

**Ms. Elizabeth M. Murphy**  
**Secretary**  
**U.S. Securities and Exchange**  
**Commission**  
**100 F Street NE**  
**Washington, D.C. 20549-1090**

Mr. Jeffrey Mooney  
 Assistant Director – Clearing and Settlement  
 Division of Trading and Markets

Ms. Heather Seidel  
 Associate Director - Market Supervision  
 Division of Trading and Markets

Dear Ms. Murphy, Mr. Mooney and Ms. Seidel

At our meeting on June 10, 2011, we agreed to send an explanation of why the triReduce portfolio compression service operated by TriOptima AB does not constitute an "exchange", "security-based swap exchange facility" or "alternative trading system" for purposes of the Securities Exchange Act of 1934 (the "**Exchange Act**"), as amended.

As a reminder, triReduce is a system that allows dealers participating in the security-based swap markets to reduce the notional amount of their outstanding swaps of a particular type without increasing or decreasing their respective market exposure. This reduces their counterparty and settlement risk, without affecting the market position that was represented by the original trades. The policy benefit of using portfolio trade compression as a tool for risk mitigation has been recognized by many authorities, including the Financial Stability Board<sup>1</sup>, the Federal Reserve Bank of New York<sup>2</sup> and the President's Working Group on Financial Markets<sup>3</sup>.

As we discussed, triReduce operates as follows:

- TriOptima identifies and publishes on its website the details of a product type that will be subject to a compression run on a specified date.

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<sup>1</sup> See Financial Stability Board report *Implementing OTC Derivatives Market Reforms*, October 25 2010 at p. 37 - "By reducing the gross notional outstanding of OTC derivatives in normal times, portfolio trade compression provides effective measures to address the risk associated with uncoordinated, disorderly close-out transactions in individual dealers of the positions of a defaulting major dealer."

<sup>2</sup> See Federal Reserve Bank of New York Staff Report No. 424 *Policy Perspectives on OTC Derivatives Market Infrastructure*, January 2010, rev. March 2010 at pp. 19-20 – "In some types of derivatives that are not cleared, major market participants tend to build offsetting positions with different counterparties, long with one set of counterparties, and short with the others. In many cases, these offsetting positions are redundant. They serve no useful business purpose and create counterparty risk. Market participants should continue to engage in regular market-wide portfolio compression exercises ... in order to eliminate these redundant positions"

<sup>3</sup> See President's Working Group On Financial Markets - Policy Objectives For The OTC Derivatives Market, November 2010 (<http://www.treasury.gov/resource-center/fin-mkts/Documents/policyobjectives.pdf>) – "Prudential 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." (italics added)



- triReduce participants indicate their interest in participating in the compression run and send details of the trade population that they wish to compress (which may be a subset of their total eligible population) to TriOptima by upload to TriOptima's secure website.
- TriOptima reviews the trade populations submitted by the participants and identifies each transaction that has been submitted by both parties. Only those linked transactions are capable of being compressed in the compression run.
- The participants also submit their tolerances for the relevant compression run. The tolerances are user-defined parameters for compression transactions, including the maximum exposure to any individual counterparty that the participant is prepared to accept. That exposure is calculated using the mark-to-market values provided by the relevant participant; mark-to-market value and price otherwise plays no role in the compression run.
- On the specified date for the compression run, the triReduce algorithm uses the linked trade populations and the participants' respective tolerances to devise a proposal for terminations and/or replacement transactions that would compress each participant's submitted trade population as much as possible, while complying with the tolerances and leaving each participant's market exposure unaffected.
- TriOptima sends to each participant the list of terminations and replacement transactions that apply to that participant. Each participant reviews the unwind proposal and, if it accepts the terminations and replacement transactions that are proposed, faxes a signed version back to TriOptima, as agent for each of the other participants. Once all of the participants have executed the unwind proposal, each of the participants is bound to execute the terminations and replacement transactions it sets out.

From our discussion, we understand that the staff is interested in whether the procedure surrounding the unwind proposal constitutes activity that falls within the definition of an "exchange", a "security-based swap exchange facility" or an "alternative trading system" under the Exchange Act.

