotland, UBS and Wells Fargo & Co. (WFC), according to ISDA.

One area the CFTC is probing is whether ICAP brokers delayed updating rate-swaps prices on the 19901 screen after they facilitate a trade between banks, said one of the people, who asked not to be identified because the matter is private, and a former broker in ICAP's Jersey City rate-swaps group.

Publishing stale prices can potentially boost profits for banks in a market where trades are tied to tens of millions of dollars at a time.

ICAP enters the prices manually onto the screen. That allows dealers to tell the brokers to delay putting trades into the system instead of in real time, according to the former broker, who said he witnessed such activity first-hand.

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