MEMORANDUM

TO:	File No. S7-08-11; S7-06-11
FROM:	Andrew Blake Division of Trading and Markets
RE:	Meeting with Representatives from ICAP
DATE:	May 17, 2011

On May 17, 2011, representatives from the Securities and Exchange Commission ("SEC") met with representatives from ICAP and Patton Boggs LLP. SEC representatives were Haime Workie, Jeff Mooney, Catherine Moore, Tom Eady, Andrew Bernstein and Andrew Blake. ICAP representatives were Chris Ferreri, Patrick McCarthy, Mark Beeston (ICAP ReMATCH) and Guy Rowcliffe (ICAP RESET). Attending from Patton Boggs were Micah Green and Erin McGrain.

During the meeting, the participants discussed the SEC's proposed rules for Clearing Agency Standards for Operation and Governance (File No. S7-08-11) and Registration and Regulation of Security-Based Swap Execution Facilities (File No. S7-06-11).

Basis Risk Mitigation in the New Regulatory Framework

Washington, May 2011

Definition of Basis Risk

- Basis Risk is defined by the Derivative Consulting Group Glossary as:

  "The risk of loss arising from the difference between the economic or legal terms of two derivative transactions that are intended to hedge each other."

- Investorpedia.com explains this further:

  "What Does *Basis Risk* Mean?
  The risk that offsetting investments in a hedging strategy will not experience price changes in entirely opposite directions from each other. This imperfect correlation between the two investments creates the potential for excess gains or losses in a hedging strategy, thus adding risk to the position."

Risk Mitigation Services at ICAP

- ICAP owns and operates two industry leading basis risk mitigation services, RESET and ReMATCH.
- RESET reduces the basis risk from fixings on financial instruments such as Libor fixing risk, FX NDF fixing risk and inflation fixing risk.
- REMATCH focuses on the basis risk occurring in Jump to Default risk on Credit Default Swap (CDS) portfolios.
- Both services remove significant quantities of these second order risks from the market and operate in ways distinctly different from voice and electronic market places.
- Appropriately accommodating these types of risk mitigation services in the new regulatory landscape is key for the continued effective reduction of significant quantities of market risk, a primary goal of Title VII of the Dodd-Frank Act.

Understanding a leading risk mitigation platform

To set the scene it is best to take a look at perhaps the largest basis risk mitigation platform in the market today and answer the following questions:

- What does RESET do?
- Why is it of value?
- How does RESET operate?

Some Key Facts about RESET

- RESET represents a significant volume and its use is widespread across the user community:
  - Total notional volumes over the last 3 years: **$525 Trillion**
  - **250** client banks and **1100** individual users 2007
  - **352** client banks and **2320** individual professional traders 2010
  - **326,000** deals in 2007/08 (1280+ per day)
  - **631,000** deals in 2009/10 (2500+ per day)

RESET Risk Mitigation

- RESET provides a service which focuses on risk mitigation in the interest rate derivative market.

- RESET enables banks and their traders to execute Forward Rate Agreements (FRAs), Single Period Swaps (SPSs), and Non Deliverable Forwards (NDFs) to offset, remove or reduce the outstanding reset (or fixing) risk from their trading portfolios.

Why is RESET valuable?

