Morgan Stanley

November 20, 2013

Via Electronic Submission: http://comments.cftc.gov
Ms. Melissa Jurgens
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, DC 20581

**Re: Javelin Made Available to Trade Submission for Certain Interest Rate Swaps
         (Submission No. 13-06R)**

Dear Ms. Jurgens,

Morgan Stanley appreciates the opportunity to comment to the Commodity Futures Trading
Commission (the "***Commission***" or "***CFTC***") regarding the submission by Javelin SEF LLC
("***Javelin***") on interest rate swaps that Javelin proposes be deemed made available to trade
("***MAT***"). We also reference the MAT submissions of trueEx LLC ("***trueEx***") and TW SEF LLC
("***Tradeweb***"), because we believe that there is valuable information to be gleaned from a
comparison of the various submissions.

In our letter of February 7, 2012 regarding the then proposed MAT rule, we noted the conflict of
interest inherent in for-profit entities (i.e., SEFs) making MAT determinations that serve their
own self-interest. We therefore recommended that the Commission, and not individual SEFs,
make MAT determinations and suggested that objective criteria be established for each of the six
factors to be considered in making a MAT determination. We concluded, "Morgan Stanley
advocates having an actual definition with objective criteria, consistent with Congressional intent,
which can be applied by the Commission in a uniform way. Anything else will result in a race to
the bottom, which is a place none of us wants to be." [1]

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[1] See Morgan Stanley comment letter dated February 7, 2012 re: Process for a Designated Contract Market or Swap
     Execution Facility to Make a Swap Available to Trade (76 FR 77728).

The breadth of the Javelin submission demonstrates the need for the CFTC to exercise meaningful oversight over the MAT determination process. As Commissioner Wetjen noted when finalizing the MAT rule, given the "challenge of creating a new market structure on paper while being informed only by what we know or think we know about the swap markets today", the Commission "must remain open to course correction where necessary." Morgan Stanley believes that unless the Commission rejects the Javelin submission in its current form, there could be a material adverse impact on the liquidity of the U.S. interest rate swap market, as well as the potential for some U.S. market participants to be shut out of the market for certain swaps.

Comparison of the Various MAT Submissions

In order to compare the MAT determinations of trueEx, Tradeweb and Javelin, we make certain simplifying assumptions. We consider only fixed-for floating par coupon fixed notional swaps, where the holiday calendar and business day conventions of the fixed and floating legs of the swap are the same. In addition, because Javelin allows for any start date out to 10 months, we limit the Javelin swap tenors to 10 months plus 1 day or more. Finally, to simplify the counting, we analyze the possibilities as they would look on March 1, 2014. Table 1 shows how many interest rate swaps are being proposed as MAT:

Table 1

Possibilities for	trueEX	Tradeweb	Javelin
Currency units	1	3	3
Floating rate indices	1	5	3
Payment frequency conventions:			
Fixed Leg	1	1	4
Floating leg	1	1	4
Day count conventions:			
Fixed Leg	1	1	5
Floating leg	1	1	2
Holiday calendars	1	1	3
Business day conventions	1	1	3
Tenors	8	10	11,017
Start dates	1	1	307
Product = Number of swaps proposed as MAT	*8*	*150*	*43,833,558,240*

While the breadth of the Javelin proposal does not necessarily make it inconsistent with the Commodity Exchange Act or the Commission's regulations, the difference is striking.[2] In the subset of swaps that are par fixed-for-floating, Javelin would make over 43 billion distinct swaps MAT, compared to Tradeweb's 150 and trueEX's 8. Thus, it is not surprising that Javelin does not even attempt to establish that the CFTC's determination factors apply to each of the swaps covered by Javelin's MAT submission. Instead, Javelin adopts a self-serving classification methodology that glosses over, and indeed obscures, meaningful liquidity differences within each of the categories in Javelin's MAT submission.

In its submission, Javelin cites the following factors in defense of its broad MAT proposal:

- Willing buyers and sellers;
- Volume and trade count;
- Bid-offer spread;
- Usual number of bids and offers; and
- Number and types of market participants

Javelin classifies swaps using a category, maturity bucket and class framework. It defends the use of this framework in asserting that as long as any swap in a particular category, maturity bucket and class satisfies one of the aforementioned factors, then every swap in the same category, maturity bucket and class should satisfy such factor. Therefore, to demonstrate the flaw in the use of this framework, we need only take one highly idiosyncratic example. We respectfully suggest the following example,[3] where we assume that a customer wishes to see firm bid and offer prices for a swap with the technical specifications provided in Table 2 below.

