

INTERCONTINENTAL EXCHANGE/TRAYPORT MERGER INQUIRY

SUMMARY OF HEARING WITH ICAP ON 10 JUNE 2016

Introduction

1. ICAP said that, with the exception of precious metals, all of its commodities non-oil business were on Trayport. It said these businesses included wet freight, dry freight, iron ore, gas, coal, power and, to a smaller extent, emissions.
2. ICAP explained that markets developed over time and it was possible for them to transition from voice/hybrid models to electronic execution. It said this had happened in the emissions market.
3. ICAP said it had approximately [X] brokers using Trayport in London, with approximately another [X] brokers in Bergen, Amsterdam and Madrid.

Front end screen

4. ICAP said that out of approximately [X] to [X] trades per day, the vast majority required only a light touch from the broker. It said traders using Trayport/Trading Gateway Joule screen had a dropdown list of all the brokers they could trade with, which in most cases was every broker in the market. It said at the point of confirming their order, the trader decided which broker they wanted to put the price with. It said if they chose ICAP it went onto the ICAP screen and was seen by ICAP's brokers, along with everyone connected to the market at the trader level. It said it might execute immediately or within a short period of time based on price, with no heavy broker interaction required. It said at the other end of the spectrum there were trades that happened via the screen, but which had more voice interaction, with the broker speaking to customers or trying to stimulate interest in the product -this largely depended on the liquidity of the market.
5. ICAP said that most of the time there was a screen element to trades, with only occasional pure voice trades, where the order was initiated and executed via voice. It said that almost all traders in the power and gas markets entered its trades onto Trayport so that it flowed through into the trader's own system. It said this was because all traders were connected via Trayport to their own trade management system. It said if a trade was not entered onto Trayport, it

would have to be entered into the trader's own system manually, which was inefficient and at risk of error.

Brokers and exchanges

6. ICAP explained that traders could be initiators or aggressors. It said an 'initiator' was a trader who developed interest and establish market prices. An 'aggressor' was a trader who executed on a price already available in the market. It said when a trader was an aggressor it executed at the available price, whether it was on an exchange or whether it was with one of the brokers, like ICAP, GFI or Griffin. It said if credit was an issue broker interaction would be required to get a third party, known as a 'sleeve', to stand between the two and provide credit.
7. ICAP said that it was not typical for a fee to be attached to acting as a sleeve. It said charging a fee was only the case for some counterparties, like banks, who were being charged for credit. ICAP said that although it appeared strange for a sleeve to want to be involved in a trade, it benefited from gaining market information and promoting liquidity. There was not a focus on credit risk when the market started in 1996/97 - it was low on the list of priorities, and extra counterparty risk was taken on as a service, as it was not seen as an issue.
8. ICAP said that the overall fee that a broker or exchange charged for trading affected a trader's choice of trading venue. It said that the more homogeneous the market, the more likely the trader would execute using a broker or exchange with the lowest fees. It said for a more complex trade, the quality of the broker may have been more important than the fee. It said some customers were more price sensitive than others, with some customers more focused on the quality and efficiency of the service where minimising the workflow burden on the trader was important. It said brokers therefore competed not just on price but also on quality and efficiency.
9. ICAP said that in the gas and power markets over the last three years it had seen many firms charge no fees for initiation, particularly in the gas market. It said firms had taken the view that they would attract as much trade as possible and only charge the 'aggressor' party. It said some firms had gone further and paid a rebate to the 'initiator' of a trade. ICAP explained that the 'aggressor' did not choose the venue where it traded because they were focused solely on the price of the contract -it therefore executed where the initiator placed it.
10. ICAP said that those, like Griffin, who came to the market with rebate offers to take market share, were most active in the more liquid part of the market.

