

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

**Re: RIN 3038-AD18 – Comment Letter on CFTC Proposed Rule on Core Principles and Other Requirements for Swap Execution Facilities**

Dear Mr Stawick

TriOptima AB welcomes the opportunity to comment on CFTC Proposed Rule referred to above (the "**Proposed Rule**").

TriOptima operates the triReduce portfolio compression service. triReduce is a post-trade risk management service that allows multiple participants to reduce counterparty credit risk, the number of outstanding swaps and/or the outstanding notional value under their respective swap portfolios by participating in a single, coordinated algorithmic compression cycle. As the CFTC's proposed rules for swap execution facilities ("**SEFs**") are currently drafted, there is a risk that triReduce and similar portfolio compression systems would be required to register as SEFs.

TriOptima believes that this is an unintended and inappropriate consequence of the current definitions, which would hamper risk management by limiting the compression services available to swap market participants. SEF registration would impose rules which do not work in the context of compression services and would constitute a significant barrier to entry to compression service providers that are independent of existing designated contract markets or SEFs.

TriOptima encourages the CFTC to adopt provisions to clarify that portfolio compression services are post-execution activities that do not require compression service providers to register as SEFs or as designated contract markets. If the CFTC declines to give compression services a comprehensive exclusion, TriOptima requests that a number of the regulatory provisions planned for SEFs should be disappplied or amended with respect to compression service providers in order to prevent inappropriate rules from preventing effective risk reduction.

***About TriOptima***

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 better and safer OTC markets including:

- Terminating interest rate swap derivatives in 23 currencies with a notional principal value of \$108 trillion, (including both uncleared and



cleared swap transactions) 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 (including indices, single names and tranches) since 2005, eliminating 50% of the global gross notional outstanding in 2008 alone;
- Maintaining extensive data for more than 6 million live OTC derivatives contracts covering all asset class (interest rates, credit, commodity, FX, equity, etc.) from more than 3,450 legal entities, representing approximately 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 which produces weekly reports covering 3.9 million OTC interest rate derivative transactions with a notional value of \$486 trillion for regulatory review.

### **Description of a Portfolio Compression Cycle**

The Commission has described portfolio compression<sup>1</sup> as a process that "allows for a reduction in outstanding trade count and outstanding gross notional amount by replacing redundant trades with a smaller number of trades and reduced gross notional value." TriOptima believes that this is an effective working definition, although we note that in some cases, the gross notional value may be reduced by terminating or modifying existing trades, rather than replacing all trades. In this letter, the term "compression" has a meaning consistent with that interpretation.

The main features of the triReduce portfolio compression service are set out below.

- Swap market participants become eligible to participate in triReduce compression cycles by adhering to the standard form documents that set out the essential terms on which a compression cycle will be conducted (each a "**triReduce Participant**"). triReduce Participants are not contractually bound to participate in any compression cycles.
- TriOptima periodically publishes a timetable of scheduled compression cycles, typically giving a several months' notice for each swap product.
- Interested triReduce Participants may then sign up to a scheduled compression cycle (they are referred to in this letter as "**Cycle Participants**"). In connection with a specific compression cycle each Cycle Participant provides detailed data about its portfolio of the relevant type of swap, and provides details of the tolerances within which it could accept a compression solution (including, for example, maturities, counterparty concentration and net cash position). Once they have

<sup>1</sup> See the Commission's notice of proposed rulemaking on *Confirmation, Portfolio Reconciliation and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants* at 75 FR 81520 and the definitions of "Bilateral Portfolio Compression exercise" and "Multilateral Portfolio Compression exercise" at 75 FR 81530

provided their tolerances, other than to update mark-to-market values shortly before the compression cycle is run, Cycle Participants have no further input into the compression process, which is entirely controlled by the triReduce algorithm.

- On a specified date TriOptima runs the compression cycle. The output is a set of proposed transactions for each Cycle Participant which, if effected, would reduce counterparty credit risk, the number of outstanding swaps and/or the outstanding notional value of the Cycle Participants' portfolios without changing the Cycle Participants market risk outside their respective tolerances.
- Each Cycle Participant receives only details of the proposed compression transactions to which it is party, but all of the compression transactions must be accepted in order for the unwind proposal to be effective. I.e. each Cycle Participant must agree to, sign and return to TriOptima, its own unwind proposal. If a single Cycle Participant declines to agree to the unwind proposal, the cycle fails and the pre-compression swaps remain in effect.
- The unwind proposal only becomes effective if all Cycle Participants agree to it.

