July 13, 2015

Via Electronic Submission: http://www.sec.gov/rules/proposed.shtml

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Application of Certain Title VII Requirements to Security-Based Swap Transactions Connected with a Non-U.S. Person's Dealing Activity that are Arranged, Negotiated, or Executed By Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent (Release No. 34–74834, File No. S7-06-15)

Dear Mr. Fields:

Citadel LLC[1] ("Citadel") appreciates this opportunity to provide comments to the Securities and Exchange Commission (the "Commission") in response to its proposed rules and proposed rule amendments (the "Proposal") concerning security-based swaps (each, a "SB Swap") that are arranged, negotiated or executed by personnel located in the United States.[2]

Citadel firmly believes that the reforms advanced in Title VII of the Dodd-Frank Act - *in particular the clearing and security-based swap execution facility ("SB SEF") trading requirements* - will, if appropriately implemented, mitigate systemic risk, increase transparency, promote competition, and otherwise improve the safety, stability and integrity of the SB Swap markets. Therefore, while we agree with the Commission's proposal to generally apply Title VII requirements to transactions between two non-U.S. persons if they are arranged, negotiated, or executed by personnel routinely located in the United States but booked to a non-U.S. entity ("Nominally Offshore Transactions"),[3] we believe the Commission's proposal to exempt Nominally Offshore Transactions from *the clearing and SB SEF-trading requirements* (the "Proposed Exemption") would have wide-ranging adverse consequences, and should not be included in any final rule.[4]

[1] Citadel is a global investment firm built around world-class talent, sound risk management, and innovative market-leading technology. For nearly a quarter of a century, Citadel's hedge funds and capital markets platform have delivered meaningful and measurable results to top-tier investors around the world. Citadel's team of more than 550 investment professionals deploy capital across all major asset classes, in all major financial markets, from offices in Chicago, New York, San Francisco, Boston, London, Hong Kong, and Shanghai.

[2] Application of Certain Title VII Requirements to Security-Based Swap Transactions Connected With a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent, 80 Fed. Reg. 27,444 (May 13, 2015).

[3] For example, a non-U.S. person would be required to count such SB Swap transactions towards the *de minimis* threshold for SB Swap dealer registration.

[4] While we appreciate that Nominally Offshore Transactions may at some point become subject to foreign clearing and/or trading requirements, we nevertheless believe that Nominally Offshore Transactions are too integral to the U.S. financial system to be granted a permanent exemption from U.S. clearing and trading requirements. Substituted compliance would provide a more appropriate mechanism to handle any duplicative requirements that may one day apply to such transactions.

We believe that the Proposed Exemption would undermine key Dodd-Frank reform objectives to the detriment of investors, the SB Swap markets and the broader U.S. financial system. As we detail in Section II below, we believe the Proposed Exemption would:

- impair the development of U.S. SB SEFs and liquidity on those SB SEFs;
- harm end-users of SB Swaps by perpetuating the legacy two-tiered market structure;
- inhibit pre-trade price transparency in the SB Swap markets;
- frustrate impartial access to SB Swap markets; and
- stifle competition, disadvantage domestic SB Swap dealers and further concentrate risk in the SB Swap markets.

Further, we believe that the premises underlying the Proposed Exemption merit further scrutiny and reconsideration. As we discuss in Section III below:

- Nominally Offshore Transactions do present sufficiently material risks to the U.S. financial system to justify the application of the clearing and SB SEF-trading requirements;
- Nominally Offshore Transactions in fact represent a very significant segment of the SB Swap markets in the United States;
- the conclusion that SB Swaps are illiquid, and thus unsuitable for clearing and SB SEF-trading, is premature, and is based in part on data that appears to be flawed in certain important respects;
- the premise that the application of regulatory capital and margin requirements is sufficient, and an appropriate substitute for clearing and SB SEF-trading requirements, is also flawed;
- a complete consideration of the competitive implications of the Proposed Exemption is lacking; and
- the risk of dealers relocating personnel is vastly overstated.

I. Threshold Considerations

A. The Proposal Effectively Carves Out the Inter-Dealer Market from Title VII's Clearing and SB SEF-trading Requirements

Commissioner Stein correctly observed that one of the most profound impacts of the Proposal is to carve out the inter-dealer market from the SB SEF-trading requirement.[5] The Proposed Exemption would indeed yield a U.S. SB Swap market that "consist[s] of one very large pool of transactions . . . (inter-dealer trades, and transactions between dealers and non-U.S. person non-dealers) and one much smaller pool limited to transactions between dealers and U.S.-person counterparties."[6] If the Proposal were adopted, the New York trading desks of two U.S.-based financial groups could transact a single-name credit default swap ("Single-Name CDS") with each other, and so long as each booked the transaction to an offshore affiliate that does not benefit from direct credit support from a U.S. person, the trade would be exempt from the Title VII clearing and SB SEF-trading requirements. That is, dealers could avoid any requirement to participate in open, competitive, transparent markets in which all participants have equal access simply by engaging in unguaranteed Nominally Offshore Transactions. Consequently, the Proposal would ingrain "offshore," dealer-only pools of SB Swap liquidity in circumstances where the SB SEF-trading mandate would otherwise apply.[7] Therefore, it would ensure that the legacy, pre-Dodd-Frank paradigm of opaque, two-tiered markets dominated by a few large dealers persists, despite clear congressional intent to reform the SB Swap markets.

