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FILE NUMBERS: S7-06-11 and S7-08-11  
Security-Based Swap Execution Facilities RIN 3235 – AK93 and  
Clearing Agency Standards for Operation and Governance RIN 3235 – AL13

Dear Ms. Murphy, Messrs. Eady and Mooney:

Thank you for meeting with my ICAP plc (“ICAP”) colleagues and me on May 17, 2011 to discuss ICAP’s two industry leading bulk portfolio basis risk mitigation services, Reset and ReMatch. We write to provide you and your staff with further information regarding these services. In addition, we discuss how to best accommodate and encourage the operation of these types of risk mitigation services in the new financial markets regulatory landscape.

As we discussed, the reduction of risk in the over-the-counter (“OTC”) derivatives markets is a global regulatory priority. We also explained that not all risks in the complex and diverse OTC environment (complex and diverse due to the complexity of the real-economy) can be mitigated by clearing. In order to meaningfully address risks that reside within portfolios of OTC derivatives ICAP encourages the Securities and Exchange Commission (“SEC” or “Commission”) and the Commodity Futures Trading Commission (“CFTC” and, together with the SEC, the “Commissions”) to accommodate the operation of bulk portfolio risk mitigation services (“Bulk Risk Mitigation Services”) in an appropriate regulatory framework. Reset and ReMatch, along with other similarly situated Bulk Risk Mitigation Services, help market participants to efficiently identify and mitigate risk by analyzing their portfolios of existing trades and by identifying offsetting risk requirements amongst other market participants and execute offsetting trades. These new trades offset basis and/or fixing risk, (where otherwise comparable derivatives have brief periodic mismatches in time or reference valuation in time), as well as “jump to default” risk. As such these services compare existing trades, to identify and remove risk, and do not permit participants to trade in real-time, or initiate directional trades (*i.e.*, long or short positions).

Bulk Risk Mitigation Services, which do not permit the posting of bids and offers, do not allow participants to negotiate prices and do not permit the initiation of additional directional trades, should be recognized as distinct from facilities, systems or platforms that allow or facilitate the active “trading” of swaps (*i.e.*, swap execution facilities (“SEFs”). However, the absence of a clear reference to Bulk Risk Mitigation Services in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) regulatory construct creates uncertainty as to the proper regulatory classification of these risk reduction services.<sup>1</sup> We encourage the Commissions to clarify that Bulk Risk Mitigation Services are valuable services/activities that have an impact on **reducing the risk of trades that have already been entered in to** and do not require the services or providers to register as SEFs.<sup>2</sup> Further, we recommend that the Commissions include a narrowly drawn, non-exclusive safe harbor in the SEF regulations for Bulk Risk Mitigation Services and portfolio compression services to promote clarity regarding the regulatory classification of these valuable services.

### **Efforts to Encourage the Development of Risk Mitigation Services**

Global regulators have consistently sought to identify and encourage efforts to bring improvements and risk reduction to global OTC derivatives markets.<sup>3</sup> In 2008, frequent portfolio compression of outstanding trades was identified by the President’s Working Group on Financial Markets as a key policy objective in the effort to fortify the OTC derivatives market infrastructure.<sup>4</sup> More recently, as the CFTC noted, “[c]onfirmation, portfolio reconciliation, and portfolio compression have been recognized as important post-trade processing mechanisms for reducing risk and improving operational efficiency for both current market participants and their regulators.”<sup>5</sup>

While the considerable benefits of traditional portfolio compression services to individual market participants and the market as a whole have been explicitly recognized by regulators, portfolio compression currently is not available for all asset classes and all transactions within an asset class.<sup>6</sup> In recognition of the nascent development stage of these services, the CFTC has explicitly encouraged swap dealers and major swap participants to develop additional portfolio compression opportunities.<sup>7</sup> Additionally, pressure from global regulators to ensure a robust infrastructure for identifying, managing and mitigating risk in the OTC swap

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<sup>1</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (2010).

<sup>2</sup> Likewise, Bulk Risk Mitigation Services do not fit within the Dodd-Frank Act constructs for derivatives clearing organizations (“DCOs”), swap data repositories (“SDRs”) or clearing agencies.

<sup>3</sup> See *e.g.*, Federal Reserve Bank of New York Staff Report No. 424: “Policy Perspectives on OTC Derivatives Market Infrastructure,” (Jan. 2010)(revised Mar. 2010), *available at*: [http://www.ny.frb.org/research/staff\\_reports/sr424.pdf](http://www.ny.frb.org/research/staff_reports/sr424.pdf).

