

July 18, 2016

Mr. Christopher J. Kirkpatrick  
Secretary  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21st Street NW  
Washington, DC 20581

**Re: Clearing Requirement Determination for Certain Interest Rate Swaps  
(RIN 3038-AE20)**

Dear Mr. Kirkpatrick:

Citadel LLC<sup>1</sup> (“Citadel”) appreciates the opportunity to provide comments to the Commodity Futures Trading Commission (the “Commission”) on its proposal to establish a clearing requirement for certain additional interest rate swaps (the “Additional IRS Instruments”).<sup>2</sup>

As a significant participant in the OTC derivatives markets, we applaud the Commission for recognizing the important role of central clearing in achieving the Dodd-Frank Act objectives of reducing interconnectedness, mitigating systemic risk, increasing transparency, and promoting competition in these markets. We fully support the Commission’s proposal to establish a clearing requirement for the Additional IRS Instruments.

Central clearing is a fundamental cornerstone to open, efficient and transparent markets. In a centrally cleared market, participants all face the clearinghouse and bilateral counterparty credit exposure to other participants is eliminated, thereby reducing interconnectedness and systemic risk. In addition, market participants benefit from the safeguards in the risk management and default management frameworks of the clearinghouse, including with respect to margin collection, robust end-of-day pricing, and guaranty fund contributions.

The elimination of bilateral counterparty credit exposure through central clearing also transforms how OTC derivatives can be traded, increasing competition and providing new sources of liquidity for market participants. Since market participants no longer face each other when executing a cleared OTC derivative, complex bilateral trading documentation can be eliminated and a wider range of execution counterparties can be accessed. This leveling of the playing field with respect to execution spurs price competition and yields a number of benefits to market

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<sup>1</sup> Citadel is a global financial firm built around world-class talent, sound risk management, and innovative market-leading technology. For more than a quarter of a century, Citadel’s hedge funds and capital markets platforms have delivered meaningful and measurable results to top-tier investors and clients around the world. Citadel operates in all major asset classes and financial markets, with offices in the world’s leading financial centers, including Chicago, New York, San Francisco, Boston, London, Hong Kong, and Shanghai.

<sup>2</sup> 81 Fed. Reg. 39506 (June 16, 2016) (“**Proposed Clearing Determination**”).

participants, including narrower bid-ask spreads, improved access to best execution, and increased market depth and liquidity. In addition, the elimination of bilateral counterparty credit exposure and complex bilateral trading documentation can spur further market structure innovations, such as trading solutions that allow investors to transact directly with other investors without the use of intermediaries.

The U.S. has been a global leader in implementing clearing for OTC derivatives markets. As recently highlighted by Chairman Massad, more than 75% of index credit default swap and interest rate swap transactions (measured by notional value) are now being cleared in the U.S., compared to only about 15% in 2007.<sup>3</sup> Importantly, this transition to clearing has been successfully implemented across the market, including trading activity by both dealers and end investors. Each of the largest derivatives clearing organizations (“DCOs”) registered with the Commission has now successfully cleared trillions of dollars of outstanding OTC derivatives transactions for end investors following the Commission’s first mandatory clearing determination in 2013.<sup>4</sup>

As other jurisdictions continue to implement the G20 reforms for the OTC derivatives markets and require mandatory clearing of additional instruments, we support Commission efforts to update the scope of U.S. rules in order to harmonize the set of products subject to mandatory clearing globally. This will ensure a level playing field and deter regulatory arbitrage, while enhancing liquidity in cleared instruments to the benefit of end investors.

## **I. The Additional IRS Instruments Are Suitable for Mandatory Clearing**

Under the Commodity Exchange Act, the Commission must take into account five factors when making a clearing requirement determination.<sup>5</sup> We agree with the Commission that market data and the existing DCO clearing offerings support a finding that each of these factors is met with respect to the Additional IRS Instruments. We briefly comment on each of the five factors below.