B. Significant Policy Concerns

We believe the Proposed Exemption represents a significant step backward in Commission policy concerning clearing and SB SEF trading. As former Treasury Secretary Timothy Geithner has observed, amnesia causes financial crises,[8] and the Proposal understates the contribution of purportedly "offshore," uncleared credit derivatives transactions to the recent U.S. financial crisis. Commissioner Stein is correct to recognize that merely booking transactions in foreign entities will not protect the United States.[9] We believe that the Proposed Exemption, if implemented, would compromise the mitigation of systemic risk and undermine efforts to address ongoing weaknesses in the SB Swap marketplace, thereby perpetuating vulnerabilities and inefficiencies in the American financial system and economy. Given the roots of the

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[5] Kara M. Stein, Commissioner, S.E.C., Statement on Proposed Rules for U.S. Personnel and Certain Activities of Non-U.S. Person's Security-Based Swaps Dealing (Apr. 29, 2015), *available at* http://www.sec.gov/news/statement/stein-statement-on-proposed-security-based-swaps-dealing.html ("[I]f the transactions governed by today's proposed rules are swept out of the U.S. SEF execution requirement, that could result in an unfortunate loss of liquidity for U.S. SEFs. It seems to me that we risk losing some, or even all, interdealer liquidity from the U.S. SEF marketplace.").

[6] Proposal, *supra* note 2, at 27,449.

[7] In fact, in the context of the Commodity Futures Trading Commission's ("CFTC") efforts to regulate cross-border swaps activities, the financial press has observed that swap dealers may engage in restructuring exercises precisely to allow them to preserve access to these dealer-only pools. *See, e.g.*, Silla Brush, *Wall Street Defends Overseas Swap Trading From U.S. Regulation*, Bloomberg (July 1, 2014, 5:00 AM), http://www.bloomberg.com/news/articles/2014-07-01/wall-street-defends-overseas-swap-trading-from-u-s-regulation; Katy Burne, *Big U.S. Banks Make Swaps a Foreign Affair*, Wall St. J. (Apr. 27, 2014, 4:52 PM), http://online.wsj.com/articles/SB10001424052702304788404579520302570888332; Silla Brush & Jesse Hamilton, *Banks' Overseas Swaps Moves Said to Draw CFTC Attention*, Bloomberg (Apr. 26, 2014 12:01 AM), http://www.bloomberg.com/news/2014-04-25/banks-overseas-swaps-moves-said-to-draw-cftc-attention.html. *See also* the CFTC's comment that it is "aware that some non-U.S. [swap entities] removed guarantees in order to fall outside the scope of certain Dodd-Frank requirements." CFTC., Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants 39 (2015), *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister062915.pdf.

[8] "Amnesia is what causes financial crises. These reforms are worth fighting to preserve." Timothy Geithner, Op-Ed, *Financial Crisis Amnesia*, Wall St. J. (Mar. 1, 2012, 7:19 PM), http://www.wsj.com/articles/SB10001424052970203986604577253272042239982.

[9] Stein, *supra* note 5 ("[T]he U.S. is such an important market center, and the swaps marketplace is so interconnected. Are there really many situations in which swaps booked abroad would actually pose no risk to the United States?").

last financial crisis, it strains belief that the Commission might not impose clearing and SB SEF-trading requirements in respect of a multi-trillion dollar segment of the U.S. Single-Name CDS market. While we note the Commission's intent to monitor progress in this area,[10] we encourage the Commission to recognize that it would be very difficult for the Commission to reverse the Proposed Exemption if it is adopted.

II. Adverse Implications of the Proposed Exemption

A. The Proposed Exemption is Detrimental to the Development of SB SEFs and SB SEF Liquidity

The Proposed Exemption would result in a crippling absence of inter-dealer liquidity from the SB SEF marketplace. This means that, contrary to Congressional intent[11] expressly recognized by the Commission,[12] the development of SB SEFs would be materially impaired. Commissioner Stein is correct to observe that, consequently, the Proposal would destroy liquidity on SB SEFs;[13] as long as the pools of offshore, off-facility, inter-dealer liquidity described above exist, there would be no incentive for SB Swap dealers to meaningfully support the development of SB SEFs beyond replicating the channels that currently exist to serve dealer-to-customer flow. Given current market dynamics, without incumbent dealer liquidity, an SB SEF can neither attract customer liquidity nor can it attract alternative liquidity providers, who, without access to inter-dealer market liquidity, cannot adequately service customer demand. The Proposal would, therefore, largely seal the fate of any all-to-all SB SEFs in the U.S. market.