<sup>4</sup> See “Policy Objectives for the OTC Derivatives Markets,” President’s Working Group on Financial Markets (Nov. 14, 2008), *available at*: <http://www.treasury.gov/resource-center/fin-mkts/Documents/policyobjectives.pdf>. (To strengthen the OTC derivatives market infrastructure, the President’s Working Group advised that “[p]rudent supervisors should continue their cooperative efforts to improve the operational infrastructure for all OTC derivatives, including encouraging further improvements to post-trade automation, frequent portfolio compression for outstanding trades and enhancing standardized documentation.”)

<sup>5</sup> Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants, 75 Fed. Reg. 81,519 at 81,520 (Dec. 28, 2010).

<sup>6</sup> See 75 Fed. Reg. at 81,526, n. 27. (“At the present time, the principal portfolio compression vendors offer compression exercises for limited types of trades in a limited number of asset classes. Compression currently is available for certain interest rate swaps and credit default swaps and, to a lesser degree, specific energy products. For example, TriOptima’s TriReduce service provides portfolio compression services for: (1) Interest rate swap transactions in twenty-three currencies; (2) credit default swaps (index, single name, and tranches); and (3) a more limited number of energy products. Markit and Creditex offer portfolio compression for credit default swaps.”)

<sup>7</sup> See 75 Fed. Reg. at 81,526.

markets has promoted a demand for advances in the development of a range of post-trade risk management services. Reset<sup>8</sup> and ReMatch<sup>9</sup> are two examples of risk mitigation services that go beyond trade compression to identify and reduce basis<sup>10</sup> and/or fixing risk and jump to default risk in the OTC swap markets.

### **The Value of Bulk Portfolio Risk Mitigation Services**

The CFTC has defined portfolio compression as a “mechanism whereby substantially similar transactions are terminated and replaced with a smaller number of transactions with decreased notional value in an effort to reduce the risk, cost, and inefficiency of maintaining unnecessary transactions on the counterparties books.”<sup>11</sup> While distinct in their operations from traditional portfolio compression services, Reset and ReMatch services have identified additional ways to reduce market participants’ net risks. Bulk Risk Mitigation Services focus these concepts and techniques to eliminate or lower the basis date and/or fixing risk and jump to default risk and market risk in interest rate swaps, in the case of Reset, and credit default swap portfolios, in the case of ReMatch, through portfolio data analysis and the identification of risk reducing offsetting trades between service participants. These services remove significant quantities of second order basis and/or fixing risk and jump to default risk and unwanted accumulations of market risk from the market.

Appropriately classifying these types of risk mitigation services in the new regulatory landscape is essential for the continued reduction of systemic risk, a primary goal of Title VII (the Wall Street Transparency and Accountability Act of 2010) of the Dodd-Frank Act.

### **Bulk Risk Mitigation Services Are Not Swap Execution Facilities and Should Not Be Required to Register as Such**

The Dodd-Frank Act is recognized as bringing comprehensive reform to the regulation of OTC derivatives. Toward that end, the Dodd-Frank Act seeks to ensure appropriate regulation of both participants and markets. The goals sought by this regulation include effective risk management, high levels of price transparency and electronic trading. Policymakers and regulators have recognized the need to ensure that the ultimate mosaic of regulation of the derivatives market advances these goals, rather than detracts from them.<sup>12</sup> The absence of a clear reference to Bulk Risk Mitigation Services in the Dodd-Frank Act creates uncertainty as to the proper regulatory classification and treatment of Reset and ReMatch and similar risk reduction services.

In attempting to define the parameters of an appropriate regulatory framework for Bulk Risk Mitigation Services, we believe the Commissions should take care to ensure that the final regulatory framework will

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<sup>8</sup> Reset is the industry leading expert on fixing risk management. The Reset service focuses on risk mitigation in the interest rate derivative market.

<sup>9</sup> ReMatch is a post-trade Bulk Risk Mitigation Service designed for today’s credit derivative marketplace. The service identifies many of the basis and calendar risks that accumulate as a result of market making and management of legacy portfolios. ReMatch builds accurate mid-level curves and through collective action generates exit liquidity producing unrivaled results. Additional information regarding ReMatch is available at: [www.rematchrisk.com](http://www.rematchrisk.com).

<sup>10</sup> Basis risk is the risk of loss arising from the difference between the economic, legal or structural terms of two offsetting investments.

<sup>11</sup> 75 Fed. Reg. at 81,525.

