MEMORANDUM

TO: File No. S7-06-11

FROM: Iliana Lundblad

RE: Implementation of Dodd-Frank Wall Street Reform and Consumer Protection Act

S7-06-11 – Registration and Regulation of Security-Based Swap Execution Facilities

DATE: July 28, 2011

On July 27, 2011, Heather Seidel, Tom Eady, David Liu, Constance Kiggins, Steven Varholik, Leah Mesfin, Iliana Lundblad, Sarah Schandler, Chester Hill, and Jasmin Sethi, met with Vinayek Singh (CEO, Vyapar Capital Market Partners LLC), Kenneth Skloyer (CCO, Vyapar Capital Market Partners LLC), Stephen Gould (SVP, Vyapar Capital Market Partners LLC), Derek Simpkins (Credit Group, Vyapar Capital Market Partners LLC), and Jeffrey Maron (GFI Group).

The discussion topic was swap execution facility-type trading platforms. Supplemental materials are attached.

TOTAL derivatives

Platforms' progress: Vyapar's VOLMAX

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The market for derivatives trading platforms is following the advice of well-known capitalist Chairman Mao, and letting a hundred flowers blossom and a hundred schools of thought contend.

The interest rate swaps market has seen a brace of product launches recently including some streaming platforms (see the reports **Tradition and GFI launch new IRS platforms** and previously **Fill Kill 2: Dawn of the platforms**).

However, matching or session-based platforms - rather than streaming, hybrid or RFQ (request for quote) - are gaining share in interest rate options and inflation. Vyapar Capital Market Partners is one company offering a matching platform - VOLMAX) - to derivatives dealers. Vinayek Singh, Vyapar's President and CEO, discussed the prospects for platforms with *Total Derivatives* earlier this week.

- **Total Derivatives:** Could you outline the matching process on VOLMAX?

  VOLMAX markets and mids are submitted by participating dealers and are not broker-generated. Clients have a counterparty credit filter to ensure they execute trades only with pre-qualified market participants. Users also select structures they would like included in forthcoming sessions and submit levels that are used to generate consensus mids. There are system managed alerts to off-market prices for participants ('Fat Finger'). Order activity occurs at the resulting consensus mids. Orders are executed either instantly or on a stack priority allocation methodology, depending on the instrument. Blotters and STP are available electronically post trade.

- What products trade through the platform?

  We run several sessions in a day globally for USD, EUR and GBP on a variety of interest rate derivatives products, including swaptions, caps/floors, switches, skews, and inflation swaps and options. We occasionally run special sessions outside the schedule to accommodate market events such as FOMC meetings and the like. We are expanding our market coverage based on client feedback and sponsorship.

- Is the process broadly the same across all the products or are there subtleties for say options versus inflation swaps? What about the size of the trades?

Our process is indeed broadly similar but, for example, in inflation swaps there is little need to ask clients to select structures, owing to the restricted range of possible swaps. Some products run on a first-come first-trade basis while some work on an allocation basis. There are of course product-specific nuances. The minimum trading sizes are based on market practice, and range from 5 million to 250 million notional amounts.

In more than one thousand interest rate derivative sessions globally, we have seen over 2 trillion in market interest, and over a quarter of a trillion in notional executed.

- Are matching platforms generally better suited to certain markets/products? Why?

VOLMAX addresses the five major issues for matching platforms that are relevant to most OTC market/products:

1. Liquidity concentration through scheduled sessions.
2. Structure selection - market-relevant structures determined by participants.
3. Converging on a tradable consensus price - by getting market-maker-supported prices.
4. Counterparty suitability for credit-sensitive instruments.
5. Anonymous trading where it is desirable to execute without the prospect of moving the market adversely.

- Other than matching platforms, do you see growth in other types of platform such as streaming or RFQ, or aimed at other markets e.g. interdealer versus dealer to client?

Vyapar certainly expects more continuous trading and RFQ platforms to emerge. With increasing regulation, the forthcoming arrival of SEFs (Swap Execution Facilities) and uncertainty over the extent to which D2C (dealer to client) and D2D (interdealer) markets converge, it is not yet clear which type of platforms will better suit particular markets and products.

Complex markets can be traded efficiently using a fully electronic methodology and process. The methodology we have can be applied to segregated liquidity pools or combined liquidity pools depending upon whether the trades are done bilaterally or are cleared.