B. The Proposed Exemption is Detrimental to End-Users

The Proposal does not strike an appropriate balance between competition and regulation and would have significant adverse effects on competition in the SB Swap markets. Commissioner Piwowar is correct to express concerns about the impact of the Proposal on swap dealers' counterparties.[14] The Commission itself observes that incumbent swap dealers benefit greatly from opaque, two-tiered markets in which customers are prevented from observing and accessing liquidity at the levels routinely shown by swap dealers to each other.[15] Because it entrenches this legacy two-tiered market structure, the Proposed Exemption would hinder the evolution of SB Swap market structure, ensuring that improvements to pricing, liquidity and transparency, that would otherwise accompany the development of SB SEFs, simply do not materialize. Perpetuating the legacy two-tiered market structure also confines end-users to a permanent "price-taker" role in the SB Swap markets, limited to transacting only with swap dealers. This would prevent the emergence of any all-to-all trading platforms where end-users could also become

[10] *See* Proposal, *supra* note 2, at 27,468.
[11] *See, e.g.*, 156 Cong. Rec. S5915 (daily ed. July 15, 2010) (statement of Sen. Reid) ("[The Dodd-Frank Act] will move as many swaps as possible from being opaque, bilateral transactions onto clearinghouses, exchanges, and other trading platforms.").
[12] Registration and Regulation of Security-Based Swap Execution Facilities, 76 Fed. Reg. 10,948, 10,949 (Feb. 28, 2011) ("A key goal of the Dodd-Frank Act is to bring trading of SB swaps onto regulated markets.").
[13] *See* Stein, *supra* note 5.
[14] Michael S. Piwowar, Commissioner, S.E.C., Statement at Open Meeting on Cross-Border Security-Based Swap Rules Regarding Activity in the United States (Apr. 29, 2015), *available at* http://www.sec.gov/news/statement/statement-cross-border-security-based-swap-rules.html ("[The Commission] must balance a number of relevant considerations, including how to effectively implement our regulatory authority, the potential market impact of any rules we put in place, and concerns related to competition between market participants . . . these rules will impact not just the non-U.S. dealers operating under this model, but also their counterparties and U.S. competitors.").
[15] *See* Proposal, *supra* note 2, at 27,452 ("The high level of inter-dealer trading activity reflects the central position of a small number of dealers, each of which intermediates trades between many hundreds of counterparties. While we are unable to quantify the current level of trading costs for single-name CDS, those dealers appear to enjoy market power as a result of their small number and the large proportion of order flow they privately observe. This market power in turn appears to be a key determinant of trading costs in this market.").

"price-makers" and function as an additional source of liquidity to the market. Consequently, the Proposal does have real economic costs for end-users of SB Swaps.

C. The Proposed Exemption Would Inhibit Pre-Trade Price Transparency

The Commission believes that it is important to foster pre-trade transparency to encourage greater price competition.[16] As the Commission is aware, there is currently limited pre-trade price transparency in SB Swap markets.[17] End-users can neither observe, nor access, the dealer-only pools of liquidity described above. As the Commission notes in the Proposal,[18] trading platforms like SEFs offer a degree of pre-trade price transparency that is simply unavailable in the bilateral context. Because the Proposed Exemption heads off the prospect of liquid SB SEFs, it inhibits pre-trade price transparency. While we agree with Chair White that the introduction of post-trade reporting will bring some degree of needed transparency to the inter-dealer market, this pales in comparison to, and is not an adequate substitute for, introducing pre-trade price transparency.[19] If the Proposed Exemption is ultimately adopted, from the perspective of end-users, post-trade reporting of inter-dealer activity will merely show prices that were available in a market from which end-users are excluded by virtue of the Commission's rulemakings.

D. The Proposed Exemption Frustrates Impartial Access

The Proposed Exemption will allow the inter-dealer market for SB Swaps to remain off-SB SEF, and by extension, eliminates the prospect of obtaining impartial access to that liquidity pool. Congress intended SB SEFs to create a level playing field on which all eligible market participants would have fair and impartial access to SB Swap liquidity. By ensuring that the inter-dealer market remains off-SB SEF, the Proposed Exemption effectively disapplies the Dodd-Frank requirement for impartial access to the SB Swap markets.

E. The Proposed Exemption Stifles Competition and Disadvantages Domestic Swap Dealers

The Proposed Exemption is particularly harmful to the competitiveness of domestic SB Swap dealers that choose not to operate through offshore affiliates. Commissioner Piwowar is correct to express concerns about the impact of the Proposal on such domestic swap dealers.[20] In the Proposal, the Commission states that, in the absence of the rules contained in the Proposal, U.S. persons would be incentivitized to deal through non-U.S. affiliates to avoid becoming subject to Title VII requirements.[21] In fact, the Proposed Exemption creates precisely that incentive. The same logic that drives the need to count Nominally Offshore Transactions towards the *de minimis* threshold for registration drives the need to subject them to the SB SEF-trading mandate; allowing those transactions to reside outside important elements of the Commission's Title VII regulatory scheme will cause liquidity fragmentation. To access