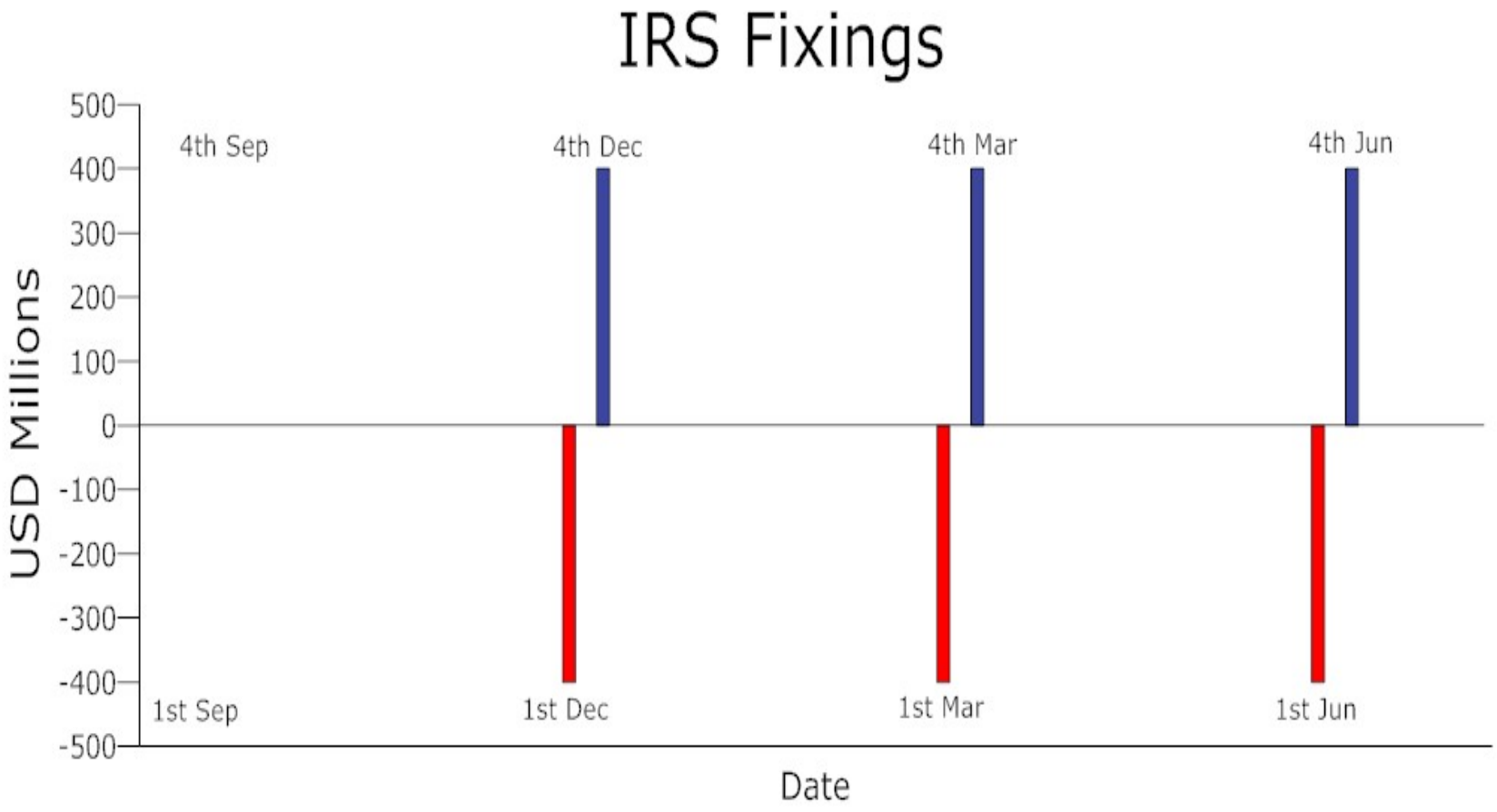
What is “reset” or “fixing” risk and where does it come from?

- Fixing risk is a 2nd order risk within interest rate derivative portfolios resulting from the structure of the instruments held in the client’s portfolios and a mismatch of exposures over time.