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[2] Javelin's original MAT submission on October 18 included swap tenors out to 51 years with no limitation on start dates. Using those specifications, the number of MAT swaps would have been more than 100 times larger, at roughly 4.4 trillion. Javelin subsequently amended its MAT proposal to encompass "only" 43.8 billion swaps.

[3] This example seems contrived, but it is just one of the many billions of swaps that Javelin proposes be MAT. Only a small fraction of the swaps covered by Javelin's proposal would *not* seem contrived. For example, the probability that a swap chosen randomly from Javelin's submission would have both a non-standard tenor and a non-standard start date is approximately 95%.

Table 2

Example Swap	
Currency	GBP
Notional size	$110 million
Tenor	27 years, 4 months, 13 days
Trade date	March 1, 2014
Forward start date	8 months, 5 days
Holiday calendar:	TARGET
Business day convention	Following
Fixed leg:	
Rate	To be determined for a par swap
Payment frequency	Monthly
Day count	ACT/360
Floating leg:	
Index	USD LIBOR
Payment/reset frequency	Annual
Day count	ACT/365

According to Javelin's classification system, the example swap shown in Table 2 is in (i) Category C (because of the GBP denomination), (ii) the Curve Back-End maturity bucket (because tenor exceeds 10 years), and (iii) Class 2 (because of its forward start). We also note that its notional size is below the established block threshold of $120 million, so the parties would be subject to pre-trade transparency requirements when trading on a swap execution facility ("*SEF*").

Willing Buyers and Sellers

Javelin asserts that because it has identified seven dealers who routinely make markets in GBP-denominated swaps, there would be willing buyers and sellers of the example swap. Javelin adds that this group would potentially be augmented by algorithmic trading firms as well as other customers. However, we respectfully contend the following:

- The chances of any algorithmic trading firm, or another customer, being interested in trading this swap on a moment's notice is nil. The counterparty would almost certainly be a swap dealer.
- No SEF order book would list this swap.
- This trade would therefore take place via request for quote (RFQ) to a minimum of 2 market makers.
- The unusual swap characteristics, plus the large notional size of the swap, would be outside the parameters of what any swap dealer would auto-price. The transaction would therefore be routed to human traders for modeling.
- Human traders might easily "pass" on such an RFQ, either because they are busy or because they lack the time or inclination to price such an unusual structure.

- Assuming a market maker did respond, it would do so knowing that at least one other market maker knew the swap was taking place. The winning dealer would be exposed to a significant degree of "winner's curse" risk, as well as a likely adverse market move created by the information leakage.
- We estimate that a sophisticated dealer would require about 5 minutes to determine an appropriate price for the swap. This period is sufficiently long that the customer might conclude that no responses were forthcoming. Even if the customer did not terminate the RFQ, it would be exposed to market movements during this wait.
- Because of the above factors, we believe the likely bid-offer spread for this swap would be approximately 6 basis points.

For all of these reasons, we disagree with Javelin's claims that there would be multiple dealers prepared to make a market in such a swap at any given time because such market makers exist for other much simpler GBP-denominated swaps. We respectfully urge that the Commission require actual evidence from Javelin, and not mere assertions.

Volume and Trade Count

Javelin asserts that the data from LCH.Clearnet on cleared volumes year to date "confirm that sizable liquidity exists in this vibrant market when considered both on an aggregate Category basis or by individual maturity bucket within a given Category." We disagree with this assertion and respectfully submit that:

- The claims of "sizeable liquidity" and a "vibrant market" for the example swap are inaccurate, as the data provided by Javelin show that less than 1% of the year to date cleared volume, and fewer than 2% of the cleared trades, are in Category C swaps in the long maturity bucket. [4]

- As previously noted, the characteristics of the example swap are unusual and it is extremely unlikely that LCH.Clearnet or any other CCP has cleared a swap anything like it, in 2013 or in any other year.

Because the existence of less than 1% of cleared volume in the entirety of long Category C swaps is insufficient to justify Javelin's claims, we respectfully disagree with Javelin's assertions that the volume and trade count justify the scope of its MAT determination. We respectfully urge the Commission to reject Javelin's argument that the volume and trade count justify the scope of its MAT determination.

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[4] 2013 volumes for long maturity Category C swaps were 2,181,063 out of a total volume of 280,445,421 and 2013 trade count for such instruments was 12,634 out of a total trade count of 693,578.