<sup>12</sup> For example, in the context of exempting FX swaps and forwards from central clearing and exchange requirements, the Department of the Treasury indicated that, given the unique characteristics of the market and the existing procedures to mitigate risk and ensure stability, central clearing requirements “could actually jeopardize practices in the FX swaps and forwards market that help limit risk and ensure that it functions effectively.” Department of the Treasury, Fact Sheet: Notice of Proposed Determination on Foreign Exchange Swaps and Forwards, (Apr. 29, 2011), available at: <http://www.treasury.gov/press-center/press-releases/Pages/tg1152.aspx>.

promote the continued operation of these important risk reduction services. We believe that Bulk Risk Mitigation Services should be recognized as being separate and distinct from facilities, systems or platforms that trade swaps (*i.e.*, SEFs). Section 3(a) of the Securities Exchange Act of 1934, as amended by the Dodd-Frank Act, defines the “security-based swap execution facility” as follows:

The term ‘security-based swap execution facility’ means a trading system or platform in which multiple participants have the ability to execute or trade security-based swaps by accepting bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility, that:

- (A) facilitates the execution of security-based swaps between persons; and
- (B) is not a national securities exchange.

We strongly believe that Bulk Risk Mitigation Services, such as Reset and ReMatch, do not meet the SEF statutory definitions and should not be required to register as SEFs. While Reset and ReMatch’s services result in new offsetting swap trades being entered into by market participants, there are several material differences between these services and the SEF definition, as well as the expected operation of SEFs as trade execution platforms.

- **No Price Negotiation.** Bulk Risk Mitigation Services do not permit participants to post bids and offers. Rather, Reset and ReMatch set the curve and price for all trades pre-run. Further, the services run advanced proprietary algorithms, which identify a significant series of trades across multiple counterparties that offset basis and/or fixing risk as well as jump to default risk between participants.
- **Non-Continuous Market.** The services are not run as a continuous market. Instead, the services are scheduled – in the case of Reset, weekly or less frequently, and in the case of ReMatch, at irregular intervals for each individual underlying reference credit.
- **Risk Reduction Only.** The services operate only at the bulk portfolio level to reduce basis and/or fixing risk as well as jump to default risk at the portfolio, rather than the individual, trade level.
- **Service Process.** Participants agree, in advance, to enter into trades based on a proprietary curve, established by the Bulk Risk Mitigation Services (subject to the participants’ set counterparty and other portfolio risk tolerances). The services, through the operation of algorithms determine the resulting series of risk mitigating trades; selection of the resulting trade set is not actually trader or participant driven.
- **Bulk Trades – All or None.** Results are presented as a bulk run, rather than as individual transactions from which the participants can pick or choose.

As all new swap transactions are executed against a curve established by Reset and ReMatch, there is no opportunity for market participants to negotiate, use the services to initiate a directional trade or speculate. Instead, Reset and ReMatch allow market participants to periodically reduce their basis and/or fixing risk and jump to default risk exposure. This contributes to a reduction in systemic risk, as it removes unintended risk, uncertainty and volatility from the various portfolios.

As is the case with portfolio compression services, the diminished risk for the individual market participants achieved through the use of these services, in turn, may lessen systemic risk and enhance the overall stability of the financial markets. As such, these valuable risk reducing services should be provided clear and appropriate regulatory treatment that allows them to continue to offer these services to market participants. Specifically, these Bulk Risk Mitigation Services should not be characterized as a facility or platform for the trading or processing of swaps subject to SEF regulation. We believe that the Commissions should promote these valuable risk reducing services by specifically recognizing that Bulk Risk Mitigation Services and portfolio compression services are not SEFs by providing an explicit, narrowly drawn, non-exclusive safe harbor for Bulk Risk Mitigation Services and portfolio compression services in the SEF rules. The safe harbor should only be available to services that reduce risk and do not permit the posting of bids and offers. The curve is set by the service and not by the participants. It is not a continuous market, and the participants

are not permitted to put on any directional trades among other items. Further, any new trades coming out of such services must comply with reporting requirements (upon completion of the run). If the new trade is a swap which is subject to mandatory clearing, then such swap will be submitted for clearing.

A failure to recognize and encourage the use of these services will not only detract from the Dodd-Frank Act's goal of reducing systemic risk in the OTC swap markets but instead contribute to a significant increase in risk retained within the system.