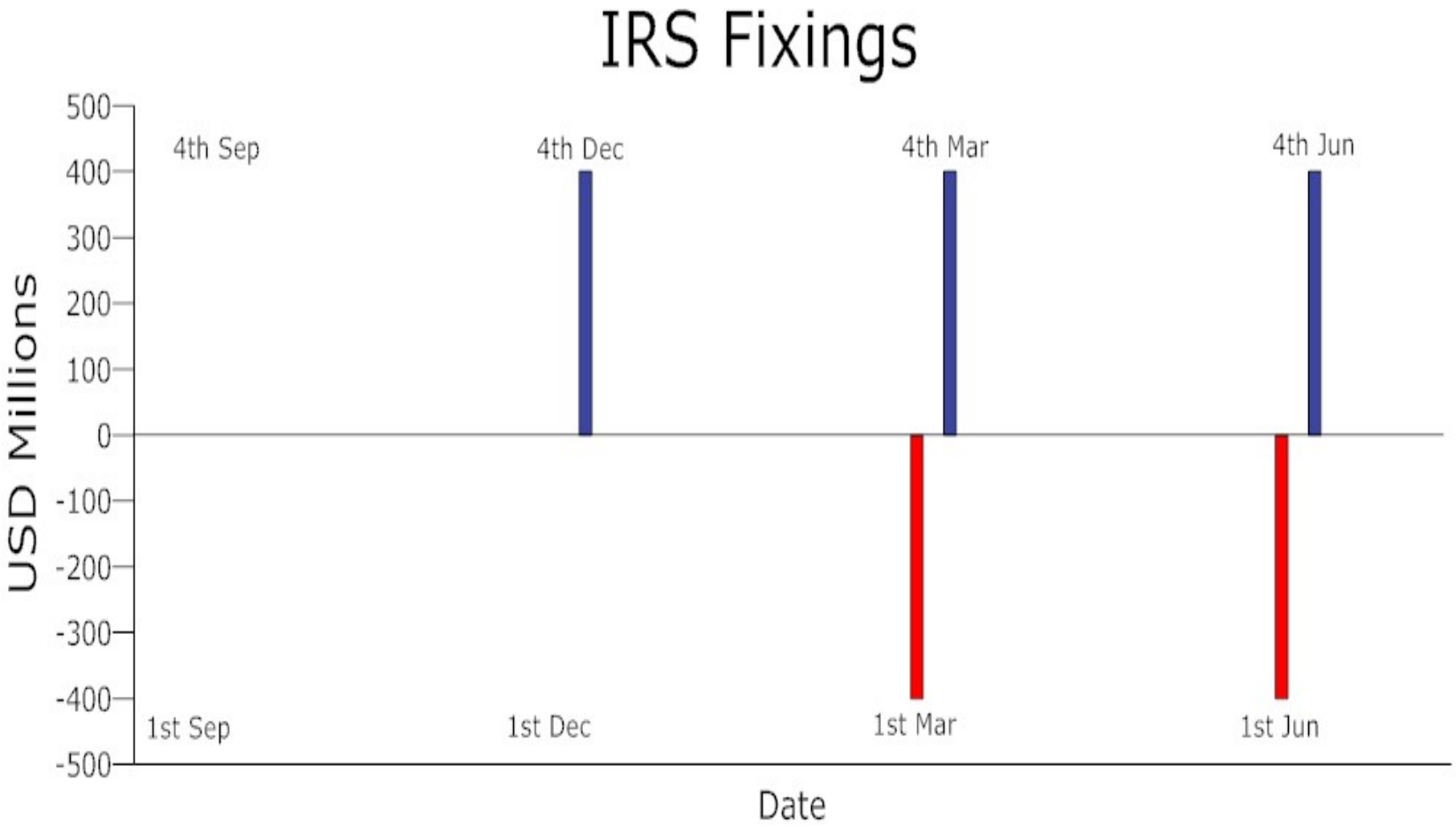
- Fixing risk is a natural by-product of a client’s core trading activity.

- The following basic example of 2 equal and opposite, plain vanilla 1 year interest rate swap deals (mismatched slightly by value date) will serve to illustrate the issue.

