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January 16, 2013

Chairman Gary Gensler
US Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, D.C. 20581

REQUEST FOR AFFIRMATIVE ACTION ON BASIS RISK REDUCTION SERVICES

Dear Chairman Gensler,

We are writing to express our deep concern at how the Commodity Futures Trading Commission (the "CFTC" or the "Commission") may treat ICAP's basis risk reduction services under its Title VII Dodd-Frank rulemakings; specifically that it may require the transactions created by the service to be executed on a Swap Execution Facility (SEF). ICAP intends to register as a SEF operator, and is an experienced operator of several regulated platforms, including the iSwap platform and the ISDX exchange[1]. However, despite the obvious advantage of SEFs, they are not a viable means of reducing system-wide basis risk.

ICAP's RESET and ReMATCH basis risk reduction services (BRRS) have existed for over 10 years and provided hundreds of trillions of dollars in valuable risk reduction benefits to swap market participants and the safety of the financial system as a whole. In our November 16, 2012 no-action letter, a copy of which is attached hereto, we described (i) how our basis risk mitigation services worked, (ii) how they were distinct from trading, (iii) how they operated on a multilateral portfolio basis, (iv) how they did not permit parties to negotiate price, (v) how risk mitigation cycles were based on a pre-run curve set by the service that generated prices that were stale by the time trades were finalized, and (vi) how participants were required to accept the trades generated by the risk reduction cycle on an all-or-nothing basis. We also conveyed that we did not believe such activity constituted trading that could take place on a SEF or should be required to, and sought confirmation of the continued viability of BRRS under the emerging swaps regulatory framework.

[1] iSwap (Euro) Limited is authorized and regulated by the FSA as a "Multilateral Trading Facility"; ICAP Securities & Derivatives Exchange Ltd (ISDX) is a Recognized Investment Exchange, recognized as an SRO by the FSA

We understand from discussions with staff that the CFTC is nonetheless of the view that transactions generated by our BRRS must be executed on a SEF. For the reasons explained below, we urge the CFTC to reconsider this position, or to at least provide for a mechanism within the SEF rule that permits these services to continue. We do not believe our BRRS would be viable if subject to the current proposed execution requirements for SEFs,[2] and that without these services Swap Dealers in particular would build up substantial and complex basis risks from timing mismatches in their portfolios. Given Congress' express view – echoed often by the Commission itself – that a principal objective of Title VII is to reduce systemic risks associated with swap activity, it would be highly anomalous to regulate out of existence a service that has so consistently and effectively furthered that objective.

I. Transactions generated by our BRRS should not be required to be executed on a SEF

The transactions generated by our BRRS do not constitute "trading" in any conventional sense. They are not arms-length transactions, they are not negotiated, they are not price-forming, they are generated by a service designed for risk reduction, not risk taking, and they operate pursuant to parameters that make them highly ill-suited to a trader seeking to put on material new risk. The effect of ICAP's BRRS is to amend existing exposures, typically for short periods in the future, rather than having the effect of creating new trading exposures.

For transactions subject to mandatory clearing, the proposed SEF rule generally requires non-block trades to be executed either on a central limit order book (CLOB) or request for quote (RFQ) system meeting CFTC requirements. The risk reduction benefits that BRRS provide, however, cannot be achieved through a live CLOB or RFQ mechanism.

Here is a simplified illustration of the problem:

Three Swap Dealers hold a variety of swap positions. On any given date they will have a long (positive) short (negative) or flat exposure on a net basis across each of their portfolios. The transactions that create that net exposure on any given day may have been entered for a variety of purposes and may have on-going commercial lifespan of months or years. For the purposes of explanation only, the example below shows the net long, short or flat position on a given dates in March or April 2013. Here we have assumed that for each Swap Dealer, on days where it has a net exposure, it is of $20M notional (positive, 20, or negative -20).

[2] The CFTC has issued a proposed rule for comment. Core Principles and Other Requirements for Swap Execution Facilities, 76 Fed. Reg. 1214 (January 7, 2011).

	Bank A	Bank B	Bank C
6-Mar-13	-20	20	
11-Mar-13		-20	20
14-Mar-13	20		-20
8-Apr-13	-20		20
24-Apr-13		20	-20
30-Apr-13	20	-20	

Each Swap Dealer, however, interacting on its own with a SEF's CLOB or RFQ, is extremely unlikely to find simultaneous interest for the other side of its idiosyncratic exposure – i.e. there will be no natural counterparties for a transaction covering the comparatively short intervals of time in the future that the banks have their exposures. If one multiplies this scenario by all the market participants that use our BRRS and by the very large number of basis risk mismatches within each bank portfolio on any given day, the problem becomes very material and systemic.

As an alternative, the same portfolios entered into a BRRS cycle would identify the following offsets, which in reality are numerous, complex and rely on the multilateral effects of comparing the portfolios – the elimination of any one of these net exposures on its own may itself create an un-wanted asymmetry or exposure; **in the example below the vertical parabolas show where there is an interdependency between two exposures, and the horizontal parabolas show where there is a potential offset.** It shows that in order for Swap Dealer A to eliminate its March 6, 2013 exposure by trading with Bank B, Bank B has to be able to reduce its opposite March 11, 2013 exposure by trading with Bank C, and in turn that Bank C can only reduce that exposure on March 11 if it can also reduce its exposure on March 14, and so on. This illustration therefore shows the simultaneous interdependence of each stage in the chain, which a BRRS "run" seeks to identify.