#### ***A portfolio compression service should not be regulated as a Swap Execution Facility***

Section 1a(50) of the Commodity Exchange Act of 1936, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "CEA") defines a Swap Execution Facility as follows:

The term "swap execution facility" means a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or system ... including any trading facility that-

- (A) facilitates the execution of swaps between persons; and
- (B) is not a designated contract market.

Because the definition and the Proposed Rule are broadly worded, there is uncertainty as to whether the Commission would interpret them to include a compression service. TriOptima submits that, for several reasons, the Commission should not.

#### **1. Compression is a post-trade activity**

The Commission stated in its commentary to the proposed rulemaking on portfolio compression that "[p]ortfolio compression is an important, *post-trade processing* and netting mechanism that can be an effective and efficient tool for the timely and accurate *processing* and netting of swaps by market participants."<sup>2</sup> The Commission has further stated in

<sup>2</sup> 75 FR 81525, emphasis added

the Proposed Rule that "entities that operate exclusively as swap processors do not meet the SEF definition (and should not be required to register as SEFs) because: (1) They do not provide (as required by the definition) the ability to "execute or trade" a swap ...".

TriOptima believes that treating compression services as post-trade activities is the appropriate regulatory treatment, because compression services increase the efficiency of, and reduce risk in, existing trade portfolios. However, we are concerned that, as a technical matter, compression services may fall within the definition of a SEF, to the extent that compression transactions are replaced in a compression cycle, i.e. involving "execution" of the replacement transaction(s). This technicality should not, we believe, disqualify compression services from being treated as post-trading services which are exempt from the requirement to register as a SEF, and we respectfully request the Commission to clarify this position in the Proposed Rule or the final adopting release.

## 2. A compression service is not a market or trade execution venue

Post-trade functions like compression services should not be regulated as SEFs; there are crucial distinctions between, on the one hand, a compression service and a designated contract market/trade execution venue on the other (collectively "**Trade Execution Venue**").

A traditional Trade Execution Venue is a market, established as a forum for the assumption of a specified risk for a readily discoverable price<sup>3</sup>. A compression service, by contrast, merely provides for the *reduction* of existing counterparty credit risks, number of outstanding swaps and/or outstanding notional values without changing the Cycle Participants' market risk outside their specified tolerances. The compression service's purpose is to take existing gross exposures and reduce them down to a consolidated position that represents the actual net exposure of each Cycle Participant. It operates on the basis of open disclosure to the compression service provider of the population of existing risk positions that are to be netted, and is not susceptible to price manipulation. A compression service represents a closed system in which trades are compressed without having any implications for the real market in terms of price or volume. This distinction is, we believe, central to the regulatory attitude that should be taken with respect to compression services: because the compression service does not perform the role of a market, it should not be regulated as a market.

## 3. Cycle Participants are not motivated by traditional trading concerns

Participants in compression cycles are not primarily driven by the classic trading factors – price and quantity – that prevail on a traditional Trade Execution Venue. Traditionally, a buyer or seller will determine its own demand and place a commensurate order in the market to determine the

<sup>3</sup> See, for example, Section 3 of the CEA, which sets out the findings and purpose that underpin the CEA. The central finding is that the transactions that are subject to the CEA are

"affected with the national public interest by providing a means for managing and assuming price risks, discovering prices, or disseminating pricing information through trading in liquid, fair and financially secure trading facilities."

price at which the supplier will meet that demand. The Proposed Regulations set out detailed proposals for the use of Order Book or Request for Quotation methods for placing orders (outside of block trades). By contrast, compression services select trade populations according to the most efficient means of cancelling risk exposure, and then transmit the proposals for the transaction population to be terminated to the participants (buyer and seller), regardless of the price or quantity. Only then do the Cycle Participants assess whether they accept the terms for the identified trade population by which the primary objective – lower counterparty credit risk, reduction of the number of outstanding swaps and/or the outstanding notional value – is to be achieved. Consequently, Cycle Participants are not motivated by price or other transaction trading concerns but rather by the desire to reduce portfolio size and counterparty credit risk.