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[16] Registration and Regulation of Security-Based Swap Execution Facilities, *supra* note 12, at 10972.
[17] *Id.* at 10,949 ("The current market for [security-based] swaps is opaque, with little, if any, pre-trade transparency (the ability of market participants to see trading interest prior to a trade being executed) . . . .").
[18] *See* Proposal, *supra* note 2, at 27,457.
[19] Mary Jo White, Chair, S.E.C., Statement at Open Meeting on Cross-Border Security-Based Swap Rules Regarding Activity in the United States and Pay Versus Performance (Apr. 29, 2015), *available at* http://www.sec.gov/news/statement/statement-at-open-meeting-april-29-2015.html ("The trade reporting and public dissemination of transaction data . . . should bring needed transparency, particularly to the inter-dealer market, to the benefit of all participants in the market -- dealer and non-dealer alike.").
[20] *See* Piwowar, *supra* note 14.
[21] *See* Proposal, *supra* note 2, at 27,449 ("In the absence of the rules being proposed in this release, these competitive effects of disparate regulatory treatment may create an incentive for U.S. persons to use non-U.S.-person affiliates or non-U.S.-person agents that are located in the United States to engage in dealing activity with non-U.S.-person counterparties, because these non-U.S. persons could continue to deal with non-U.S.-person counterparties without being required to comply with any Title VII requirements.").

the "offshore" pool of dealer-only liquidity described above, such domestic swap dealers would be forced by the Proposal to establish separately capitalized, offshore affiliates and to book trades there. Therefore, the Proposed Exemption actually pushes SB Swap activity away from the SB SEF-trading mandate.[22] We struggle to see how the Commission aligns this outcome with its understanding of congressional intent.[23]

Also, as we discuss further below, the Commission's consideration of the competition implications of the Proposal is materially incomplete because it understates the role of clearing in promoting competition and gives inadequate consideration to the anti-competitive implications of excluding Nominally Offshore Transactions from the SB SEF-trading requirement.

These anti-competitive elements of the Proposal also exacerbate "too-big-to-fail risk" by allowing the continued concentration of SB Swap risk in the hands of a small number of incumbent dealers. In that respect, the Proposal runs contrary not only to congressional intent, but also to G20 goals with regard to systemic stability.[24]

III. Unsupported Premises for the Proposed Exemption

A. *"Offshore" Trades Have a Well-Documented History of Threatening U.S. Banks and the U.S. Economy*

The Commission's position in the Proposal that, absent explicit support from a U.S. entity, the risks in Nominally Offshore Transactions reside primarily outside the U.S. financial system[25] is inconsistent with the empirical evidence and inconsistent with other Commission rulemakings.

As we note above, Commission Chair White has correctly observed that some of the most significant non-U.S. dealers are members of U.S.-based financial groups.[26] The CFTC has noted that the U.S.'s largest banks each have somewhere between 2,000 and 3,000 legal entities around the globe and that some of them have hundreds of legal entities in the Cayman Islands alone.[27] Upon review of the recent financial crisis, the Commission should find ample evidence that purportedly offshore transactions pose significant risks to the U.S. financial system and to U.S. investors, whether or not the "offshore" entities involved benefitted from explicit credit support from U.S. entities.

Indeed, the Commission observes that U.S. financial groups will likely stand behind the obligations of their offshore affiliates even in the absence of explicit guarantees and that this implicit support poses risks to U.S. financial markets and to U.S. investors.[28] As we understand it, the Commission preliminarily believes that such risks need not be mitigated through the application of the clearing mandate because U.S. markets are adequately protected by other provisions of the Dodd-Frank Act

[22] And would, in fact, promote the type of "restructuring charades" that Commissioner Aguilar intended them to avoid. *See* Luis A. Aguilar, Commissioner, S.E.C., Statement on Focusing on Dealer Conduct in the Derivatives Market (Apr. 29, 2015), *available at* http://www.sec.gov/news/statement/focusing-on-dealer-conduct-in-the-derivatives-market.html.

[23] *See* Registration and Regulation of Security-Based Swap Execution Facilities, *supra* note 12.

[24] *See* Leaders' Statement, the Pittsburgh Summit (Sept. 24-29, 2009), *available at* https://g20.org/wp-content/uploads/2014/12/Pittsburgh_Declaration_0.pdf ("*Improving over-the-counter derivatives markets:* All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. . . . We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.").

[25] *See* Proposal, *supra* note 2, at 27,481.

[26] White, *supra* note 19.

[27] Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations, 78 Fed. Reg. 45292, 45371 (July 26, 2013).

[28] *See* Proposal, *supra* note 2, at 27,482.

concerning, for example, capital requirements.[29] In Section 3C of the Securities Exchange Act of 1934[30] (the "Exchange Act"), Congress established a list of factors to be considered by the Commission when determining whether to apply the clearing requirement to a class of SB Swap.[31] The list of factors does not include whether other legislative initiatives dispense with the need for clearing. The Dodd-Frank Act was intended as a comprehensive package of reforms of which clearing of SB Swaps was intended to be an integral element. The Commission's apparent reading of the Dodd-Frank Act would, instead, make much of Title VII redundant. We note that the CFTC, which has implemented a significant number of rules called for under Title VII's clearing requirements, clearly does not share the Commission's apparent interpretation. In fact, in this regard, there could hardly be less regulatory consistency between the Commission's Proposal and the apparent position of the CFTC.[32] This is of particular concern given the close economic relationship between the Single-Name CDS market regulated by the Commission and the CDS index market regulated by the CFTC, and the fact that many market participants maintain portfolios that include both sets of instruments.