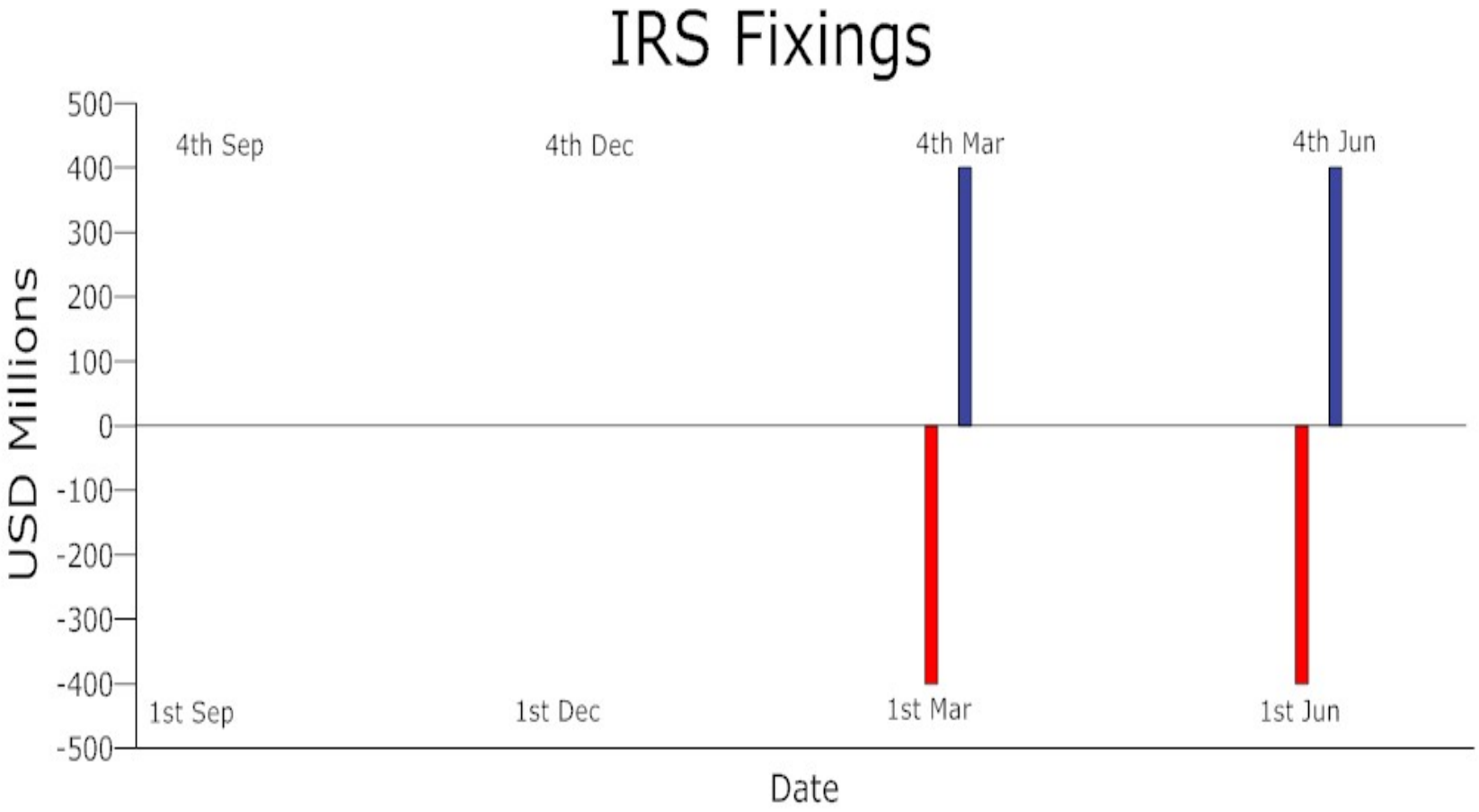
IRS Floating rate fixing



IRS Floating rate fixing



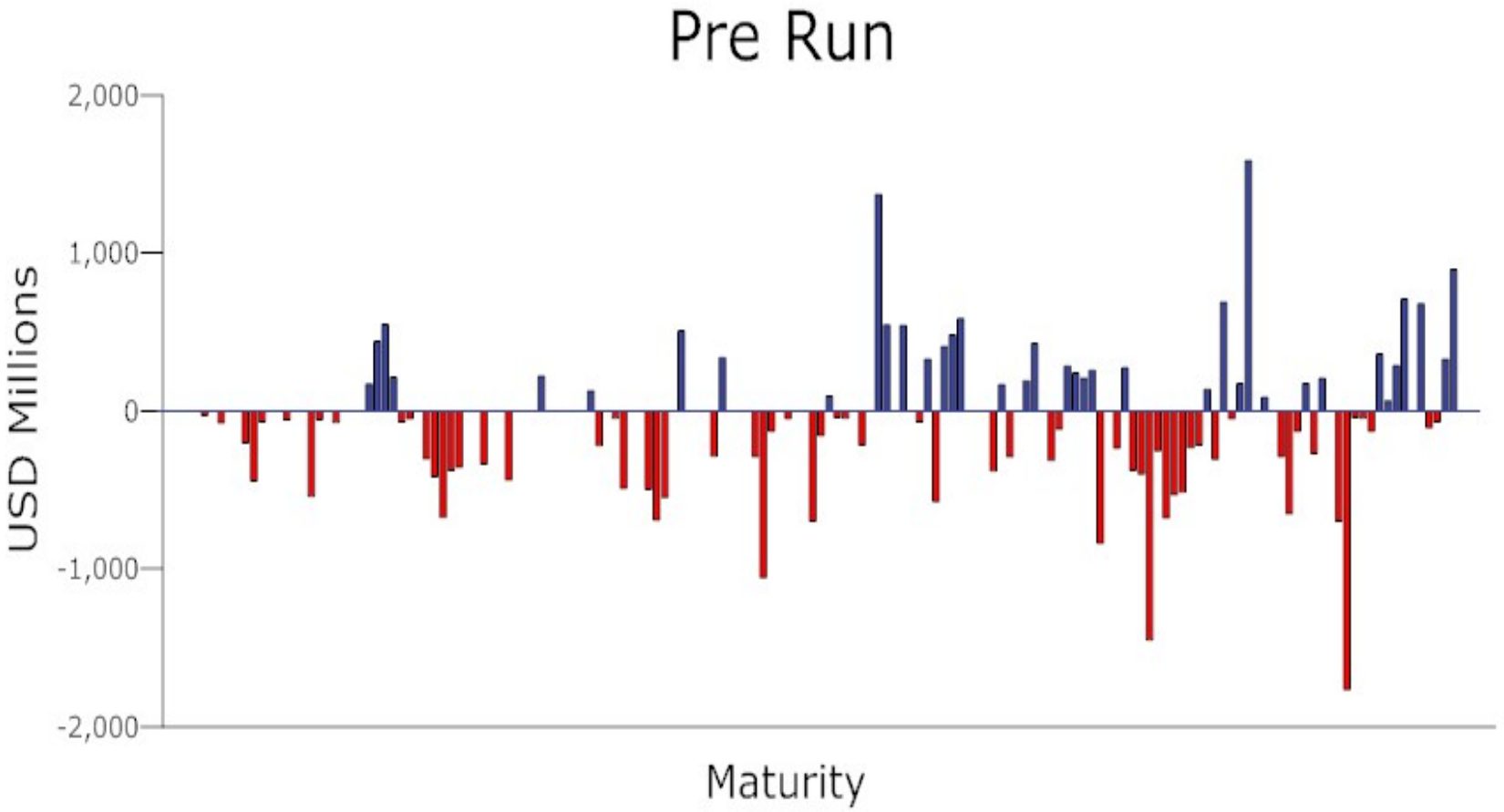
IRS Floating rate fixing



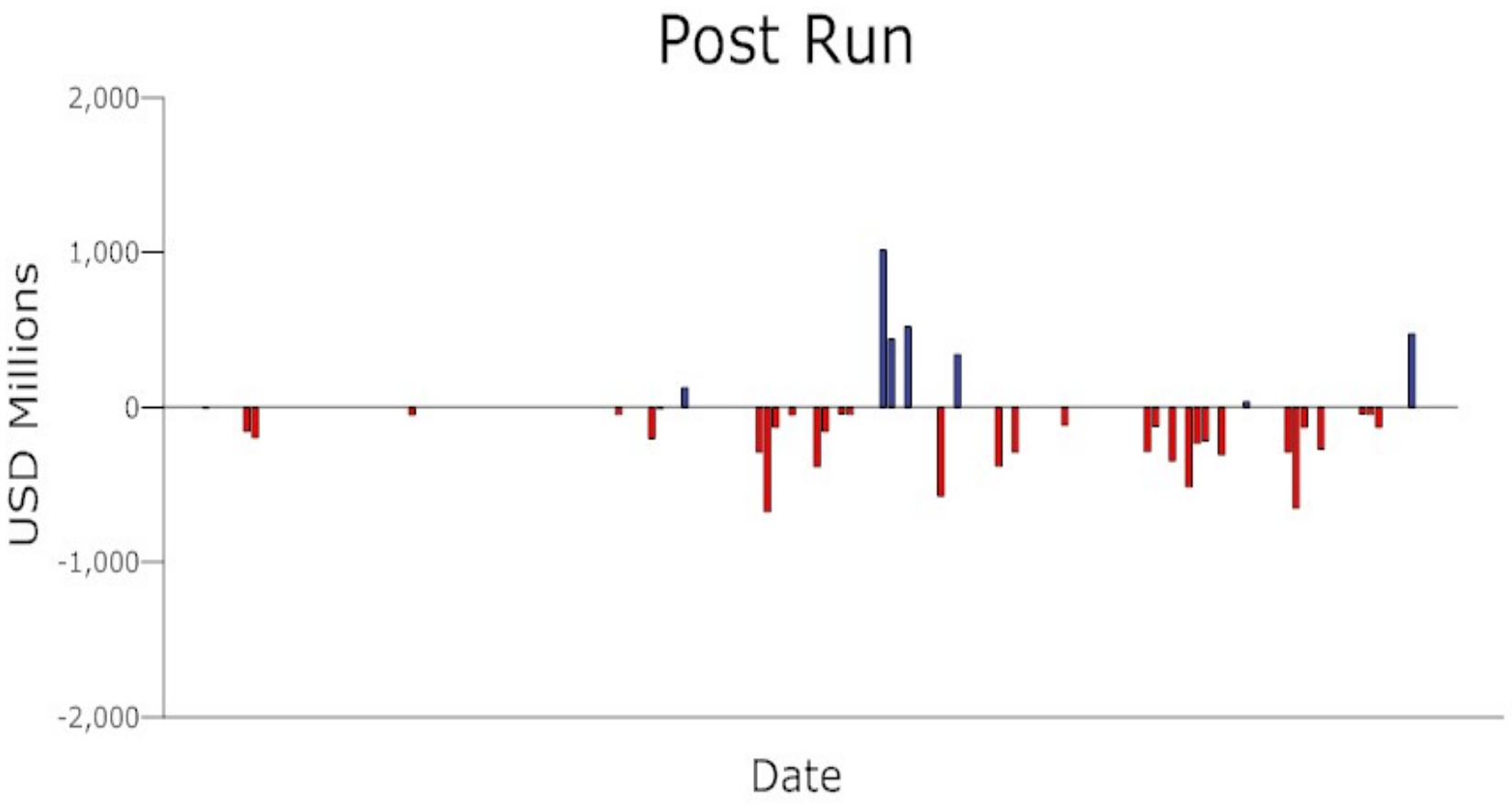
Why RESET is valuable

- 1 basis point on US $1m for 3mths is worth approx $25.
- In our $400m deal example that is a risk of $10,000 per basis point move in LIBOR, every 3 months, for the few days between offsetting fixings.
- Portfolio owners will have fixings of this type nearly EVERY SINGLE DAY.
- Average DAILY LIBOR volatility reached as high as 8-10 basis points during the credit crisis.
- Removing offsetting positions removes exposure to this risk and is demonstrated graphically on the next slides.

