markit™

620 8th Avenue
35th Floor
New York
NY 10018
United States

tel +1 212 931 4900
fax +1 212 221 9860
www.markit.com

February 28, 2011

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

Re: Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants [RIN 3038-AC96]

Dear Mr. Stawick:

Markit[1] is pleased to submit the following comments to the Commodity Futures Trading Commission ("***CFTC***" or the "***Commission***") on the proposed rulemaking to implement certain requirements included in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "***DFA***")[2] titled Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants (the "***Proposed Rule***").[3]

1. Introduction

Markit provides portfolio compression, independent data, valuations and related services for swaps and security-based swaps across many regions and asset classes in order to reduce the risk and improve operational efficiency in these markets. As a service and infrastructure provider to the global swaps markets, Markit supports the Commission's objectives of increasing efficiency in the OTC derivatives markets and of reducing both systemic and counterparty risk.

In our comments below, with respect to the portfolio compression ("***Portfolio Compression***" or "***Compression***")[4] aspects of the Proposed Rule, Markit wishes to: (a) highlight some significant market consequences and impacts of implementing the Proposed Rule as currently drafted; and (b) identify potential areas for improvement in the Proposed Rule.

2. Executive Summary

Markit believes that: (i) the Commission should establish thresholds to ensure that portfolio compression is only required where it provides sufficient net benefit; (ii) the frequency of Compression should depend on the relevant market and product characteristics; (iii) the choice of the provider of Compression services should be

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[1] Markit is a financial information services company with over 2,000 employees in North America, Europe and Asia Pacific. The company provides independent data and valuations for financial products across all asset classes in order to reduce risk and improve operational efficiency. Please see www.markit.com for additional information.

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

[3] Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants, 75 Fed. Reg. 81519 (proposed Dec. 28, 2010).

[4] *See* § 23.503 of the Proposed Rule. The Proposed Rule provides the following two definitions that collectively comprise "Portfolio Compression": *bilateral portfolio compression*, which is "an exercise in which two swap counterparties wholly or partially terminate some or all of the swaps outstanding between those counterparties and replace those 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," and *multilateral portfolio compression*, which is "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. The replacement swaps may be with the same or different counterparties." Proposed Rule, 75 Fed. Reg. at 81530 (to be codified at 17 C.F.R. § 23.500(b), (h)).

open and fair, and be based on its competency and ability; and (iv) non-SDs/MSPs or non-"financial entities" should generally not be required to participate in Portfolio Compression.

Our views below are largely based on the experience we have gathered in performing Compression services for single name Credit Default Swaps ("***CDS***") and may apply differently to other asset classes given the number of participants, customization of products, trading frequency, and other factors specific to those asset classes.

3. Introduction - History and Current Market Practice of Portfolio Compression

Markit regards Portfolio Compression as an essential tool to allow counterparties to swaps to close out economically redundant transactions, or those swaps whose characteristics are identical or highly similar to those of other transactions in their portfolio and that do not otherwise serve a valuable economic purpose (*e.g.*, hedge other unrelated swaps or a party's physical commodity or some other economic exposure). Such swaps not only contribute to operational and counterparty risk, they also produce little economic benefit. We therefore believe that Portfolio Compression can play an important role in reducing counterparty, operational, and systemic risks in the swaps markets. While DCOs typically directly offer netting for the increasing numbers of centrally cleared swaps, as demonstrated by several industry initiatives, we expect that Portfolio Compression cycles will continue to be performed for non-centrally cleared swaps even if not required by rule. This is because Portfolio Compression allows counterparties to reduce capital requirements and operational risk for these positions. Therefore, while we recognize the benefits of the Portfolio Compression framework laid out in the Proposed Rule, we encourage the Commission to acknowledge the established market practices that have evolved over the past years without the direct legislative mandate to do so.

The concept of removing economically redundant transactions from portfolios of financial instruments relates back to the 1980s, but serious attempts to perform regular Portfolio Compression have only been initiated in the last decade. Particularly in the past few years, Compression has become a key tactical solution for reducing regulatory capital and operational risk. For example, it has been part of G14 commitments for the credit and interest rate swaps markets.[5] Notably, Portfolio Compression was recently attempted in other asset classes such as commodities and foreign exchange, but was not pursued further because the trial cycles had limited success.