### *A. Outstanding notional exposures, trading liquidity, and pricing data*

As stated by the Commission in the Proposed Clearing Determination, the OTC derivatives market is a global market.<sup>6</sup> Therefore, we applaud the Commission for taking into account multiple sources of available data when assessing the liquidity characteristics of the Additional IRS Instruments, including data from swap data repositories, DCOs, the Bank for International

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<sup>3</sup> See Remarks of Chairman Timothy Massad before the CCP12 Founding Conference and CCP Forum, Shanghai, China, June 7, 2016, available at: <http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-46>. See also <http://www.swapsinfo.org/>.

<sup>4</sup> See LCH Daily Volumes – SwapClear Global, available at: <http://www.lch.com/en/asset-classes/otc-interest-rate-derivatives/volumes/daily-volumes-swapclear-global>; CME Open Volume Tracker, available at: <http://www.cmegroup.com/education/cme-volume-oi-records.html>; ICE Clear Credit, available at: <https://www.theice.com/clear-credit>

<sup>5</sup> Section 2(h)(2)(D)(ii) of the Commodity Exchange Act.

<sup>6</sup> See Proposed Clearing Determination at 39513.

Settlements, and industry organizations.<sup>7</sup> Together, these data sources provide a more holistic view of the market for any particular OTC derivative and are indicative of the various sources of pricing data that DCOs have access to for purposes of their risk management and default management frameworks.

In assessing the available data, we agree with the Commission that there are significant outstanding notional exposures and robust trading liquidity in the Additional IRS Instruments. As a result, DCOs have access to adequate pricing data in order to appropriately risk manage these instruments. These conclusions are further supported by the fact that DCOs already have approved clearing offerings for each of the Additional IRS Instruments and market participants have voluntarily decided to clear significant volumes in these instruments prior to the introduction of a clearing mandate.<sup>8</sup>

*B. Availability of a rule framework, capacity, operational expertise and resources, and credit support infrastructure*

As noted above, all of the Additional IRS Instruments are currently being cleared by DCOs in material volumes, demonstrating the infrastructure and operational expertise that already exists to support a clearing mandate. Furthermore, no material changes are required to the current DCO rule frameworks and credit support infrastructures in order to implement a clearing mandate for the Additional IRS Instruments. The existence of significant voluntary clearing demonstrates the confidence that market participants have in these aspects of the current DCO clearing offerings.

*C. Effect on the mitigation of systemic risk*

We strongly agree with the Commission that central clearing provides greater systemic risk mitigation than bilateral margining for uncleared swaps.<sup>9</sup> While bilateral margining may help reduce the market impact of a counterparty default, central clearing eliminates the complex web of interconnected bilateral counterparty credit exposures. These interconnected bilateral exposures are replaced not only with a margin framework applied by the DCO, but also centralized risk management and default management frameworks that are specifically designed to manage and mitigate the potential systemic impact of unexpected market events, including a counterparty default.

DCOs operate in accordance with an ongoing set of regulatory requirements and responsibilities, including with respect to financial resources, stress testing, and model back testing, that serve to distinguish the risk management of cleared positions from uncleared positions. In addition, DCOs facilitate multilateral netting and compression, increase efficiency with respect to collateral management and trade reconciliation, and provide market participants with increased transparency around end-of-day pricing. Finally, more market participants are able to become liquidity providers in cleared instruments as a result of the elimination of bilateral counterparty credit exposure and complex bilateral trading documentation, increasing market diversification

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<sup>7</sup> *Id.*

<sup>8</sup> *Id.* at 39530.

<sup>9</sup> *Id.* at 39523.

and the resiliency of liquidity during times of market stress. All of these benefits of central clearing ultimately serve to mitigate systemic risk by enhancing the risk management of OTC derivatives and reducing the prospect of firms becoming too interconnected-to-fail due to bilateral uncleared positions.