Typical IRS portfolio fixing exposures (client X)



Same Client X portfolio after a RESET run



How RESET operates

STEP 1

RESET sends a **Portfolio spreadsheet** on day of run to all customers

FULL PRICE TRANSPARENCY

STEP 2

Traders fill in their matching options, credit limits for counterparties and position interests

STEP 3

Once filled in, it is **emailed back to RESET** before a specified cut-off point

Sophisticated proprietary algorithm and multi year risk management expertise

STEP 4

RESET sends results back to the trader and confirmations go to back office

RESET's transparent market neutral operations

1. We provide a preset mid market curve (there is no bid/offer spread) with FRA prices for every days value out to approximately 1 year in the future.
2. These are the prices at which all participants will trade if liquidity and individual matching criteria allow.
3. The curve is a snapshot of the market determined from a poll of market participants.
4. All potential participants receive the prices before executing any trades (in ReMATCH this is not the case).
5. The service allows only market neutral transactions. Every buy must be offset by an equal and opposite amount of notional sell (just for different future value dates).
6. Every trader can individually select from a number of standard matching criteria and restrictions which determine which combinations of offsetting trades can be done from the full set of positions submitted to the service. Each selected criteria or restriction is incorporated into the algorithmic solution.
7. The service is only run periodically (not daily or live). For example in liquid currencies such as USD it is run weekly every Monday.
8. Traders submit portfolios during the late afternoon and execution only occurs overnight once all the data has been collected and the matching algorithm run on the full data set.

Now moving to ReMATCH

ReMATCH is a newer company established by ICAP in 2009 to perform basis risk mitigation for Credit Default Swaps.

- CDS market size in GROSS notional outstanding: $32.7 Trillion (BIS)
- CDS market size in NET notional outstanding: $1.8 Trillion (BIS)
- However there are significant risk management challenges
  - Net Open Position (NOP) is a multiple of net notional outstanding
    - NOP adds all net notionals per maturity date across the curve
    - Net notional risks change quarterly for individual market makers
    - Managing micro curve risks is extremely difficult
- Exiting of odd-dates is often cost prohibitive
  - Little liquidity
  - Curves are hard to define
  - Results in accumulations of unwanted risk

ReMATCH

- Market making traders typically cover 10 credits (range of 1-50 credits)
  - Each credit has between 40-120 maturity dates
  - Only the 5 year point usually has meaningful liquidity (80% of volumes)

- A trader with 10 credits manages >400 maturities with just 10 highly liquid contracts leaving many default risks and curve exposures un-hedgeable

- ReMATCH's proprietary service allows clients
  - potential liquidity on all maturity dates
  - mid-market execution which removes prohibitive crossing of bid-offer
  - a **discreet** moment for the industry to access across-the-curve liquidity

- ReMATCH success in this area:
  - Over $250B in NOP reduced
  - Increasing frequency, now twice weekly sessions
  - Typically reducing 20-30% of portfolios NOP content on each submission