The Commission also appears to take significant comfort from the fact that U.S. financial groups may be required to disclose implicit support obligations under provisions of the Exchange Act.[33] If that were sufficient, Congress need not have prohibited banking entities from sharing the same name as a hedge fund for corporate, marketing, promotional, or other purposes[34] and the Commission need not have endorsed this prohibition in its final rulemaking to implement the Volcker Rule[35] (the "Volcker Rulemaking") by recognizing that a banking entity could come under pressure for reputational reasons to support an entity in distress that bears the banking entity's name.[36] Disclosure, in this instance, simply is not adequate.

More strikingly, in its Volcker Rulemaking, the Commission states that if personnel of a non-U.S. entity that arrange, negotiate or execute transactions (including swap transactions) are located in the United States then it would not be possible to "ensure that . . . risks remain largely outside of the United States" or to "limit potential risk that could flow to the U.S. financial system."[37] These statements, around which the Commission was in full agreement with the Department of the Treasury, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the CFTC, cannot be squared with the position of the Commission in the Proposal and there is no discernible technical justification for the apparent change in the Commission's position.

We urge the Commission to reconsider the factual bases for its conclusion that the financial risks of Nominally Offshore Transactions reside primarily outside the United States. We ask that, in doing so, the Commission adopt a final position that comports with its other Dodd-Frank rulemakings and reflects greater consistency with the approach to statutory interpretation adopted by the CFTC.

B. Given that Nearly All Transactions in the U.S. SB Swap Markets Have Some Cross-Border Element, a Comprehensive Regulatory Regime is Required

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[29] *Id.*
[30] Securities Exchange Act of 1934, 15 U.S.C. § 78a-78kk (2012).
[31] *See* Securities Exchange Act § 3C(b)(4)(B), 15 U.S.C. § 78c-3(b)(4)(B) (2012).
[32] Section 712(a)(2) of the Dodd-Frank Act which provides in part that the Commission shall "consult and coordinate to the extent possible with the Commodity Futures Trading Commission and the prudential regulators for the purposes of assuring regulatory consistency and comparability, to the extent possible."
[33] *See* Proposal, *supra* note 2, at 27,482.
[34] *See* 12 U.S.C. § 1851(d)(1)(G)(vi) (2012).
[35] *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536 (Jan. 31, 2014).
[36] *Id.* at 5713.
[37] *Id.* at 5655.

Albeit that a Single-Name CDS has cross-border elements, it may still be a transaction conducted in the U.S. markets. Typically, when buy-side traders in the United States that are responsible for North American SB Swap trading execute a Single-Name CDS, the entity that is the ultimate counterparty to the transaction is a U.S. dealer, a foreign affiliate of a U.S. dealer,[38] or a foreign dealer. The buy-side entity may book the trade to a U.S. or non-U.S. trading vehicle and its prime broker in respect of the transaction may be a U.S. dealer or a non-U.S. dealer. However, in our experience, buy-side decision makers with respect to a given trade deal directly with the U.S-based sales and trading staff of the dealer. Indeed, to us, if a principal place of business test were applied to the SB Swap business of a typical dealer participating in the U.S. SB Swap markets, as opposed to the legal entity in which the dealer merely books its trades, the principal place of business would almost certainly be the United States. Further, as the Commission knows,[39] much of the inter-dealer market in North American Single-Name CDS is currently cleared by ICE Clear Credit, a clearing agency based in Atlanta, Georgia. The Proposal does not reflect these realities when it excludes Nominally Offshore Transactions from U.S. clearing and SB SEF-trading requirements.

We believe that Nominally Offshore Transactions are too integral to the U.S. financial system to be left to the as-yet-unsettled regulations of foreign regulators. Once foreign SB Swap regulatory regimes develop more fully, an approach to Nominally Offshore Transactions that takes substituted compliance into account in suitable cases may be appropriate and we encourage the Commission to keep that option open in the interests of international comity and avoiding duplicative regulation. However, it is impossible to predict precisely how foreign SB Swap regulatory regimes will develop. It also possible that, in some jurisdictions in which Nominally Offshore Transactions are booked, none will develop. We believe the Commission agrees with us that Nominally Offshore Transactions clearly constitute activity conducted within the United States.[40] We urge the Commission to conclude that, presently, it would be inappropriate to exclude such activity from central aspects of the Title VII regime like the clearing and SB SEF-trading requirements in the hope that the interests of U.S. taxpayers will be adequately protected by foreign regulators.

C. *The SB Swap Markets are Not Illiquid*

1. The Data Presented Does Not Support the Commission's Conclusions

The Proposed Exemption is premised on a conclusion that the market for Single-Name CDS is thinly-traded and not suited to SB SEF trading.[41] First, we see no basis for that conclusion in the data underlying the Proposal; a conclusion that SB Swap markets are smaller than other swap markets[42] is not a conclusion that SB Swap markets are illiquid and unsuitable for SB SEF trading. By the Commission's own estimate, the Single-Name CDS market is an almost $11 trillion dollar market. Also, considering only the notional size of the market relative to the notional size of other swap markets is misleading; risk and notional amounts are not necessarily correlated and, on a risk-adjusted basis, the risks embedded in the Single-Name CDS market are very significant even if the market is overshadowed by notional amounts in the interest-rate swaps market. Single-Name CDS is also one of the most standardized swap

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[38] Commission Chair White is correct to observe that "some of the most significant non-U.S. dealers are, in fact, members of U.S.-based financial groups." White, *supra* note 19.