The first swap Compression services were not risk-neutral. As a result, participation was limited because participants would be left with a changed risk profile after the netting rounds. Markit, in conjunction with Creditex[6], addressed this issue by launching the first fully risk-neutral Portfolio Compression process for single name Credit Default Swaps ("***CDS***") in August 2008. Through the use of sophisticated algorithms and the creation of a small number of new swaps transactions, it enabled participants to complete a Portfolio Compression cycle without any change in their risk profile. Because a much higher level of participation and Compression efficiency can be achieved through such multilateral risk-neutral Portfolio Compression approach, this process has established itself as the standard for CDS indices and single-names. To date, we have completed more than 200 weekly Portfolio Compression cycles in the United States and in Europe that included a total of 900 single name CDS. This Compression activity has successfully removed a total notional amount of close to $7 trillion of economically redundant single name CDS transactions.

Portfolio Compression also regularly takes place for interest rate swaps. However, such cycles are not truly risk-neutral, largely due to the lack of standardized end-dates for these products.

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[5] A table summarizing the Commitments of the G14 Dealers to regulatory authorities can be found on www.newyorkfed.org/newsevents/news/markets/2010/100301_table.pdf.
[6] *See* ISDA News Release dated July 2, 2008, available via www.isda.org/press/press070208.html.

4. Comments related to the proposed rules

a. The Commission Should Establish Thresholds to Ensure that Portfolio Compression is Only Required where it Provides Sufficient Net Economic Benefit

The Proposed Rule would require SDs and MSPs to participate in Portfolio Compression cycles if required by the Commission or if offered by a self-regulatory organization ("***SRO***") that the SD or MSP is a member of.[7] We are concerned that such mandatory participation might lead to Portfolio Compression cycles being required for a range of swaps where the potential benefits to compress do not justify the cost of operating them.

As a preliminary matter, we believe that performing risk-neutral Portfolio Compression for centrally cleared swaps will almost always be worth the cost because compressing a portfolio of centrally cleared swaps in a risk-neutral manner is fairly straightforward. However, we believe that the Commission should carefully consider the cost and benefits of performing Portfolio Compression for the non-cleared population of swap transactions.

(i) *Costs*

The most active dealers currently participate in regular compression cycles for certain products and, in doing so, have established appropriate operational infrastructure for such products. However, we believe that the proposed Portfolio Compression requirements would impose significant additional burdens on (i) the large number of SDs and MSPs that currently do not participate in Portfolio Compression cycles, and (ii) all SDs and MSPs for those products for which Portfolio Compression cycles are currently not performed.

Based on our experience, the operational and technological preparation that is required from counterparties to allow them to participate in Portfolio Compression cycles can be very demanding. Processes and procedures must be established by each of those counterparties to allow efficient and timely validation and execution. This typically requires changes to the participant's risk systems and connectivity enhancements to platforms that enable the confirmation of the transactions that were executed as a result of the Compression cycle. For example, some of the Compression cycles that we perform create the need for participants to book and process up to 5,000 single name CDS transactions on a single day. This represents a significant operational challenge, particularly seen in the context of the 40,000 CDS transactions that are executed on average per month.[8]

The Commission should take these costs into account when considering the introduction of new Portfolio Compression obligations that go beyond current market practice in any given asset class.

(ii) *Benefits*

A number of recent initiatives have been aimed at performing Compression in other asset classes, such as foreign exchange and commodities. However, little benefit was obtained from these exercises except for those swaps that were already in scope for central clearing. Given the operational burden of participating in Compression, we encourage the Commission to establish additional variables that are designed to ensure that Compression cycles will only be performed if they create at least a minimum level of benefit.

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[7] *See* Proposed Rule, 75 Fed. Reg. at 81532 (to be codified at 17 C.F.R. § 23.503(c)(2)).

[8] *See* the Quarterly Metrics for further details related to average monthly volumes of the G14 dealers, available on http://www.markit.com/en/products/research-and-reports/metrics/metrics.page.

Generally, the potential to remove economically redundant transactions for a given product and the challenges to perform Compression cycles depend on several product specific variables. These are, for example, the number of counterparties with outstanding swaps positions, the total number of outstanding swaps transactions in the product, the number of transactions held by each counterparty, the amount of ongoing trading activity, and the differences between transactions.

