February 28, 2011

Mr. David Stawick,
Secretary
Commodity Futures and Trading Commission
Three Lafayette Centre, 1155 21st Street, N.W
Washington, DC 20581

Re: RIN 3038-AC96 - Notice of Proposed Rulemaking on Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants

Dear Mr Stawick,

TriOptima welcomes the opportunity to submit comments in response to the proposed rules on Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants in which the Commodity Futures Trading Commission (the "Commission") solicited comments on its proposed rules to implement Section VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank", and such rules, the "Proposed Rules").

TriOptima's comments reflect our extensive experience serving as a key provider of OTC derivatives market infrastructure offering operational and counterparty credit risk management tools to the OTC derivatives market. TriOptima has significantly contributed to the promotion of more robust and safer OTC markets including:

- Inventing the methodology and the process for multilateral portfolio compression/termination for OTC derivatives and introducing the process known as triReduce to the market;

- Terminating interest rate swap derivatives in 23 currencies with a notional principal value of $108 trillion, with the participation of more than 150 dealing institutions globally over the course of the past ten years;

- Terminating and compressing more than $68.2 trillion in notional value of credit derivatives since 2005, eliminating 50% of the global gross notional outstanding in 2008 alone;

- Innovating the concept of proactive portfolio reconciliation for OTC derivatives portfolios and developing a service, triResolve, which now reconciles approximately 75% of all non-cleared OTC derivatives, and which has been extended into other asset classes and other activities supporting margin management and dispute resolution;

- Maintaining extensive data records for more than 6 million live OTC derivatives contracts covering all asset classes (interest rates, credit, commodity, FX, equity, etc.) from more than 3,450 legal entities, representing 75% of all non-cleared OTC derivatives, for the purpose of reconciling and ensuring the accuracy of that data;

- Developing and supporting the global Interest Rates Trade Reporting Repository (the “Rates Repository”) which produces weekly reports to regulators and the public, covering 3.9 million OTC interest rate derivative transactions with a notional value of $485 trillion.

TriOptima’s service offerings are all centered on enhancing operational efficiency and minimizing operational and counterparty risk. To achieve those goals, TriOptima has been a market leader in innovating and offering new services including triReduce for multilateral portfolio compression and triResolve for proactive portfolio reconciliation. Based on our experience with these services, we are pleased to provide the following comments to the Commission regarding the Proposed Rules.

Portfolio Reconciliation

Terms to reconcile

It is important to note that portfolio reconciliation is based on a comparison of terms and valuations for each swap in a portfolio with the counterparty. The purpose of portfolio reconciliation is to reach agreement on the trade populations and, to the extent possible, the valuation of the contracts, in order to assess and mitigate the credit risk. In order for such a process to be effective, it is important that the parties compare the complete and unique set of bilateral transactions, since only then will it be certain that any detected omission represents an exception that needs to be investigated and resolved urgently. Thus the priority in portfolio reconciliation is on completeness of population, rather than granularity in trade details, and hence we support the Commission’s proposal to focus on the material terms of the contract.

Reconciliation frequency

As noted in the Proposed Rules, under the auspices of the OTC Derivatives Supervisors’ Group (ODSG), a large number of swap dealers (SDs) (including the G-14 financial institutions) and major swap participants (MSPs) already regularly reconcile their portfolios with each other and with other entities. Continued improvements in frequency and the inclusion of increasingly smaller portfolios, as outlined in the Proposed Rules, should prove no obstacle to those institutions.

We support the Commission’s proposal for regular portfolio reconciliation between SDs or MSPs and other entities, either on a bilateral basis or by qualified third parties. While many transactions with other entities are not currently collateralized and may not be collateralized in the future, depending on the outcome of the Commission’s deliberations, we believe that regular portfolio reconciliation for all portfolios will identify issues that can minimize counterparty credit exposure and operational risk.

Reconciliation procedures

TriOptima has observed a significant amount of work done by the industry to outline policies and guidelines for reconciliation and collateral over the past couple of years. The Commission should consider encouraging the use of industry wide practices and protocols like the **ISDA Portfolio Reconciliation Best Practices and Minimum Market Standards** (ISDA Best Practices) published in January 2010, rather than promoting bilaterally agreed guidelines and policies defining the reconciliation process between counterparties. This would contribute to developing a global standard which achieves the goals of the Commission and eliminates confusion over proper policies and guidelines.

Valuation Differences

The Commission proposes that valuation differences above a certain threshold should be resolved within a certain deadline. However, it is important to understand the source and nature of these valuation differences and, based on our extensive experience and expertise in this area, we would like to offer the following observations on the nature of valuation differences in the OTC derivatives market.