[39] *See* Proposal, *supra* note 2, at 27,454-55.

[40] *See, e.g.*, Proposal, *id.* note 2, at 27,465 ("Because we are focusing in this proposal solely on transactions in which the non-U.S. person is engaged, directly or indirectly, in dealing activity in the United States, the proposed rules would not impose requirements on non-U.S. persons that are 'transacting a business in security based swaps without the jurisdiction of the United States' for purposes of section 30(c).").

[41] *Id.* at 27,482 n.308 ("We also note in this regard the relatively low liquidity of the security-based swap markets in general, even for the most liquid products").

[42] *Id.* at 27,457.

products traded today[43] and, as such, is potentially well-suited to SB SEF trading. Given the ongoing efforts in the capital markets to establish electronic trading venues for corporate bonds,[44] it is anomalous to suggest that the derivative product that references this underlier, but that is far more standardized than the underlier, is ill-suited to electronic trading. Finally, the fact that *some* Single-Name CDS are illiquid or trade infrequently is not a justification for preliminarily concluding that *all* Single-Name CDS are unlikely to be suited to clearing or trading on SEFs. While Figure 5 in the Proposal shows a long, infrequently traded "tail" of instruments in the Single-Name CDS market, this is not particularly surprising, and belies the fact that Figure 5 also shows that there is a significant liquid core of the Single-Name CDS market that may be well-suited to clearing and SB SEF-trading.

2. Elements of the Commission's Data Appear Flawed

The data that form the basis of the Commission's understanding of the effect of the Proposal appear to suffer from certain defects.[45] Further, it appears to us that the data have produced some misleading results. They appear to lead to the conclusion that SB Swap dealing is not a customer-driven business, which is not at all consistent with our experience. For example, while 99% of Single-Name CDS price forming transactions in 2014 may have involved a dealer, staff estimates that more than 80% of notional volume has ISDA-recognized dealers as counterparties on *both* sides of the transaction[46] are unlikely to be accurate. In the post-Volcker environment, SB Swaps is entirely a customer-driven, intermediation business for dealers. Dealers trade with each other largely to hedge risk acquired from their customer base. As the Commission may have noted on page 27,452 of the Proposal ("The high level of inter-dealer activity reflects the central position of a small number of dealers, each of which intermediates trades between many hundreds of counterparties"), the Commission's figures may be skewed by arrangements such as derivatives prime brokerage, where every customer trade results in at least two trades involving a dealer.

Further, we agree that reliance on DTCC-TIW entity domicile determinations results in mischaracterization of the market, since it appears to us that it does not accurately reflect the involvement of hedge funds managed by U.S.-based investment advisors that are U.S. persons for purposes of the Commission's cross-border rules, which we believe play a significant role in the U.S. SB Swap markets.

3. Inter-Dealer Markets for Single-Name CDS Already Have Clearing

The Commission has recognized that the clearing of CDS plays an important role in reducing systemic risk[47] and it is difficult to marry the Commission's concerns about the systemic implications of uncleared CDS trading with the suggestion that the market is illiquid and thinly traded.[48] As the Commission knows, as a risk management matter, it would be unsafe and unsound for a clearing house to engage in the clearing of illiquid instruments. Yet the Commission has approved ICE Clear Credit and

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[43] Indeed, the Commission's own data indicates that 71% of certain recent Single-Name CDS activity was suitable for clearing. *Id.* at 27,454.

[44] *See, e.g.*, TruMid, *Overview* (last visited July 9, 2015), https://www.trumid.com//Overview.aspx ("TruMid is a revolutionary new electronic trading marketplace for corporate bonds and CDS that will dramatically increase liquidity in the credit markets.")

[45] See, for example, the Commission's comments about data quality in the Proposal, *supra* note 2, at 27,449-50.

[46] *See* Press Release, SEC, SEC Adopts Cross-Border Security-Based Swap Rules (June 25, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542163722.

[47] *See, e.g.*, Order Granting Temporary Exemptions Under the Securities Exchange Act of 1934 in Connection With Request on Behalf of Ice Clear Europe Limited Related to Central Clearing of Credit Default Swaps, and Request for Comments, 74 Fed. Reg. 37,748, 37,749 (July 29, 2009).

[48] ISDA appears to disagree with the Commission's apparent position that segments of the market are cleared notwithstanding their illiquidity when it says: "Today, most activity in the liquid CDS indices and single-names is eligible for clearing. And much of this activity has been cleared." ISDA, Non-Cleared OTC Derivatives: Their Importance to the Global Economy 15 (2013), *available at* http://www2.isda.org/attachment/NTM2OA==/Non-Cleared%20OTC%20Derivatives%20Paper.pdf.