### **The Transparent and Safe Operations of Bulk Portfolio Risk Mitigation Services**

Bulk Risk Mitigation Services operate in a safe and sound manner, promoting risk reduction. No regulatory objective or need will be met by requiring such services to register as SEFs. Reset and ReMatch's Bulk Risk Mitigation Services function in a well defined and structured manner. The services have provided significant risk reduction benefits to swaps market participants for several years. The proposed regulatory framework governing trade reporting, recordkeeping, public dissemination and clearing (in the case of swaps subject to the mandatory clearing requirement) will apply to the new swap transactions which are produced by these services. Like compression services, Bulk Risk Mitigation Services do not lend themselves to market abuse as market participants do not have the ability to increase or decrease perceived demand or to affect prices by participating in the services. Moreover, none of the abusive trading practices identified by the CFTC, such as "front running, wash trading, pre-arranged trading [and] money passes"<sup>13</sup> could be effected through a Bulk Risk Mitigation Service. Further, the current participants in the Reset and Rematch services are large financial institutions, most of whom we expect will become registered as swap dealers or major swap participants and be subject to extensive regulatory oversight by the Commissions. Finally, since the resulting transactions constitute a large series of new swap trades, the resulting transactions will be reported to SDRs and submitted for clearing to a DCO or clearing agency as appropriate, as with any other similarly featured individual swap trade.

With new regulatory safeguards soon to govern swap transactions and participants of bulk portfolio risk mitigation services, requiring Bulk Risk Mitigation Services themselves to be subject to SEF registration and trading rules would be unnecessary and could actually jeopardize or curtail existing, successful risk mitigation operations. To avoid this unintended result, we request that the Commissions state specifically in the SEF rules, through a narrowly drawn, non-exclusive safe harbor, that the provision of Bulk Risk Mitigation Services or similar risk reduction services does not require registration as a SEF or other entity,<sup>14</sup> whether for cleared or uncleared swaps.

### **Bulk Risk Mitigation and Other Risk Reduction Services Shouldn't Be Required to Register as Clearing Agencies**

For many of the same reasons articulated above, we also believe that Bulk Risk Mitigation and Portfolio Compression Services should not be required to register with the SEC as clearing agencies. A class exemption or a non exclusive safe harbor would be the appropriate treatment for these risk reduction services. The statutory definition of "clearing agency" found in the 1934 Act is very broad and includes entities which act as CCPs as well as entities which provide other types of services such as data analysis of securities transactions and reduction in the number of securities settlements. The Bulk Risk Mitigation and Portfolio Compression Services may fall within the definition of "clearing agency" if they are deemed to "provide facilities for the comparison of data regarding the terms of settlement of securities transactions, to reduce the number of settlements of securities transactions, or the allocation of securities settlement responsibilities." Should the SEC determine that the risk reduction services meet the statutory definition of

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<sup>13</sup> Core Principles and Other Requirements for Swap Execution Facilities, 76 Fed. Reg. 1,214, 1,242 (Jan. 7, 2011).

<sup>14</sup> See Clearing Agency Standards for Operation and Governance, 76 Fed. Reg. 14,472, 14,495-96 (Mar. 16, 2011).

“clearing agency,” we believe it would be consistent with the public interest and the Commission’s clear statutory authority under Section 17A to provide a class exemption from clearing agency registration for such risk reduction services. These entities do not clear securities-based swap transactions and are not acting as central counter parties. While it could be argued that these entities fit within the broader part of the statutory definition of clearing agency, requiring them to register as clearing agencies would impose additional costs on entities which are providing services today which reduce risks in the security-based swaps arena – a primary regulatory goal of the Dodd Frank Act – without providing any tangible regulatory benefits. As an alternative to the class exemption, we would support a narrowly drawn, non exclusive safe harbor for these risk reduction services in the Clearing Agency rule. The non exclusive safe harbor should be restricted to services which reduce risks, are not novating or clearing security-based swap transactions, and are not engaged in other clearing agency type functions. We note that the CFTC won’t be requiring these risk reduction services to register as derivatives clearing organizations (DCOs) in connection with their services related to swaps. Either approach - a class exemption or a non exclusive safe harbor for these risk reduction services in the clearing agency rule - would harmonize regulatory treatment between the SEC and the CFTC and provide much needed clarity regarding the regulatory treatment of these valuable risk reduction services.

**Conclusion**

ICAP appreciates your attention to the matters discussed herein. We strongly urge the Commission to ensure that the final regulatory regime supports the activities of Bulk Risk Mitigation Services that will serve to offer efficient and effective risk management solutions to swap market participants. Should the Commission wish to discuss these matters further, please contact me at 011-44-207-050-7121 or [mark.beeston@icap.com](mailto:mark.beeston@icap.com).

Sincerely,



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