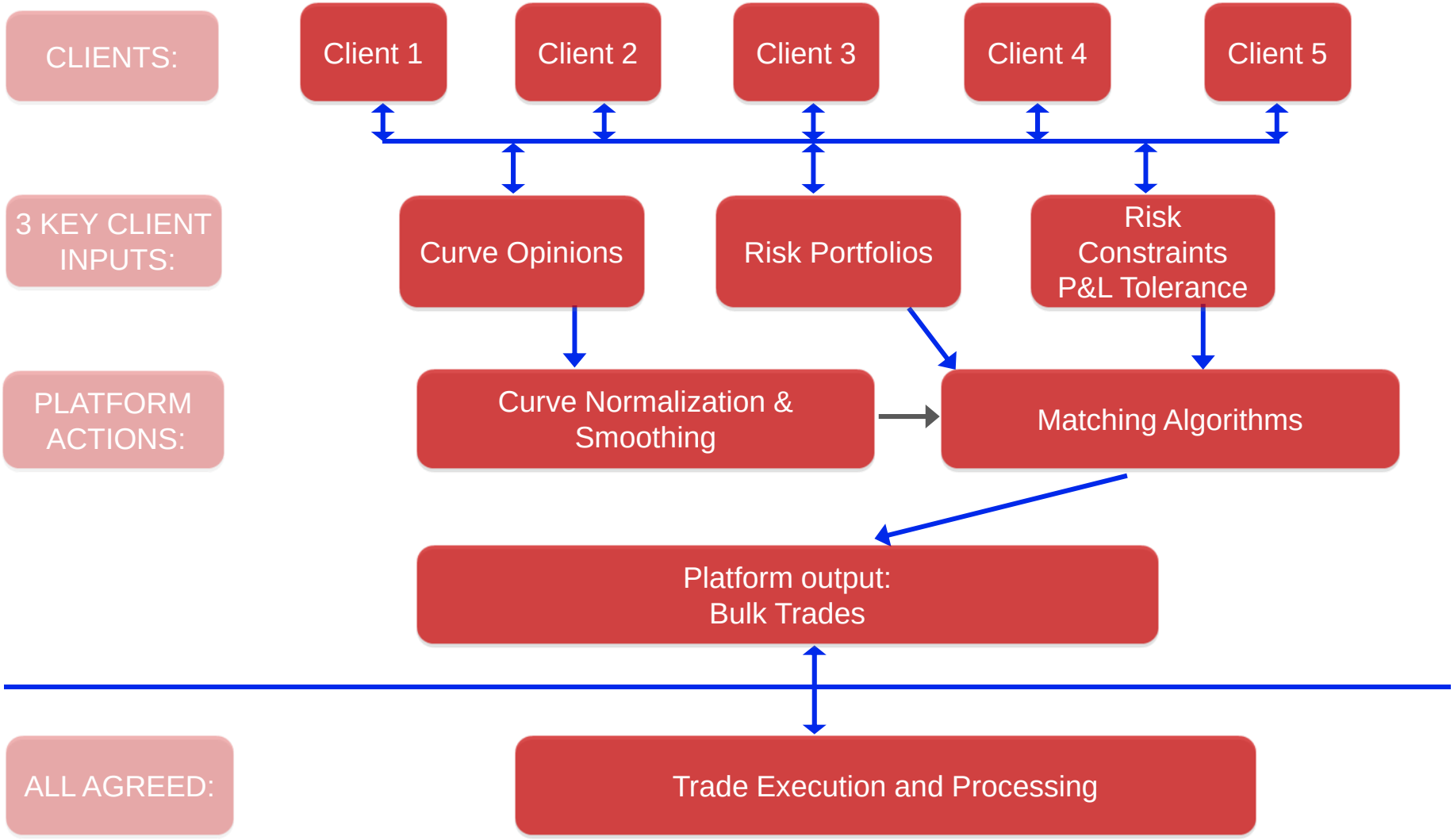
Summary

- These basis risk mitigation services remove significant risk from the financial system *(even in a fully cleared world).*
- They are very established in the older markets and increasingly established in the newer ones.
- They exhibit significant differences from the traditional voice and E-trading models that the new SEF rules are intended to regulate.
- We would welcome engagement on how these services fit into this new regulatory paradigm to the benefit of continued risk mitigation across the street.
- The next slide summarises the difference from more typical trade execution models. The final one shows a generic basis risk reduction process.

Comparison of how RESET and ReMATCH compare to ICAP Voice and E-Platforms

Platform type / Feature	Voice or E-Platform	RESET	ReMATCH
Price determination	Bid-offer	Platform sets a mid market price	Platform sets a mid market price
Market type	Continuous	Regular scheduled (weekly or less frequent)	Irregularly scheduled
Risk positioning	Individual risk assuming	Bulk risk mitigating	Bulk risk mitigating
Risk input	Individual trade interest - bid or offer	Portfolio level risk interests	Portfolio level risk interests
Execution model	Trader driven execution	Platform determined execution	Platform determined execution
Results	Individual transaction	Bulk runs of transactions	Bulk runs of transactions

Portfolio Risk Mitigation Methodology (Generic)



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