For these reasons, TriOptima submits that the treatment of a compression service as a post-trade processing function, which is not required to be registered as a SEF, is consistent both with the Commission's previous statements about trade processing and, more importantly, with the public policy concerns of encouraging risk reduction while maintaining orderly and well-regulated markets.

#### ***Proposed SEF rules are inappropriate for compression service providers***

A further indication that a compression service should not be regulated as a SEF is that many parts of the Proposed Rule are incompatible with the business and operations of a compression service. The Proposed Rule addresses the Commission's public policy objectives through regulating SEFs' activities and business conduct. As the following provisions show, many of the rules and functions addressed in the Proposed Rule are irrelevant to, or inconsistent with, portfolio compression.

#### **Core Principles and Other Requirements for Swap Execution Facilities**

##### **Proposed Rule (section) Implications for compression service**

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|----------------|--|
| 37.3(b)(1)(ii) | <i>The Commission may only grant temporary grandfather relief to an applicant if the applicant can show that "execution or trading of swaps has occurred and continues to occur ... at the time the applicant submits the request."</i> Compression services are not in continuous operation. Compression cycles occur periodically, and it would be a capricious result if a compression service provider were required to register as a SEF, but were denied grandfather relief merely because no compression cycle was performed on the day the provider submitted its request. |
| 37.4(a)        | <i>SEF applicants can request approval of listed swap products or its rules and contract terms and conditions periodically.</i> Swaps are not "listed for trading" on a compression service, although by definition compression services operate with specified existing swap products. In some cases, the swaps may be removed from a clearing organization for the purposes of the compression cycle, before the swap is re-cleared with a decreased notional value. Compression services should not be  |

expected to seek re-approval for swaps that are put through a compression cycle.

37.4(b)

*SEF applicants must self-certify as to the CEA and rule compliance of swaps listed for trading on the facility, which were not voluntarily submitted for approval to the CFTC.* Compression services deal only with existing swaps, which would have been either originally executed on a regulated exchange and submitted for clearing, or executed bilaterally because they were not available or mandated for clearing, but otherwise subject to all of the applicable requirements of the CEA and the regulations.

The compression service will make no assumptions about the regulatory status of the swaps that are compressed. If the applicable regulations require it or if the counterparties to resulting reduced-notional swap so wish, the counterparties will reintroduce the swap to a clearing organization. The parties to the relevant swap will be required to comply with all applicable provisions of the CEA and the regulations, just as they were before the compression cycle took place. The mere fact that a swap has been subjected to a compression cycle does not change the essential character of the swap (apart from its notional value) and should not impose on the compression service the burden of a compliance process which would be wholly duplicative of the pre-compression process.

37.5(c)

*SEFs must notify the CFTC upon entering into any agreement(s) that could result in an equity interest transfer of ten percent or more in the SEF, including a brief description of the purpose and impact of the transfer and confirmation that the SEF meets all of the requirements under Section 5h of the CEA and the applicable regulations.* Some compression service providers are privately held companies. They are not "utilities" in the trading and clearing infrastructure for OTC derivatives that are owned or controlled by market participants that could influence the conduct of their business in a manner that is unfavorable to other market participants. As noted above, any compression cycle would have to be completed on the basis of tolerances set by the Cycle Participants (and not the compression service provider), with no discretion allowed to the compression service provider. Further, compression services do not represent a systemic risk to the viability of the markets since, as noted above, they play a limited role that is only relevant when compression cycles are actually being conducted. The failure of a compression service provider would have no effect on any outstanding swaps, and new providers would undoubtedly emerge to take on the risk reduction role if the market so demands.

For those reasons, TriOptima submits that there is no overriding policy objective to restrict equity transfers in a compression service provider. Further, TriOptima believes that the imposition of equity restrictions would deter third-party service providers from establishing compression services,

limiting innovation and competition and impairing the development of risk reduction tools for market participants.