#### *D. Effect on competition*

As discussed above, the elimination of bilateral counterparty credit exposure and complex bilateral trading documentation as a result of central clearing enables market participants to access a wider range of execution counterparties and encourages the entry of new liquidity providers. This spurs increased price competition, lowering execution costs for investors and enhancing overall market liquidity.

We have already witnessed these benefits start to accrue to investors in those OTC derivatives that are subject to mandatory clearing. New liquidity providers have entered both the index credit default swap and interest rate swap markets directly as a result of the Commission's existing clearing mandates, bringing innovations such as firm pricing and faster response times.<sup>10</sup> In addition, market research confirms the link between central clearing and improved liquidity. A recent study of the index credit default swap market found that "the reduced counterparty risk and increased post-trade transparency associated with central clearing have beneficial effects on liquidity."<sup>11</sup> Separately, recent Bank of England research found that the implementation of the Commission's clearing and trading reforms in the USD interest rate swap market led to a significant improvement in liquidity and a significant reduction in execution costs, with market participants saving as much as \$20 million - \$40 million per day, of which \$7 million - \$13 million was being saved by market end-users alone per day.<sup>12</sup>

Importantly, the increased competition among execution counterparties resulting from central clearing is not dependent on there being a certain number of DCO clearing offerings per instrument. While competition across DCOs can be positive for market participants, and more than one DCO offers to clear most all of the Additional IRS Instruments, we do not believe there should be a strict requirement that multiple DCOs clear a given instrument in order to implement a clearing mandate. In many cases, market participants prefer to consolidate their cleared positions at a single DCO in order to maximize netting, compression, and margin offset opportunities, thereby reducing overall clearing costs. In addition, in the context of assessing the fees and charges applied to clearing as required by the Commodity Exchange Act, the Commission should note that clearing costs for many market participants are primarily driven by the fees charged by their

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<sup>10</sup> See, e.g., New players break into credit derivatives, FT (Nov. 17, 2015), available at: <http://www.ft.com/intl/cms/s/0/22b83fa4-8c6e-11e5-8be4-3506bf20cc2b.html#axzz3rj5Mtwil>; and Dealer algos strike back in swaps market showdown, Risk.net (Feb. 24, 2016), available at: <http://www.risk.net/risk-magazine/feature/2446836/dealer-algos-strike-back-in-swaps-market-showdown>.

<sup>11</sup> See Loon, Y. C., Zhong, Z. K. Does Dodd-Frank affect OTC transaction costs and liquidity? Evidence from real-time CDS trade reports. *Journal of Financial Economics*, 119 (3), 645–672 (2016) at page 4, available at: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2443654](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2443654).

<sup>12</sup> See Staff Working Paper No. 580 "Centralized trading, transparency and interest rate swap market liquidity: evidence from the implementation of the Dodd-Frank Act", Bank of England (January 2016), available at: <http://www.bankofengland.co.uk/research/Documents/workingpapers/2016/swp580.pdf>.

clearing FCM (and not the DCO). As FCM clearing fees are based primarily on the portfolio being cleared rather than the number of different DCO clearing offerings, competition among FCMs is more relevant to ensuring that the overall fees and charges applied to clearing are set at a reasonable level. Finally, it is worth noting that the imposition of a clearing mandate may itself create the commercial rationale for another DCO or FCM to launch or expand its clearing offering given the expected increase in overall cleared volumes.

Based on the above and market experience with the prior clearing mandates, we agree with the Commission that the Proposed Clearing Determination will enhance market competition with respect to the Additional IRS Instruments.

*E. Reasonable legal certainty in the event of insolvency*

We agree with the Commission that reasonable legal certainty exists in the event of an insolvency of a DCO or one or more of its clearing members when clearing the Additional IRS Instruments. The regulatory framework governing the treatment of customer and swap counterparty positions, funds, and property is set forth in the U.S. Bankruptcy Code, the Commodity Exchange Act and Commission regulations, and this long-standing framework has only been strengthened following the implementation of the Dodd-Frank Act. Furthermore, as the regulatory framework applies equally to all instruments cleared by a DCO, the Commission should leverage the analysis included in prior clearing determinations.