Competition between brokers and exchanges

11. ICAP said that some traders go to the last trading venue of an initiated product as, in theory, that venue will have the most up to date information about who was interested in the product. However, when a product was very liquid, it was more likely that the trader had specific preferences.
12. ICAP said that liquidity was an important factor in deciding whether to trade through a broker or through an exchange, like ICE.
13. ICAP said that CME did not have a screen for gas and power on which it could trade, and was not therefore a competitor of the brokers in that market. It said that EEX had liquidity in German power, and approximately 45 per cent of the total market of National Balancing Point (NBP) was executed on ICE. It said UK gas was traded predominantly on the ICE screen, which made ICE the biggest single execution venue in the market. It said the exchanges were strongest where there was no voice interaction required, and therefore no brokers. It said this applied to simple front month, quarter and season trades, which represented a major chunk of volume –and that brokers were more necessary in the less liquid areas, but that was by definition less volume.
14. ICAP said that an exchange coming to launch would typically broadly replicate what was already trading bilaterally, as coming up with something completely new was less likely to succeed.
15. ICAP said that where traders saw contracts as effectively fungible, the competition for execution was total. For these contracts, which would include NBP and TTF bilateral (e.g. ICAP) and exchange traded (e.g. WebICE) contracts, traders would not give prime importance to the execution venue (exchange or broker) but to price, rather than the execution fee. Hence, traders would typically execute the best price available regardless of the venue it was at. It said to compete effectively the exchange needed their liquidity to be aggregated into the front end trader stack. It said due to the closed nature of the Trayport API this meant that any trading venue wanting to compete effectively for execution and clearing would need to connect to trader front-end systems via an agreement with Trayport -rather than directly with traders as they can do in the majority of other markets.
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venue it was at. Therefore the best market price was always the best bid and offer regardless of the venue being an exchange or a broker. It said part of an aggregated stack was of paramount importance to an execution venue and, due to the closed Trayport API, the only way a trader can see an aggregated stack and a broker or exchange execution venue be part of it, was by using Trayport software (trader, broker or exchange system) or by dealing directly with Trayport to get them to agree to integrate your prices. Trayport would likely not agree to integrate your non-Trayport venue and if they did they would charge for this.

17. ICAP said that ICE did not have liquidity in short end prompt trades. Although there was no reason why this cannot trade on screen, ICE, and other exchanges, have struggled with getting a prompt day ahead contract that works well from the clearing house risk perspective and the customer's perspective.
18. ICAP said that although some traders had a preference to do large trades with brokers, WebICE and Trayport functionality mimicked the workflow of brokers with an example being ghost and hidden size (iceberg) functionality where customers could put a series of orders on a system that trade automatically at a certain price and does not disclose the ultimate size of the order.
19. ICAP said that traders who were primarily financial, who do not want to take delivery of a physical product, still often traded physical products so long as it was in a liquid product where the position can be closed before they take delivery e.g. ICE NBP futures which expire into physical delivery but which have sufficient liquidity such that open positions can be closed before this happens.
20. ICAP said that in markets where liquidity was concentrated in few contracts and there are many counterparties, trading was more suited to an exchange as there would be less requirement and potential for broker interaction. For example, there were approximately 2000 initial counterparties involved in emissions with liquidity mainly concentrated in two or three contracts. These characteristics ultimately meant that emissions trading was suited to exchange trading and indeed ICE now have close to 100% market share. With coal, which was a relatively small market, there were 30-40 active counterparties who often valued understanding who was on the other side of the trade and therefore favoured a broker. If they traded through an exchange they would never know who the counterparty to the trade was. However, even in the coal market ICE competes aggressively with brokers for execution, offering trader rebates, and have recently been successful in gaining execution market share.

21. ICAP said that Griffin, with coal prices aggregated into the trader stack, had offered over the counter (OTC) anonymous trading in coal, which provided exchange anonymity for OTC trading. This attracted traders who had not traded with Griffin before. With ICE prices increasingly aggregated into the stack (as has happened since the Trayport acquisition) more and more traders will be able to execute ICE coal futures directly on ICE with the associated anonymity. Given ICE and brokers compete for execution, a switch from anonymous OTC ICE coal trading with Griffin to direct ICE execution over the coming weeks and months would provide evidence for this competition and the power and necessity of aggregation in order to compete effectively.