Bid-Offer Spread

Javelin asserts that the typical bid-offer spread for the example swap would be between 1.1 and 1.2 basis points. As discussed above, Morgan Stanley believes the bid-offer spread is likely to be approximately 6 basis points. There are several reasons for this discrepancy. First, Javelin's table does not account for the size of the trade; the typical bid-offer spread for $10 million notional is not indicative of the expected spread for $110 million. Second, the table considers only those swap maturities at the "liquid points" of the yield curve. The fact that Javelin refers only to liquid points is a tacit admission that one cannot ascribe the same characteristics to swaps at other points on the curve, such as the example swap. Finally, we designed the example swap to have unusual combinations of currencies, indices, payment frequencies, and so forth; these make it illiquid and difficult to price and hedge, thus justifying a wider bid-offer spread.

Also troubling is the fact that Javelin cites Bloomberg as the data source for its bid-offer spreads. We acknowledge that the Commission allows a SEF to consider activity on another SEF in determining whether a swap should be MAT. However, Morgan Stanley believes that in making MAT determinations based on bid-offer spread, a SEF should be held to a certain standard, such as the SEF having actual trading experience in the proposed MAT swap, or at least the reasonable expectation that bid-offer spreads would exhibit the claimed behavior on their SEF platform. Javelin does not meet this standard.[5] Therefore, Morgan Stanley respectfully urges the Commission to reject Javelin's Bid-Offer Spread argument.

Usual Number of Bids and Offers

The flaws in Javelin's logic with respect to the usual number of bids and offers are identical to the above. Javelin's data apply only to the liquid points of the curve, and therefore not the example swap. Once again, Javelin references Bloomberg data without providing a basis for the Commission to believe that there would be any bids or offers on the Javelin system. In contrast, we note that trueEX points to the existence of Designated Market Makers on the trueEX platform as their basis for believing they will have resting bids and offers for their MAT swaps.

Number and Types of Market Participants

Javelin asserts that "there are several thousands of market participants globally, that may be broadly categorized into ten groups. Such participants utilize swaps in many different ways such as market making, risk management or asserting outright views on the market to enhance total returns." Morgan Stanley agrees with Javelin's characterization of market participants. However, for the reasons previously cited, Morgan Stanley fails to see any of the ten groups as a natural counterparty to the example swap. We respectfully urge that the Commission require reasonable evidence from Javelin that there are market participants with a natural interest in the swaps being proposed as MAT.

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[5] For the 12 trading days from November 1 to November 19, 2013, Javelin had no trading activity on 7 of them, and on the other days combined, saw trading in only one currency (USD) and 6 tenors, all standard.

Javelin has provided no such evidence. It describes the business functions performed by the ten participant groups, and why they trade swaps. However, it fails to describe the types of swaps that constitute most of each group's trading. If Javelin were to undertake this analysis, it would find that these groups do not trade a very large percentage of the 43.8 billion swaps covered by the MAT proposal.

Are Javelin's Maturity Buckets an Acceptable Approach?

Javelin establishes three maturity buckets (0–5 years, 5.01–10 years, and 10.01–31 years) and asserts, "a given swap (a 'focus swap') may be routinely hedged by another swap of like duration or by a basket of swaps of different maturities with a like duration. Thus, the liquidity characteristics of the hedge swap or basket of hedge swaps readily carries to that of the other ('focus swap')." Morgan Stanley agrees with this aspect of the analysis.

Javelin then provides an example. "For example, a market practitioner may hedge a 3.6 Year USD IR Swap with a duration weighted basket of both 3 Year USD IR Swaps and 4 Year USD IR Swaps." Why would Javelin not propose a hedge involving the 3.5-year swap, which is closer in tenor to a 3.6-year swap? The answer is simple: 3.5-year swaps are not liquid enough for a trader to use them as hedges. Javelin itself has traded 3-year swaps and 4-year swaps, but never 3.5-year swaps. As for truly odd maturities, such as 3.627 years, they are less liquid still. Thus, Javelin's own example belies their proposal to make all swaps in the same maturity bucket MAT. In summary, we believe Javelin's all-inclusive maturity buckets are not a viable approach for MAT determinations.

Both trueEx and Tradeweb avoided this error. They proposed that only the most liquid tenors be MAT – 8 tenors in the case of trueEX[6] and 10 for Tradeweb.

Are Javelin's Classes an Acceptable Approach?