## **II. Implementation Timing**

We agree with the Commission that most market participants that would be subject to the proposed clearing mandate for the Additional IRS Instruments are already clearing USD, EUR, GBP, or JPY interest rate swaps pursuant to the existing clearing mandates. Therefore, we believe the Commission's proposal to require compliance 60 days after publication of the expanded clearing mandate is realistic, as the mandate should not be expected to require the establishment of a material number of new clearing arrangements. This conclusion is further supported by the significant amount of voluntary clearing that is already occurring in the Additional IRS Instruments, suggesting that most market participants are already prepared for the clearing mandate and the necessary infrastructure is in place.<sup>13</sup>

Notwithstanding the above, we are also supportive of the second implementation option, to the extent the Commission believes that it is preferable on the basis of international comity. This option would require compliance with the expanded clearing mandate on a currency-by-currency basis 60 days after the effective date of a corresponding foreign clearing mandate. In the event the Commission does select this option, it should clarify that the relevant effective date of a foreign clearing mandate is the first date on which an instrument in such currency is required to be cleared, as otherwise the presence of a phased-in compliance schedule in the non-U.S. jurisdiction may create ambiguity. In addition, the Commission should clarify that the reference to an "analogous clearing requirement" in a non-U.S. jurisdiction refers to the product set and not the scope of entities covered, as a foreign clearing mandate may not cover the exact same type of entities as the

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<sup>13</sup> See Proposed Clearing Determination at 39530.

U.S. clearing mandate. The Commission should not attempt to precisely replicate the entity scope of foreign clearing mandates, as otherwise the U.S. framework will become a confusing patchwork of foreign regulation, compelling U.S. market participants to apply different criteria on a currency-by-currency basis to determine whether (and when) they are in-scope. Finally, it is important to retain an outer bound of two years for when the final Commission rule may become effective in order to provide certainty to market participants regarding implementation.

In either implementation scenario, we agree with the Commission that there should not be any additional phase-in by counterparty type. The Commission provided a 270 day phase-in as part of its first clearing mandate in order to allow market participants time to establish clearing arrangements and become familiar with DCO clearing offerings and the associated workflows. With most market participants that would be subject to this proposed clearing mandate already clearing USD, EUR, GBP, or JPY interest rate swaps, and in many cases voluntarily clearing the Additional IRS Instruments, this type of phase-in is no longer necessary. Non-U.S. jurisdictions may implement phase-ins by counterparty type for these currencies given that, in many cases, it will be the first clearing mandate implemented in that jurisdiction. However, the Commission should avoid unnecessarily complicating and delaying the implementation of any expanded clearing mandate in the U.S. by seeking to replicate any such phase-in when it is not warranted for U.S. market participants.

Finally, we urge the Commission to proceed with finalizing the expanded clearing mandate notwithstanding ongoing discussions regarding potential amendments to the Commission's trading rules and made available to trade ("MAT") process. An assessment of whether an instrument may potentially become subject to mandatory SEF trading in the future is not part of the criteria for determining whether OTC derivatives are suitable for mandatory clearing. In addition, even under the current MAT process, only a subset of instruments subject to mandatory clearing are also subject to mandatory SEF trading. Market experience has shown that those instruments currently subject to mandatory SEF trading are actively traded, highly liquid, and suitable for SEF trading.

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We commend the Commission for recognizing the critical role of central clearing in reducing interconnectedness and mitigating systemic risk. We support the Commission updating U.S. clearing rules in order to harmonize the set of products subject to mandatory clearing globally, thereby bringing increased transparency, more competition, and better pricing to a wider range of OTC derivatives.



We appreciate the opportunity to provide comments on the Commission's mandatory clearing requirements. Please feel free to call the undersigned at (312) 395-3100 with any questions regarding these comments.

Respectfully,

/s/ Adam C. Cooper

Senior Managing Director and Chief Legal Officer