Clearing

22. ICAP said that once a clearing house was dominant in an asset class it was very hard for another clearing house to acquire some of that clearing, largely due to margin netting. The coal market was, however, an example where CME offered cheaper fees than ICE, and straight through processing (STP) via Trayport, and managed to capture 60-70 per cent of the market. Where there were two clearing houses of reasonably equal liquidity, price was likely to become a more important factor.
23. ICAP said that if you traded on ICE, and contracted on the ICE screen, you could not choose to clear it on CME.
24. ICAP said that in most markets a trader would specify an order for registration at a particular exchange e.g. ICE or CME, at the point of initiation. Under these circumstances the broker would not have much influence over this choice. In markets where this wasn't the case, at least one of the counterparties would usually have a preference for which clearing house to use.
25. ICAP said that there were occasions where the trader might not have a preference and would pass it to the other side to decide, but this was not frequent.
26. ICAP said that a trader might have a preference to initiate their price with those that have STP to the exchange so that they have a smooth experience from order initiation through to clearing, as this made the trader's life easier by reducing risk and increasing operational efficiency.
27. ICAP said that some parties thought that ICE did not respond to competition from CME's in coal markets as it was more concerned with competing with brokers for execution - which would then have brought additional clearing

business with it. It said ICE wanted a policy of not providing STP to the brokers where possible because they wanted to attract business to the WebICE screen. It said ICE failed to respond to CME's threat in the coal market until it was too late and CME had already gained substantial market share in clearing. In ICAP's view, ICE's strategy was to compete with the brokers for trade execution.

28. ICAP said that barriers to entry into new asset classes and products was incredibly low because of Trayport. Trayport enabled brokers to transfer into other products: a new broker could launch on Trayport, have their prices aggregated in the stack, and they were immediately connected to the market. This has created competition between brokers. ICAP said commission levels in the gas and power markets had collapsed in the preceding few years because of the huge amount of competition between brokers.
29. ICAP said that it was, however, impossible to launch a competitor to Trayport because the barriers to entry to the front end trader software, mainly driven by a closed API structure, were enormous. It said in 2012 Griffin had launched its own alternative model on ICE's front end that did not rely on Trayport, but it failed to attract a meaningful shift in liquidity. It said Griffin then launched on Trayport and found it easy to compete with ICAP as brokers.
30. ICAP said that the trading and brokering communities were wary when there was one dominant exchange and clearing house because they had pricing power over fees. It said new exchanges did launch and competed very aggressively on price. It said NASDAQ launched in the oil market and had some success, but exchange initiatives had failed more often than they succeeded.

Concerns about the merger

31. ICAP said that although they were never comfortable with Trayport being owned by GFI, they respected their 'Chinese walls'. It said that the Trayport asset and subscriptions were more important to GFI than their brokering system, with the brokering company worth substantially less than Trayport; BGC had effectively bought GFI for the price of Trayport.
32. ICAP said that GFI had no incentive to foreclose on ICAP alone as it would have received less subscription fees. The primary beneficiaries of ICAP not having access to Trayport would have been other brokers, with GFI amongst them, but not the sole beneficiary. It said although GFI would have derived some benefit from foreclosure, it would be much smaller than the loss of ICAP's subscription fees. ICAP said markets did not naturally gravitate towards one broker having 100% market share (and would likely rebel against

behaviour forcing this) and so any upside GFI could have got from foreclosure would be limited and extremely small in comparison to that which ICE might receive. It said this was because, in contrast to broker markets, exchange products do often gravitate towards 100% market share for clearing and exchange execution (e.g. emissions).

33. ICAP said that the situation with ICE was different as it would potentially be able to use the Trayport asset to encourage trade execution towards their ICE screen rather than the broker screens by degrading the service to brokers.
34. ICAP said that there was potential for ICE to mothball technology development of Trayport while continuing to develop WebICE, effectively forcing traders to use WebICE. It said because of the closed API model, ICAP would have no alternatives to Trayport. It said if there was an open API there would be the possibility of being able to compete on the front and back end, but it cannot see a situation where Trayport would permit open access to its API.
35. ICAP said that there was potential for ICE to increase the licensing fee of Trayport paid by brokers and other exchanges, to raise the cost of trading in relation to trading directly on WebICE. It said this would make executing via ICE relatively cheaper, thereby promoting ICE at the expense of brokers and traders reliant on Trayport.