ICE Clear Europe to clear Single-Name CDS products, suggesting that the Commission views those products as sufficiently liquid to be robustly priced on a daily basis (to allow margin calculations) and, therefore, safely cleared. As the Commission is aware, much of the inter-dealer Single-Name CDS market is already cleared. In fact, the industry is trying to increase standardization and the use of clearing as means of further increasing liquidity in that product.[49] Consequently, any efforts to exclude Nominally Offshore Transactions from the clearing and SB SEF-trading requirements are apparently not directed at the clearing requirement (since the trades will likely be cleared in any event), but rather at excluding a very significant portion of the inter-dealer market from the SB SEF-trading requirement.

4. Separate Liquidity Determinations are Already Embedded in Clearing / SB SEF-Trading Determinations – No Need to Pre-Determine that Outcome in Cross-Border Rules

It is unclear why the Commission distinguishes between Nominally Offshore Transactions and other transactions if it believes Single-Name CDS are illiquid. As the Commission is aware, in reviewing whether a SB Swap should be subject to the clearing requirement, the Commission must consider the existence of significant outstanding notional exposures and trading liquidity in the SB Swap.[50] Either Single-Name CDS are sufficiently liquid to be made subject to the clearing requirement or they are not; if the Commission believes that Single-Name CDS are illiquid, presumably the Commission will not subject Single-Name CDS to the clearing requirement under any circumstances, meaning that liquidity need not be a central element of the Commission's cross-border rulemakings. It is difficult to imagine a more controversial determination, given the focus on the role of SB Swaps in the global financial crisis, but the Commission's positions in the Proposal suggest that the Commission will determine that Single-Name CDS need not be cleared at all. Conversely, if the Proposal is adopted and the Commission concludes in future that Single-Name CDS should be subject to the clearing requirement, it would apparently be necessary for the Commission to revisit its cross-border rulemakings.

D. Neither Regulatory Capital nor Margin for Uncleared Swaps is a Substitute for Clearing

The Proposal contends that capital and margin requirements can substitute for clearing and SB SEF-trading requirements in respect of Nominally Offshore Transactions.[51] Here, the Proposal again appears to overlook lessons from the recent financial crisis. Many of the large financial institutions that U.S. tax payers bailed out during the financial crisis were heavily regulated and subject to regulatory capital requirements. Further, major dealers, themselves, have accepted that bilateral margining arrangements are not an adequate substitute for central clearing in times of crisis.[52] The Proposal does not explain why, if capital and margin can protect U.S. investors from further crippling losses, Congress created the clearing and SB SEF-trading mandates.

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[49] *See, e.g.*, Tracy Alloway, *Why Would Anyone Want to Restart the Credit Default Swaps Market?*, Bloomberg (May 11, 2015, 11:44 AM), http://www.bloomberg.com/news/articles/2015-05-11/why-would-anyone-want-to-restart-the-credit-default-swaps-market-; Nabila Ahmed & Sridhar Natarajan, *BlackRock's on a Mission to Save the Credit-Default Swaps Market*, Bloomberg (May 6, 2015, 2:00 PM), http://www.bloomberg.com/news/articles/2015-05-05/blackrock-s-on-a-mission-to-save-the-credit-default-swaps-market. See also ISDA's recommendation for an amendment to the single-name CDS roll frequency, ISDA, Amending When Single-Name CDS Roll to New 'On-the-Run' Contracts (July 8, 2015), http://www2.isda.org/asset-classes/credit-derivatives/single-name-cds-roll/.

[50] *See* 7 U.S.C. § 78c–3 (2012).

[51] *See* Proposal, *supra* note 2, at 27,482.

[52] *See, e.g.*, First Public Hearing of the Financial Crisis Inquiry Commission 100-01 (Jan 13, 2010), *available at* http://fcic.law.stanford.edu/hearings/testimony/first-public-hearing (statement of Lloyd Blankfein, CEO, Goldman Sachs Group, Inc.) ("I think that to the extent that you have a clearinghouse -- the issue we had with AIG vis-a-vis margin, or fighting over settlements, or what a mark-to-market should be for the smooth transfer of margin, we would have avoided. We got margin from them, but it was hard to get out of them and it was slow. It lagged what we thought [was] the mark-to-market.").

Congress intended that standardized, clearable SB Swaps should be cleared and SB SEF-traded, and that, only if transactions are not suitable for clearing and SB SEF trading should further requirements relating to capital and margin be used to mitigate the increased risk. Cleared SB Swaps are subject to a robust margining regime, and the intent of heightened margin requirements for uncleared swaps was to compensate for the absence of that regime in less liquid or standardized markets, not as an alternative to clearing. The Proposal turns Congressional intent and the intent of the G20 upside down; it incorrectly positions clearing as an "add-on" to regulatory capital and margin requirements,[53] when it was intended as the primary risk mitigant in relation to liquid, standardized products like Single-Name CDS. The Proposal recognizes the intent of Congress,[54] recognizes that Nominally Offshore Transactions are subject to the Commission's jurisdiction under the Exchange Act,[55] recognizes that Congress intended the Commission to develop an approach consistent with that of the CFTC[56] and then proposes a treatment of Nominally Offshore Transactions that is inconsistent with the approach advanced by the CFTC and that largely ignores the clearing and SB SEF-trading requirements of Title VII.