Moreover, we have found that the actual amount of Compression that can be achieved will often deviate significantly from the gross potential to compress for several reasons. First, even though overall Portfolio Compression is risk-neutral related to the underlying risk, the exposure to individual swaps counterparties participating in a given cycle is not. The amount of Compression that can be performed will therefore often be limited by the counterparty risk limits. Second, many swap positions cannot be characterized by the use of standard trades and therefore cannot be compressed. For example, it might not be possible to re-create an existing deeply in- or out-of-the-money net swap position by using standard swaps. Third, participants will often use swaps as specific hedges against other positions, and must therefore withhold such transactions from Compression cycles. These and other factors in combination imply that, as experience has shown, the potential to actually compress transactions is often fairly limited, and the Compression benefit for many asset classes and products will not always justify its cost.

We therefore believe that the Commission should establish thresholds for determining whether a category of non-cleared swaps should be subject to any mandatory Compression. These thresholds should relate both to the minimum number and the notional amount of transactions that must be compressed. Thus, if a Compression benefit above such set thresholds existed for the majority of participating SDs and MSPs, any existing Portfolio Compression cycles should continue or new Portfolio Compression efforts should be initiated. If the thresholds were not breached, the Commission should not mandate that market participants perform Portfolio Compression exercises at that point in time, whether or not they are offered by DCOs or SROs.

b. The Frequency of Portfolio Compression Should Depend on Market and Product Characteristics

The Commission has requested comment as to how frequently Portfolio Compression should be required.[9] Based on our experience, we believe that the ideal frequency of Compression cycles will depend on the benefit that it would deliver for each cycle, which itself is often a function of product specific variables such as the level of ongoing activity.

For single name CDS, we have performed Portfolio Compression cycles on a weekly basis for the last two and a half years. Typically, up to 50 reference entities would be included in any given cycle, and each single name credit is part of a Compression cycle every 2 to 6 months, depending on activity in that name. We continue to see sufficient interest from market participants in these exercises, and are thus planning to continue offering Portfolio Compression cycles with such frequency going forward.

Because the ideal frequency of Portfolio Reconciliation varies from one asset class to another, we believe the required frequency should depend on the achievable Compression benefit, which itself will be a function of product and market characteristics. We would therefore recommend that the Commission makes the frequency of Compression cycles equally dependent on the measure of Compression benefit and the use of thresholds as explained above.

[9] *See* Proposed Rule, 75 Fed. Reg. at 81526.

c. <u>The Commission Should Establish Standards Applicable to Potential Compression Service Providers to Ensure that Providers Will Have the Requisite Competency</u>

In our experience, Portfolio Compression requires the provision of a robust front-end, the development of sophisticated algorithms, and expertise at delivering specific parts of the service. For example, for a participant that has a multitude of different trading desks or portfolios, Portfolio Compression providers need to construct algorithms to ensure that the results of the compression leave not only the participant overall, but also all of its desks individually, risk neutral.

We therefore request the Commission to establish standards to ensure that the actual service provider for Compression is selected on the basis of its competency, its ability to deliver the service in a timely fashion, and the availability of sufficient resources to support the service and its participants. Also, the process of choosing the provider of Compression services should be open and fair. The Commission should note that it was on the back of those principles that Compression services were selected in June 2008 to help satisfy the Federal Reserve's mandated compression requirements.

d. <u>Portfolio Compression Should Not Be Required of Non-SDs/MSPs</u>

Based on our experience, we do not generally expect any noteworthy benefit from requiring non-SDs/MSPs to also participate in Compression cycles because those counterparties tend to have portfolios with only a very small number of offsetting transactions. Also, Portfolio Compression cycles involving non-SD/MSP financial entities tend to be even more complicated and costly as they often involve the participation of prime brokers. Therefore, we do not generally believe it would be useful or efficient for the Commission to require non-SDs or MSPs to engage in Portfolio Reconciliation unless it was justified by the specific situation of a particular counterparty or underlying trade type.

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For the reasons explained above, we welcome the adoption of the Proposed Rule and appreciate the opportunity to provide our comments.

We thank the Commission for considering our comments. In the event you may have any questions, please do not hesitate to contact the undersigned or Marcus Schüler at marcus.schueler@markit.com.

Sincerely,

Kevin Gould
President
Markit North America, Inc.