Today's technologies mean that markets can adopt a range of trading protocols, between RFQ and streaming markets to satisfy specific liquidity constraints and can evolve as each market evolves. We feel that session-based market platforms can bridge the extremes between these other market practices including voice/hybrid execution methodologies. As the markets adopt different ways of transacting we feel that our technology is extendable to all trading protocols.

- Why should dealers choose to trade through your platform over the many others out there?

Our platform requires more input from our clients than existing competitor platforms do, by electronically soliciting what they want to trade and the prices they are willing to trade at. In contrast, existing competing platforms, where the brokers decide both what structures are available to be traded and at what price, are essentially just order-matching platforms and arguably cannot be regarded as truly electronic. Additionally, our platform is designed around a 'give to get' principle. The more dealers contribute, the more they are likely to trade and the more market information they receive. Our sessions generally require less than 10 minutes from start to finish so traders get a substantial amount of information (as well as execution) in a very short period of time.

In addition to trading, our platforms provide valuable peer market consensus prices, indications of interest, and trading activity based information. The quality of price is useful to our clients and has attracted much interest from the marketplace, particularly for valuation and risk management.

- Some dealers in the inflation markets have complained that certain platforms have shown "random prices," trades have been "wrong," and generally some "half-baked" systems seem to have been rushed into operation in an attempt to gain first mover advantage. How do you respond?

Vyapar has heard similar comments about competing platforms where the process and systems are "half-baked". Some of these platforms simply show random structures and broker-derived levels; perhaps the platform operators feel that traders should automatically trade on those broker-determined structures and levels. This may give rise to the "random prices" and the "wrong" trades which had to be unwound in the market place. In contrast, we have a fully electronic process for soliciting client's structure interest and their pricing to derive consensus market levels for trading. VOLMAX also filters out anomalous or erroneous prices using our 'Fat Finger' protection feature. It also ensures counterparty suitability with the use of our credit filter, which until the industry move into a cleared framework is essential for preventing transactions from being broken due to credit constraints. The rules and process are clearly defined so that there is a level playing field for all participants.

We constantly talk to traders, hold roundtable conferences, refine the process, and provide enhancements to our platform and processes. This is a continuously evolving marketplace and our approach is a collaborative one with our clients.

- In terms of the flows going through these new systems, some traders have said that while it was a reasonable amount at the start, it seemed to be fading away a bit. Also there were complaints that the sudden proliferation of systems was increasing the burden on dealers. What is your take on this?

We have consistently attracted dealer participation ever since our launch in June 2010. Levels of participation on some platforms with weaker and less rigorous methodologies have faded. As mentioned earlier, our platform provides valuable information in addition to trading. Dealers, as with any intelligent and demanding customers, will gravitate towards the one or two platforms that provide the type and quality of service they require.

- Will voice-broking go the way of the futures pit? Is there an obvious division of labor between the two, for instance with voice staying for illiquid markets and platforms for more commoditized products?

There will be several forms of trading in the rapidly evolving OTC derivative markets: voice, hybrid, RFQ, and now session-based. We feel that our approach is effective by allowing the maximum number of market participants to focus for short periods of time during the trading day on structures that are important to them to maximize liquidity and information. It is a way for traders to enter orders anonymously without having a disruptive impact on the market.

OTC markets are inherently discontinuous rather than continuous due to frequency of trades and the size of individual trades. Session-based trading defines a new paradigm for trading and information for such markets. We also believe that this approach is consistent with the proposed regulatory framework and various forms of clearing. It has all the advantages of electronic trading without the disadvantage of imposing continuous trading on markets whose liquidity cannot sustain it. This methodology is here to stay - and grow.