	Bank A	Bank B	Bank C
6-Mar-13	-20	20	
11-Mar-13		-20	20
14-Mar-13	20		-20
8-Apr-13	-20		20
24-Apr-13		20	-20
30-Apr-13	20	-20	

In this example, the resulting Swap Dealer portfolios contain no net exposure:

	Bank A	Bank B	Bank C
6-Mar-13			
11-Mar-13			
14-Mar-13			
8-Apr-13			
24-Apr-13			
30-Apr-13			

In our RESET service, traders commonly seek to manage up to the next years' worth of unwanted basis risk that results from their existing swap transaction exposures. In any given "run" of the RESET service it will manage up to 250 different price points for different date structures, all simultaneously and on a multilateral basis – an analysis that typically takes some hours. Moreover, traders specify numerous additional, albeit generic, limits and criteria (often different for each individual user) that RESET is able to take into account in running its cycle. <u>It is simply untenable to expect that banks could achieve this risk reduction through posting multiple idiosyncratic bids and offers to the market at large.[3]</u>

We understand the Commission's interest in ensuring that most swap activity take place on transparent, regulated marketplaces, and support its objectives.[4] However, the Commission has recognized in a number of contexts that not all swap activity is appropriate for SEF or DCM trading. See Compression and Inter-Affiliate Transactions exemptions[5]. Indeed, the Commission appears to recognize that compression risk reduction services do not constitute "trading" and should not be subject to real-time reporting, as they are not price-forming.

The Commission, however, would treat basis risk reduction services differently. While we recognize that there are some differences between compression and basis risk reduction services, we do not think those differences merit disparate regulatory treatment. Both services are designed to reduce risk, are

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[3] We note also that ICAP intends to register and operate one or more SEFs once those rules are finalized, so that to the extent we thought BRRS were viable on a SEF, we would have an operating vehicle that could take advantage of that opportunity. We simply do not think, though, that BRRS are viable under the SEF rules as currently proposed.

[4] We also appreciate the Commission's interest in regulating swap market intermediaries and risk reduction services. Our BRRS services conduct their activities through CFTC-registered introducing brokers, and we would certainly be amenable in that capacity to enhanced Commission oversight of our BRRS activities.

[5] <u>Real-Time Public Reporting of Swap Transaction Data</u>, 77 Fed. Reg. 1182, at 1244 (January 9, 2012) ("Real-Time Reporting Rule") and <u>Clearing Exemption for Swaps for Certain Affiliated Entities</u>, 77 Fed. Reg. 50425 (August 21, 2012).

not price-forming, and do not involve the type of negotiation that is fundamental to trading. That BRRS achieve their reduction of existing risk through the generation of "new" trades does not render their service trading.

II. If the Commission requires transactions generated by a BRRS to be executed on a SEF, it should adopt a "Block-trade-like" rule that will permit BRRS-compatible execution

If the Commission requires BRRS transactions to take place on a SEF, we urge the Commission to permit a "block-trade-like" manner of flexible execution away from the SEF's CLOB and RFQ. Under this approach, our BRRS would submit the entire compound transaction coming out of a "cycle" to the SEF for execution, reporting to the SDR and submitting to the DCO, if required. This would mirror the current treatment of "block trades" in the futures markets.

We believe there are several good reasons for the CFTC to authorize SEFs to execute BRRS transactions away from the SEF or CLOB. First, as noted above, the risk reduction objectives of a BRRS cannot be achieved in any meaningful way on a CLOB or RFQ. Participants do not submit bids or offers or negotiate prices, basic attributes of a CLOB/RFQ system. Second, the prices that emerge from a BRRS cycle are stale by the time the trades are complete – their only purpose is to act as a meaningful but not perfectly accurate means of amending existing risks. If entered into a CLOB or RFQ, they would therefore likely be off-market and could inadvertently distort correct live market prices. Third, because of the volume and complexity of analysis that goes into a BRRS cycle, it cannot occur in real-time, as a CLOB or RFQ requires – BRRS transactions are generated only after a multi-hour, usually overnight out of trading hours, process.

Permitting execution within the scope of well defined and regulated BRRS services in this manner would allow BRRS to continue to fulfill their risk reduction objectives, while still providing the Commission with extensive oversight of the activity. The BRRS will operate subject to a SEF rulebook, within the required SEF governance framework, with a SEF CCO and attendant compliance and disciplinary program, and as noted, with capability to report trades to SDRs and, if applicable, DCOs.

* * *

Our BRRS services have provided tremendous benefits to the marketplace for ten years, and perform a service that is perfectly aligned with one of Dodd-Frank's principal objectives, reduction of systemic swap risk. We believe that they assist in the efficiency of transaction compression, and reduce otherwise difficult to identify concentrations of "second order" risks within Swap Dealers. We thus find ourselves greatly frustrated and concerned at the prospect of losing a franchise we have worked hard to build and that is very much part of the solution, not the problem. It is simply inconceivable that Congress intended or expected such services would find themselves without a viable home in the new regulatory landscape.[6]

[6] If the Commission is not inclined at this time to accept the views set forth above, we would respectfully ask that it at least delay the application of the SEF execution requirement to BRRS for some period of time, i.e., 12 months, to

Thank you for your consideration. Should the Commission wish to discuss these matters further, please contact me at 011-44-207-050-7121 or mark.beeston@icap.com.

Sincerely,

Mark Beeston

Chief Executive Officer
Portfolio Risk Services

Attachment

<u>Cc:</u>

Commissioner Jill Sommers
Commissioner Scott O'Malia
Commissioner Bart Chilton
Commissioner Mark Wetjen

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permit it to further review the service. While we appreciate the Commission's wariness at exempting activities from core Title VII requirements, we believe the additional time would permit the Commission a more fulsome review of BRRS activity that we believe would generate comfort that it is not a vehicle for trading and should properly not be subject to SEF execution, or at least CLOB/RFQ execution.