The difference between Javelin's two swap classes is that Class 1 swaps all have spot start dates, whereas Class 2 swaps may start on forward dates. Javelin asserts, "Because IR swaps with spot and forward dates are mathematically related, Javelin observes that liquidity considerations of Class 1 swaps directly carry to the liquidity considerations of Class 2 IR swaps within a given Category." They then provide a formula that relates spot and forward starting swaps, and claim that the forward starting swap may be synthetically created, and therefore hedged, by a combination of spot swaps with different start dates. This is Javelin's fundamental argument for claiming that forward starting swaps should be MAT. We respectfully submit that Javelin's argument is flawed in several respects.

First, Javelin's formula for a forward rate requires values for four variables, only two of which are known with certainty (based on the swap tenors). The two interest rate inputs can only be approximated, and they vary randomly over time.

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[6] trueEX did not include the 4-year tenor as a sufficiently liquid tenor, so had they used Javelin's example, the hedge would have been performed using 3-year and 5-year swaps.

Second, Javelin assumes that there are spot start swaps equivalent to the forward starting swap being considered. No such swaps exist for the example swap, and the cost of creating them is likely to be high.

Finally, the approach of hedging via the construction of synthetic instruments is far from perfect, because the real world is not obliged to behave the way a formula says it should. Here is an illustration. On November 1, the Wall Street Journal reported the 3:00 PM mid prices for three U.S. Treasury notes as follows:

Treasury 0.250%	5/15/2016	99.49610
Treasury 5.125%	5/15/2016	111.84765
Treasury 7.250%	5/15/2016	117.16410

Because all of these bonds mature on the same date, and differ only in coupon, one can synthetically create any of them from the other two. For example, a portfolio of 0.303571 of the 0.25% notes plus 0.696429 of the 7.25% notes will synthetically create one 5.125% note. However, the cost of producing the 5.125% note is only 111.80060. There appears to be an "arbitrage" of 0.04705 points to be made by buying the synthetic 5.125% note and selling short the real one.

An experienced bond trader could spot the flaws in this "arbitrage" opportunity. It entails the simultaneous purchase and sale of all three bonds, two of which are illiquid, at the advertised prices. It ignores the existence of bid-offer spreads. It also ignores capital usage, tax treatment, the cost and difficulty of shorting, and the fact that Treasury notes cannot be traded in fractional sizes. All of these flaws exist in Javelin's argument for extension of MAT treatment for spot start swaps to forward start swaps. Javelin's classes, therefore, are not a valid approach for MAT purposes.

Trade Execution - Example Swap

We believe that the best way to execute the example swap, should any U.S. customer ever wish to do so, is to negotiate with one or more swap dealers privately in the voice market, to minimize information leakage. The dealer(s) would take the necessary time to model the swap properly, understand what hedges they would want to put in place, and make an appropriate bid or offer. The customer would know how much spread the dealer(s) were applying because the dealer(s) would quote the mid-market level along with the bid or offer, per the Commission's business conduct rules. We believe this manner of execution would be less expensive for the customer than attempting this trade on a SEF. Of course, this approach can only be used if the swap is not MAT.

If the swap was MAT and the customer was required to trade on a SEF, we believe the customer could receive a worse execution. This puts the U.S. customer at a disadvantage relative to a non-U.S. customer attempting the same trade.

Monopolies

Morgan Stanley finds it troubling that if Javelin's MAT proposal were to be adopted, Javelin would have a monopoly on the trading of certain swaps because, to the best of our knowledge, *Javelin is the only SEF that currently lists them*. The table below shows some of the swaps for which Javelin is the only available SEF today.

Table 3

Interest Rate Swap Characteristic	Values Supported by Two or More SEFs	Values Supported only by Javelin
USD		
Fixed Leg Payment Frequency	Qtrly, Semi-Ann, Annual	Monthly
Fixed Leg Day Count	30/360, ACT/360	30E/360, ACT/365, ACT/ACT
Floating Leg Pay/Reset Frequency	Monthly, Qtrly, Semi-Ann	Annual
Floating Leg Day Count	ACT/360	ACT/365
Calendar Convention	New York	London, TARGET
EUR		
Fixed Leg Payment Frequency	Qtrly, Semi-Ann, Annual	Monthly
Fixed Leg Day Count	30/360, 30E/360, ACT/360	ACT/365, ACT/ACT
Floating Leg Day Count	ACT/360	ACT/365
Calendar Convention	TARGET	New York, London
GBP		
Fixed Leg Payment Frequency	Quarterly, Semi-Annual	Monthly, Annual
Fixed Leg Day Count	ACT/360, ACT/365	30/360, 30E/360, ACT/ACT
Floating Leg Pay/Reset Frequency	Quarterly, Semi-Annual	Monthly, Annual
Floating Leg Day Count	ACT/365	ACT/360
Calendar Convention	London	New York, TARGET

In addition to the swaps shown in Table 3, by Morgan Stanley's reckoning there are 171 swap product types that no SEF other than Javelin lists. For USD swaps, there are 56 such product types;[7] for EUR swaps, there are another 50; for GBP, there are 65.