OTC derivatives transactions are unique contracts that cannot be directly compared to other publicly available contracts in many cases. This means that both parties to a contract will calculate their own valuations based on their internal valuation models which use inputs either derived from other observable sources or internal calculations and which reflect that party's view on the market.

Furthermore, many OTC derivatives contracts are illiquid in the sense that there is sparse or episodic liquidity in similar contracts which can be used to calibrate valuation model inputs. This illiquidity means that there will be differences in mark-to-market values, and sometimes these differences may be significant. The question then is, what does resolving a valuation dispute mean? Is there a true and objective answer to what the value of a contract is when there is no liquid market in such a contract?

Banks and other financial institutions have a number of assets on their balance sheets, many of which have similar illiquidity characteristics. These assets are all valued by each bank according to some internal model or estimate. There is, as far as we know, no regulation that stipulates that all institutions holding a particular illiquid bond must agree on the value of such a bond. The valuation issue becomes even more complicated when it comes to truly unique assets such as real estate. These examples illustrate that the challenge of valuing illiquid assets is not unique to the OTC derivatives market and that forced convergence is not a universal solution.

We believe that the spectrum of valuations on illiquid contracts provided by independent institutions contains valuable information for supervisors and regulators. As an example, in the run up to the recent financial crisis, some institutions realized earlier than others that the price of credit risk was too low. They appropriately raised the price in their internal valuations, sometimes leading to significant write-downs of assets on their balance sheets, and to differences in valuations of their OTC derivative contracts with their counterparts. At the time, these prudent institutions were outliers in comparison with the majority of institutions, but with hindsight they were right. Regulatory transparency on such valuation differences could then serve as an early warning system on coherence and trends in the market.

Forcing the market to converge on some type of consensus view of the value of illiquid contracts would in our view be detrimental to the stability and resilience of the financial system. It would create disincentives for institutions to use their own judgment in establishing fair market values, and it would remove a valuable diagnostic tool for regulators.

It is important to distinguish between a mark-to-market value calculated by one of the parties and the mark-to-market value used for margining. For trades cleared with a central counterparty, the CCP calculates daily mark-to-market values and uses these marks for collecting variation margin. The members of that CCP generally do not agree on the mark-to-market value, but they do agree to posting variation margin based on the mark-to-market value calculated by the CCP. The OTC derivatives, which are currently cleared, are fairly standardized and liquid which means that the disagreement between a CCP's and its members' marks is generally small, and hence acceptable for margining purposes. However, as clearing is extended to more illiquid and more exotic contracts such disagreements will increase.

Similar to the situation for cleared trades, what is important from a bilateral credit risk mitigation perspective is that the parties agree on the principles for how to determine the mark-to-market values used for margining purposes. Any difference between the net positive exposure calculated with a party's own marks and the margin agreed with the counterparty becomes an unsecured exposure towards the counterparty for which that party needs to reserve capital. If trading parties were forced to accommodate artificial mark-to-market values in their internal valuations, such unsecured exposures would artificially disappear and less capital would have to be reserved. This would reduce the stability and resilience of the financial markets thereby counteracting some of the stated objectives of Dodd-Frank.

We believe that the regulation should focus on establishing principles for how to determine the margining amount on a portfolio level, rather than forcing institutions to agree artificially on the mark-to-market of individual transactions. A key element in such principles should be that an institution is consistent in its valuations. Comparing mark-to-market values with the counterpart could then be used as a tool for detecting exceptions, and such exceptions should be resolved quickly. Thus any regulation in the area of valuation differences should focus on errors and inconsistencies. For valuation differences that still persist after excluding the causes outlined above, the parties should be allowed to "agree-to-disagree" and face the credit risk and capital consequences of having unsecured exposures.

In general, we are supportive of the Commission's move towards requiring proactive, regular portfolio reconciliation between OTC derivative market participants. As evidenced by the 2011 **Asia Pacific Collateralized Portfolio Reconciliation Memorandum of Understanding** developed and promulgated by ISDA in the Asia Pacific region, the standards for portfolio reconciliation are not exclusive to the G14 core dealer community and the USA and Europe, but rather are being disseminated around the world. There is a general recognition of the value of portfolio reconciliation in managing counterparty risk and minimizing capital exposure.

Portfolio Compression

Mandating of Portfolio Compression

The risk reducing effect of portfolio compression is highly dependent on the net to gross ratio that parties have in similar contracts. Essentially, a portfolio compression exercise aims to reduce the excess gross risk while leaving the involved parties with only the net risk. The net risk cannot be compressed without changing the risk profile of each party. This would then require re-hedging by that party and expose the party to potential risk of losses in case there is movement in the market between the compression event and the re-hedging.