Here, too, the Proposal offers no basis on which to distinguish between Nominally Offshore Transactions and other SB Swap transactions and instead underscores the Commission's apparent position that no Single-Name CDS transaction need be cleared, in this case because it is sufficient that the dealer be registered with the Commission and that the uncleared transaction be subject to margin requirements.

E. The Commission's Consideration of the Competition Implications of the Proposal is Incomplete

Mitigating credit risk in the United States should not be viewed as the primary goal of the clearing requirement. First, as we note above, because financial crises are global, the Commission should not consider credit risk in domestic terms alone. Also, clearing brings more transparency to the market because clearinghouses publish objective, marked-to-market values for cleared products on at least a daily basis. Because clearinghouses mandate strict compliance with their daily and intra-day margin requirements and do not permit market participants to dispute their valuations or margin calls, clearing entails sounder credit and operational risk management. Clearing facilitates the orderly resolution of a defaulting market participant's portfolio because positions can be transferred more seamlessly to solvent market participants on standardized terms and at a price that is objectively determined by the clearinghouse, an organization that operates in a manner that is market risk-neutral. Further, clearing promotes competition; it allows liquidity providers to enter a marketplace from which they would otherwise be excluded. This additional liquidity promotes spread compression from which the entire market benefits. The Proposal would mean the loss of all of these benefits in respect of Nominally Offshore Transactions.

As the Commission correctly notes,[57] because Nominally Offshore Transactions would not be subject to the clearing requirement, they would also be excluded from the SB SEF-trading requirement. The Proposal gives inadequate consideration to the implications of that outcome. In determining whether a

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[53] *See* Proposal, *supra* note 2, at 27,482 ("Given that, under our proposed approach, a non-U.S. person that engages in significant security-based swap activity using personnel located in a U.S. branch or office is likely to be required to register and be subject to Title VII capital and margin requirements with respect to all of its transactions, we preliminarily do not believe that subjecting a subset of these persons' activities to the clearing requirement is likely to provide a significant additional reduction in counterparty credit risk in the United States.").

[54] *See id.* at 27,448 ("The Title VII framework mandates that we establish rules that apply to certain security-based swap transactions, including mandatory clearing, mandatory trade execution, regulatory reporting and public dissemination.").

[55] *See, e.g.*, *id.* at 27,463, 27,465.

[56] *See, e.g.*, *id.* at 27,446 n.12.

[57] *See id.* at 27,482.

SB Swap should be required to be cleared, the Commission must consider the effect on competition.[58] As the Commission is aware,[59] SB SEF trading affords critical pre-trade price transparency. Such transparency creates a level playing field which promotes pricing efficiencies from which all market participants benefit. By excluding Nominally Offshore Transactions from the clearing requirement, the Commission has significantly limited the prospect of these efficiencies in the SB Swap markets. The Proposal barely discusses pre-trade transparency at all, focusing instead on the post-trade transparency benefits of transaction reporting. We respectfully submit that the Commission has given inadequate consideration to the competition implications of excluding these transactions from the SB SEF-trading requirement *precisely because* they would be excluded from the clearing requirement.

F. The Threat of Relocation is Overstated

We also encourage the Commission to view with greater skepticism comments that subjecting Nominally Offshore Transactions to the clearing and SB SEF-trading mandates will cause banks to relocate their trading operations outside of the United States. Again, as Commission Chair White notes, many of those involved are U.S. financial groups. If such relocation is even achievable (which is far from certain, given, for example, the likely reluctance of key employees to relocate and the availability of other opportunities for skilled participants in the SB Swap markets in the United States), it could be achieved only with a financial cost that would greatly exceed the cost of complying fully with Title VII. In our experience, the Single-Name CDS business of U.S. dealers is closely integrated with their public and private sector corporate finance businesses (such as bond trading and bond underwriting). Consequently, any relocation would be a massive undertaking, not limited to Single-Name CDS professionals. Any advantage to be gained by such a move would be temporary and likely short-lived as other jurisdictions implement swaps markets reforms over the next few years. Consequently, the costs would likely greatly outweigh the benefits. Also, despite the CFTC's position with regard to the regulation of Nominally Offshore Transactions, there have been no mass relocation efforts on the part of swap dealers. The answer to Commissioner Stein's question[60] is that there is no credible evidence to suggest that applying the SB SEF-trading mandate to Nominally Offshore Transactions will cause a loss of liquidity on U.S. SEFs.

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We appreciate the opportunity to provide comments on the Commission's Proposal. 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

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[58] *See* 7 U.S.C. § 78c–3 (2012).

[59] See discussion of trading platforms, *id.* at 27,457. *See also id.* ("[M]oving OTC derivatives onto organized trading platforms … should help improve transparency in OTC derivatives markets, both to regulators and market participants.").

[60] Stein, *supra* note 5 ("On the other hand, if that liquidity is very likely to leave if we do apply the SEF requirements to these cross-border trades, are the proposed rules today a measured response to that reality?").