The effect of this monopoly would be to diminish competition or, in the extreme, lock customers out of the market. Customers could only trade the affected swaps through the Javelin SEF

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[7] As an example, one such product is a USD swap which has 12-month USD LIBOR as its floating rate index, with any tenor from 28 days to 31 years. To our knowledge, this swap is offered on no other SEF, regardless of the values of the other swap characteristics.

directly or by using dealers or other agents with the necessary connectivity. The customer would also require an FCM with the required connectivity to Javelin. Dealers, agents and FCMs would be in a position to charge higher fees knowing that the customer had no alternative but to trade through Javelin. If the customer lacked the required relationships or connectivity, then it would be locked out of trading those swaps in sub-block sizes.

Although we do expect that additional SEFs will be able to list these swaps, there are significant challenges that may delay their ability to do so. Facilitating trading in new instruments requires dedication of significant operational, technological and other resources that will not be currently available, especially in light of the need for SEFs to focus on meeting their new regulatory obligations. Based on our conversations with several SEFs, we believe that many SEFs will be unable to list many (or any) of these instruments within the 30-day period between the finalization of a MAT determination and the commencement of the trade execution mandate. Moreover, the fact that Javelin is the only SEF to support trading in these instruments also further suggests that these instruments currently cannot meet the standards set out by the Commission for being designated as MAT.

Morgan Stanley believes that the creation of SEF monopolies is prima facie a bad idea and is counter to both Congressional and Commission intent. We respectfully urge the Commission to grant MAT status only to those swaps listed by two or more SEFs. Conversely, the absence of multiple SEF listings for a swap should serve as a clear warning sign that it is premature to designate that swap as MAT.

Forward Rate Agreements ("*FRAs*") are a particularly interesting case in point. To say that no other SEF lists them is an understatement, because today's FRA market is almost entirely a voice market, both for customers and in the inter-dealer market. To designate FRAs as MAT would not only create a Javelin monopoly, but would be highly disruptive even to those to swap dealers and customers who were connected to Javelin. We believe that FRAs are an example of a product whose electronic trading should be nurtured as Permitted Transactions, and graduated to MAT status only when sufficient activity is evident on multiple SEFs.

If the Commission agrees that some of the instruments in Javelin's MAT submission do not satisfy the standards set forth in Commission regulations, many (or all) of the instruments can still ultimately be designated as MAT later. Once the electronic trading market for these less liquid instruments develops further and other SEFs have the resources available to devote to such an effort, Javelin and/or other SEFs can submit MAT submissions covering additional product types (including these less liquid instruments). A de facto phasing-in of the trade execution mandate, with required SEF trading beginning first for the most liquid instruments, will facilitate an orderly adjustment to the requirements of the new regulatory regime and prevent monopoly control of the trading in any particular instrument by a single SEF.

Conclusion

Morgan Stanley believes that Javelin's MAT submission is far too broad. Javelin has made exaggerated claims about the MAT suitability of literally billions of different swaps based on the characteristics of only a few dozen of the most liquid swaps. It has overlooked important factors such as the impact of trade size on liquidity. It references data from other platforms as if such data were evidence of Javelin's own readiness. It provides mathematical formulas and discusses the theoretical ability to create synthetic hedges without regard to the practical aspects of actually doing so. And it proposes to create a monopoly for itself, potentially locking certain participants out of the market. We therefore respectfully urge the Commission to reject the Javelin MAT submission in its current form. Javelin could then re-file an amended submission that more accurately identifies how the relevant factor(s) can be satisfied for specific types of swaps. In this regard, we see both the trueEX and the Tradeweb submissions as making reasonable arguments that the identified swaps should be considered MAT.

We appreciate the opportunity to comment to the Commission on the various MAT submissions, and we would be pleased to discuss any questions the Commission may have with respect to this letter. Any questions about this letter may be directed to Dexter Senft (212-761-2466).

Respectfully submitted,

Dexter Senft
Managing Director

cc: The Hon. Gary Gensler, CFTC Chairman
        The Hon. Bart Chilton, CFTC Commissioner
        The Hon. Scott O'Malia, CFTC Commissioner
        The Hon. Mark P. Wetjen, CFTC Commissioner
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