### **Exchange analysis**

The Exchange Act defines an "exchange" as

any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange.<sup>4</sup>

<sup>4</sup> Exchange Act, section 3(a)(1)

The activities encompassed by the phrase "market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange" is further defined by Exchange Act Rule 3b-16<sup>5</sup> to mean an organization, association, or group of persons which:

1. Brings together the orders for securities of multiple buyers and sellers; and
2. Uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of the trade.

Rule 3b-16 further defines an "order" as any firm indication of willingness to buy or sell a security ... including any bid or offer quotation, market order, limit order or other priced order.

triReduce does not meet this definition. Participants in a compression run do not place any orders into the system. There is no "many-to-many" matching of buy and sell orders, or any other interaction between orders. Rather, the participants provide a population of trades and tolerances, and the compression algorithm produces an unwind proposal containing a set of trades to be terminated or replaced and which is specific to a particular pair of participants. An unwind proposal, in other words, is the outcome, rather than the input and is counterparty-specific order (accepted bilaterally and not offered to or available for acceptance by anyone other than the intended counterparty).

#### **Alternative Trading System analysis**

An alternative trading system is an entity or system that meets the definition of exchange set out in Rule 3b-16 but that does not impose rules on the conduct of subscribers, other than in respect of their trading on the exchange, or discipline subscribers other than by excluding them from trading.<sup>6</sup> Since triReduce does not meet the definition of exchange in Rule 3b-16 for the reasons set out above, it is also not an alternative trading system.

#### **Security-based Swap Execution Facility**

The Exchange Act defines a Security-based Swap Execution Facility as:

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.<sup>7</sup>

Similar to the definition of "exchange", the core concept of the definition is the "many-to-many" nature of security-based swap execution facility. In the

<sup>5</sup> 17 CFR 240.3b-16

<sup>6</sup> 17 CFR 242.300(a)

<sup>7</sup> Exchange Act section 3(a)(77)

proposed rule on Registration and Regulation of Security-Based Swap Execution Facilities, the Securities Exchange Commission stated that "[c]onsistent with this requirement, the Commission proposes to interpret the definition of SB SEF to mean a system or platform that allows more than one participant to interact with the trading interest of more than one other participant on that system or platform."<sup>8</sup>

As noted above, triReduce is not a trading or execution facility that allows multiple participants to interact with other participants. The transactions set out in an unwind proposal are counterparty-specific and are not available to other participants to accept. Further, triReduce does not involve the acceptance of bids and offers, in the traditional sense of prices for the assumption or transfer of risk: triReduce participants do not make any bids or offers in connection with a compression run, and TriOptima does not offer a facility for the acceptance of a bid or offer through the triReduce platform. Consequently, triReduce does not meet the definition of a security-based swap execution facility.

#### **triReduce is not a market place or a trading platform**

These narrow, technical explanations of why triReduce does not meet the definitions of "exchange", "alternative trading system" or "security-based swap execution facility" merely evidence a broader fact: triReduce does not meet the definitions because they relate to the regulated activities of a market place or trading platform. A market place or a trading platform is a forum for trading, which is the assumption or transfer of risk for a price. triReduce does not provide any such facilities. The orders proposed in a triReduce unwind proposal are not based on any issues of price, assumption or transfer of market risk or other indicia of "trading" in any sense of the word. No new investment decision to acquire or dispose of market risk is involved in participation in a triReduce compression run.

Indeed, the essential feature of triReduce is that there is no change to any participant's market risk and there is no price impact of executing the orders. triReduce is a price-neutral, market risk-neutral post-trade service to allow participating dealers to compress their trade portfolios. Consequently, it does not present any of the risks associated with price discovery and orderly market trading that the rules relating to regulated markets seek to address, and its activities do not correspond to the regulated activities provided by an exchange, alternative trading system or security-based swap execution facility.

Consequently, for both the technical reasons and the broader policy interests discussed above, triReduce does not, and should not, be considered to be an "exchange", an "alternative trading system" or a "security-based swap execution facility" for purposes of the Exchange Act.

Please contact us at your convenience with any questions.

Yours sincerely,

**Christoffer Mohammar**  
General Counsel  
TriOptima Group

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<sup>8</sup> 76 FR 39 at 10953