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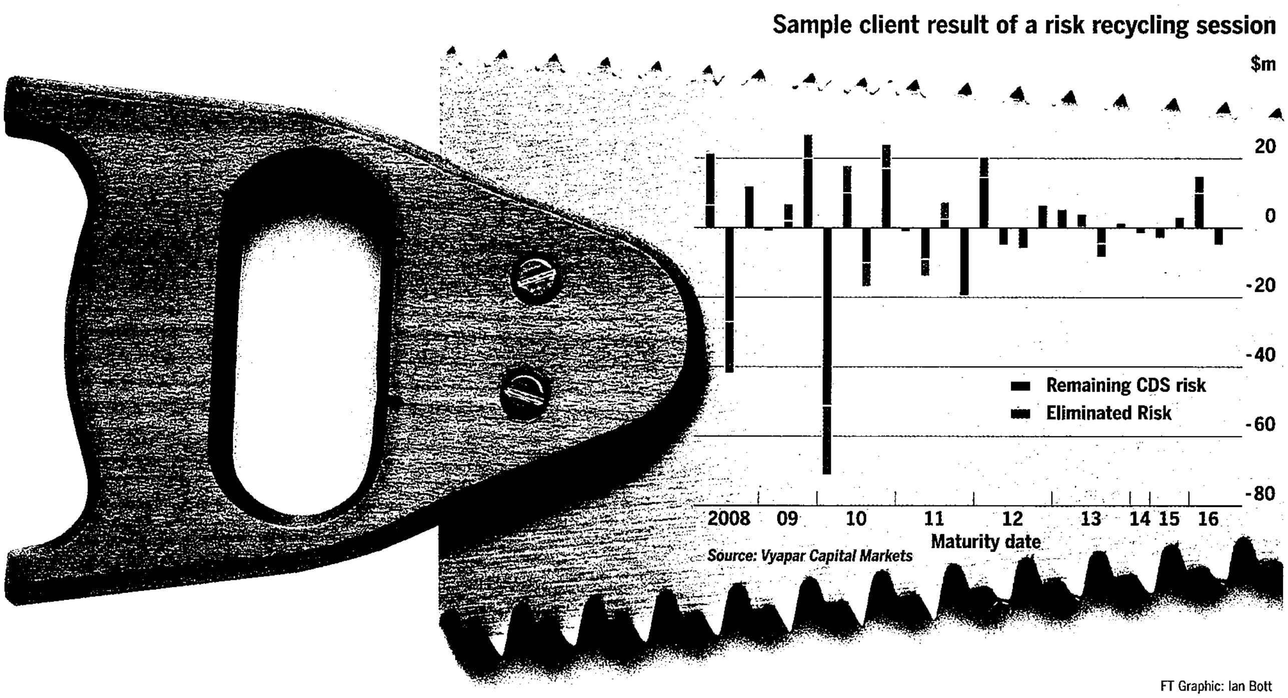
Markets & Investing

Banks look for ways to ensure old risks do not cut too deep



FT Graphic: Ian Bott
Photo: DK Images

NEWS ANALYSIS

Financial groups are hoping that a new process will help them reduce losses on their old contracts, writes **Michael Mackenzie**

Much of the debate about the risk associated with the credit derivative market, which has grown to a notional size of $62,200bn in the past decade, centres on counterparty exposure and improving the processing and accounting for trading activity.

However, another risk lurks on the trading books at banks, which hold many contracts that are rarely traded and suffer from a lack of liquid market prices.

Steve Schiff and Gene Mahon at Vyapar Capital Markets, a boutique inter-dealer brokerage, have been warning about the potential dangers associated with such illiquid positions for more than two years.

It was only a few months ago, that their message hit home. Starting with fears that the previously triple A rated bond insurers might collapse, banks were suddenly keen to enter transactions that would minimise these exposures, which can create losses when markets are volatile and turbulent.

Mr Schiff long expected the industry would eventually recognise that something needed to be done about market risk as the volume of credit default swaps have expanded enormously in recent years.

"Trading through the currency and credit crises of

Timothy Geithner, NY Fed

the 1990s, we witnessed the consequences of build-ups of risks with no way out, and thought the credit derivative market could pose similar systemic risks," he said.

Since the start of 2007, VCM Partners has helped 12 banks in both New York and London remove $60bn in net open positions from orders totalling $1000bn.

John Cortese, high yield credit trader at Lehman Brothers, said the process "provides a way to reduce risk in credit derivatives in a timely and cost-efficient manner."

While dealers continually focus on the most liquid part of the credit curve, the fiveyear maturity, their trading books are steadily filled with old positions that shorten in maturity over time. These are known as off-the-run positions and the liquidity and ease of trading such positions is significantly less than that found in trading five-year swaps.

When all of these old positions are charted, the graph looks like the teeth of a saw blade, as it shows where the

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FT Trading Room

Electronic auctions popular for less liquid derivatives

By Michael Mackenzie in New York

Attention among regulators in Washington and derivatives dealers is being focused on how quickly the most liquid types of swaps will trade electronically, or with minimal human or 'voice' assistance, on proposed new platforms known as swap execution facilities.