37.7 *SEFs may not use data received for the purpose of fulfilling its regulatory purpose for any business or marketing purposes.* Compression services may also offer their participants other services that use information provided in the context of compression cycles, for example, for the purposes of portfolio reconciliation to rationalize a single member's book of trades and optimize their collateral position. These are valuable services that promote the stability and viability of market participants. TriOptima requests that, if compression services are not excluded completely from SEF registration, this proposed regulation be amended to permit a compression service to use such data for other purposes with the express written consent of the entity providing the information.

37.9 *Permitted execution methods are restricted to Order Book, Request for Quote or Voice-Based Systems unless the Commission provides otherwise.* As discussed above, portfolio compression services do not take and match orders in the same way as traditional Trade Execution Venues. Their algorithm-based compression programs select groups of offsetting trades and generate unwind proposals which are manually accepted by the Cycle Participants. TriOptima considers this to be a reason that compression services should not be regulated as SEFs but, if they are, requests that the definition of "Permitted Transactions" at rule 37.9(a)(v) be expanded to include transactions generated by the operation of portfolio compression services.

37.200,  
37.203 and  
37.206 *Core Principle 2 requires a SEF to "establish and enforce trading, trade processing and participation rules that will deter abuses".* As discussed above, compression services do not lend themselves to market abuse in the same way as regular trading. Cycle Participants do not have the ability to increase or decrease perceived demand or to affect prices by participating in compression cycles. Rather, once they have provided details of an existing portfolio of transactions to a compression service, they have no discretion to take any action other than to accept or reject the ensuing unwind proposal.

We note, for example, that the examples of abusive trading practices cited in rule 37.203, which must be prohibited by "**all** swap execution facilities" (emphasis added) include "front-running, wash trading, pre-arranged trading [and] money passes". None of these practices could be effected through a compression service. We recognize that the list is non-exclusive, but we do not believe that there is any significant risk of market abuse through participation on a compression service.

TriOptima submits that the enforcement provisions of proposed rule 37.200, 37.203 and 37.206 are disproportionate to compression service providers. A compression service

37.300-301  
37.400-407  
and  
37.700-703

provider would be required to create and maintain a huge enforcement infrastructure and rulebook to address abuses that do not reflect the reality that portfolio compression services reinforce market integrity, and do not threaten it.

*Core Principle 3 (and rules 37.300-301) requires a SEF to permit trading only in swaps that are not readily susceptible to manipulation. Core Principle 4 (and rules 37.400-407) require a SEF to monitor trading and trade processing, including with respect to physically-settled swaps and cash-settled swaps. Core Principle 7 requires a SEF to ensure the financial integrity of swaps entered into on or through the SEF, including routine monitoring of the financial status of its members.* As noted above in the context of rule 37.4, a compression service should be entitled to rely on the regulatory status of the pre-compression swaps. The cost and managerial burden to a compression service provider of setting up a full trade and counterparty vetting system for replacement trades that are in all material respects the same as the pre-compression swaps is uneconomical and may make compression services financially unviable. In this context, it is important to note that post-trade compression services are one major driver for reducing and mitigating risk in the post-trade space.

### **Conclusion**

The Commission has stated that it believes compression services to be an essential part of a sound risk management system. However, the current Proposed Rule leaves significant uncertainty as to how compression service providers are to be treated under the new regulations. TriOptima looks forward to a regulatory regime that supports the activities of portfolio compression providers, who will innovate and compete to offer effective risk management solutions for swap market participants. To that end, TriOptima requests that the CFTC state specifically in the SEF rules that portfolio compression services are post-trade processing functions that do not require registration as a SEF, whether for cleared or uncleared swaps.

Please contact us at your convenience with any questions.

*Yours Sincerely,*

**Christoffer Mohammar**  
General Counsel  
TriOptima Group

TriOptima AB  
PO Box 182 | 101 23 Stockholm | Sweden | tel +46 8 545 25 130 | fax +46 8 545 25 140 | Company reg no. 556584-9758  
Visiting address: Klarabergsviadukten 63 | Courier address: Blekholmogatan 2F

Copy to:

The Honorable Gary Gensler – Chairman  
The Honorable Michael Dunn – Commissioner  
The Honorable Jill E. Sommers – Commissioner  
The Honorable Bart Chilton – Commissioner  
The Honorable Scott D. O'Malia – Commissioner