For many smaller institutions and also for large institutions trading illiquid contracts the net to gross ratio is sometimes close to 100% which means that all transactions are in the same market risk direction. For such parties it would not be productive to take part in multilateral compression since the market risk tolerances allowed for in §23.503(c)(3)(ii) would have the effect that no transactions would be compressed or that the resulting notional reduction would be minimal.

Furthermore, there are sometimes valid reasons for not wanting to or not being able to terminate existing transactions. In the Proposed Rules, an explicit recognition of this fact is made in §23.503(c)(3)(i) where transactions can be excluded if their inclusion "*would be reasonably likely to significantly increase the risk exposure of the swap dealer or the major swap participant*". In addition, in the case of transactions designated as hedges for accounting purposes, the accounting rules stipulate that it must be possible to specifically identify a contract with an external counterparty in order for the hedge accounting rules to apply, which excludes such transactions from compression. There could be other reasons as well to exclude trades based on compliance or internal risk policies.

For the reasons stated above we see significant challenges in making portfolio compression mandatory. We suggest that the Commission removes this requirement and instead focuses the regulation on creating incentives for institutions to take part in portfolio compression. Such incentives to some extent already exist in the form of regulatory capital requirements. However, most of the current and proposed capital requirements are based on the net risk positions of the participants and not the gross risk position, and thereby do not encourage the reduction of gross risk position.

The Proposed Rules require SDs and MSPs not to "*unreasonably withhold, delay or condition consent to an unwind proposal*". It should be noted that sometimes there are valid reasons for parties to reject an unwind proposal, (e.g. system failures, blackouts, incorrectly set tolerances, etc.). A multilateral proposal requires the consent of *all* participants. As the number of participants in a proposal increases, the probability also increases that an institution will have a valid reason for rejecting a proposal. This means that for practical reasons it may be necessary to partition the market into smaller segments in order to get a manageable number of parties in each proposal. Such partitioning should be permitted.

The Commission defines a multilateral portfolio compression exercise as "*an exercise in which multiple swap counterparties wholly or partially terminate some or all of the swaps outstanding among those counterparties and replace the swaps with a smaller number of swaps whose combined notional value is less than the combined notional value of the original swaps included in the exercise.*" We would like to point out that there can be several approaches to multilateral compression including (i) full termination of existing swaps and replacement with new swaps, and (ii) full termination and revision of notional value of existing swaps. Using the latter methodology, swaps are not replaced with a smaller number of swaps, instead existing swaps are either fully terminated or their notionals revised. A multilateral portfolio compression exercise can also achieve a range of results, including reduction of counterparty risk, reduction of the number of outstanding swaps and reduction of outstanding notional values, all of which are consistent with the overall goals of Dodd-Frank. In order to accommodate these different outcomes and methodologies used by providers of multilateral compression services, we would ask the Commission to consider defining multilateral portfolio compression exercise as follows: "*an exercise in which multiple swap counterparties wholly terminate or change the notional value of some or all of the swaps submitted by the counterparties for inclusion in the portfolio compression and, depending on the methodology employed, replace the terminated swaps with other swaps whose combined notional value (or some other measures of risk) is less than the combined notional value (or some other measure of risk) of the terminated swaps in the compression exercise.*"

In the Proposed Rule the Commission mandates compression and also requires that SDs and MSPs "*participate in multilateral compression exercises that are offered by those DCOs or self-regulatory organizations of which the swap dealer or major swap participant is a member.*" As indicated, we do not believe that portfolio compression should be mandated for the reasons outlined above but rather that the Commission creates incentives to engage in portfolio compression, such as structuring capital incentives based on gross rather than net risk positions.

However, if portfolio compression is to be mandated, we believe that requiring members of a DCO or SRO to participate in compression exercises offered by the DCO or a SRO will inhibit legitimate competition in the market among providers of compression services. Instead we propose that the Commission allows SDs and MSPs to select the compression venue rather than give preference in the rule-making to compression exercises offered by the DCO or SRO. If it makes sense for the exercise to take place within the DCO or SRO this will naturally occur, but if there are alternative services/venues that provide an equal or better service, market participants should not be constrained from taking advantage of those opportunities.

Summary

Overall, we believe that portfolio reconciliation and portfolio compression are among the best tools available for reducing both individual institutional risk as well as systemic risk. As recognized by the Commission in the Proposed Rules, there has been significant progress in advancing towards those goals, and we hope that the final rules will continue to advance towards those goals while building upon the experience gained from recent progress.

We appreciate the opportunity to provide our comments on the Proposed Rules and look forward to working with the Commission as the rulemaking process continues. Please feel free to contact us at your convenience with any questions.

Sincerely,

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