Electronic trading is already flourishing, however, in parts of the over-the-counter market that were expected to remain 'voice territory' for some time.

So-called matching services or auction sessions are being regularly offered by interdealer brokerages such as Vyapar, BGC, GFI and Creditex during the trading day for dealers in less liquid over-the-counter derivatives markets such as options on interest rate swaps, credit derivatives and inflation swaps.

This counters the long-held assertion by dealers that complicated derivative structures, such as options, can only be transacted via voice brokers and not on screens.

The auctions concentrate liquidity for a few minutes between multiple dealers. That enables a dealer to price and execute trades far more quickly than relying on voice brokers to find another dealer willing to either buy or sell an option in what are fairly illiquid markets for most of the day.

"The auctions help us move risk quickly and anonymously, which can be difficult to do in the voice-brokered market," says Mayank Chamadia, head of US dollar interest rate options trading at Barclays Capital.

GFI began using matching for some credit derivatives in 2006 and has expanded from markets in Europe to Asia, North America and Latin America. Other brokers such as Creditex have also been active in providing matching services for trades in credit.

Vyapar started their Volmax service last June in the dollar market and to date have held more than a 1,000 trading sessions in over-the-counter interest rate options and derivatives and executed $250bn in notional trades.

The head of swaps trading at a major dealer in New York said: "It's an underutilised method of trading. Generally, this is a risk reduction trade and to a certain extent we are price indifferent, we just want to the get the risk of a trade off our books."

The growing popularity of the auctions is seen opening up markets such as interest rate options to more customers, one of the aims of Dodd Frank.

"Given the regulatory environment, we do want to see more transparency and liquidity in the options market, as it will encourage more participants," says Mr Chamadia.

The use of short-lived electronic auctions is seen by brokers as emulating the essential requirements of Sefs (swap execution facilities).

"The Volmax platform meets the spirit of Sefs," says Vinayek Singh, chief executive officer at Vyapar. "Prices are provided by multiple parties; the platform establishes a fair price for multilateral trading; and all orders and trades are processed electronically," he adds.

It means electronic trading under Dodd Frank could rapidly capture much of the US derivatives market.

Matt Woodhams, head of data and analytics at GFI, says its matching service helps markets naturally evolve from voice to electronic trading that is dominated by central limit order books, or CLOBs.

"Matching focuses liquidity into a very small window that enables people to transact, but over time, dealers want to interact more with screen as liquidity keeps building," he said. "In Europe we have gone past the matching stage in a number of markets to interactive screen trading and where liquidity now facilitates CLOBs for credit derivatives and foreign exchange options."

He expects a similar evolution in US derivatives as the market moves towards Sefs.

How the Sessions Work

The sheer range of structures in OTC derivatives – a grid of the most common interest rate swap option structures contains 300 combinations – makes establishing prices in the open market difficult, as once a dealer expresses an interest to either buy or sell, other traders back away. That compounds the difficulty of transacting a large trade, say in the several hundreds of millions.

"The voice market is flawed. You sit around for 20 or 30 minutes trying to do a trade, everyone knows where the structure should trade, but they are trying to scalp a little extra out of it," says an options trader at a US bank.

The sessions take a few minutes and that helps avoid the market being disrupted by swings in prices. Dealers are asked electronically, or by voice brokers, what structures they would like to see in an upcoming session.

They send in requests, which are tallied by brokers. Then the dealers receive the most popular structures, and are asked to make a two-way price. The bids and offers are then matched and trades are executed.

Creditex sees sharp rise in electronic trading

Creditex, an interdealer broker focused on credit derivatives, has seen a rapid rise in electronic trading on its new real-time platform, launched two weeks ago. The broker, owned by Intercontinental Exchange, will say in a press release due Tuesday that over 80 per cent of CDX index trades for investment grade and high yield arranged by Creditex have been executed on its RealTime electronic platform since March 7.

The broker continues to rely on voice brokers as part of a hybrid model.

Grant Biggar, president of Creditex said: "Alongside the Creditex RealTime market leading technology, our voice brokers in the US, Europe and Asia have a vital role ensuring liquidity is maintained in all market conditions and providing voice execution when the trade size or product liquidity require it."