



September 6, 2012

Via Electronic Submission: <http://comments.cftc.gov>

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

Re: Clearing Requirement Determination Under Section 2(h) of the CEA
RIN Number 3038-AD86

Dear Mr. Stawick:

Citadel LLC¹ (“Citadel”) supports without qualification the Commodity Futures Trading Commission’s (the “Commission”) proposed *Clearing Requirement Determination Under Section 2(h) of the CEA*² (the “Determination”) for the classes of credit default swaps (CDS) and interest rate swaps (IRS) set out in the Determination.³

Implementing the mandatory clearing requirement for these liquid and standardized swap classes is a critical milestone towards achieving the Dodd-Frank Act’s objectives of reducing interconnectedness, mitigating systemic risk, increasing transparency, and promoting competition in the swaps market – all essential steps towards restoring the safety and soundness of our financial markets.

The CDS and IRS specified in the classes identified for mandatory clearing in the Determination are all cleared today in material volumes on a dealer-to-dealer basis and we thus agree with the Commission that “there is already a blueprint for clearing and appropriate risk management.”⁴ We recommend that the Commission maintain the full identified product scope in

¹ Established in 1990, Citadel is a leading global financial institution that provides asset management and capital markets services. With over 1,100 employees globally, Citadel serves a diversified client base through its offices in the world’s major financial centers including Chicago, New York, London, Hong Kong, San Francisco and Boston.

² 77 Fed Reg. 47170-47222 (August 7, 2012)

³ See *Id.* at 47220-1 for the specific fixed-to-floating swaps, basis swaps, FRAs, and OIS as well as CDX and iTraxx CDS indices listed in §50.4

⁴ See *Id.* at 47172

its final Determination and urge the Commission to adopt the Determination as presently drafted at the earliest possible opportunity.

We address below the following areas for public comment:

- I. The products included in the Determination satisfy the five statutory factors that the Commission is required to consider for clearing requirement determinations⁵
- II. The Commission's approach to specifying the classes of IRS and CDS contracts subject to the clearing requirement is appropriate
- III. The inclusion of iTraxx indices in the Determination is warranted
- IV. The Determination is justified by a cost-benefit analysis

I. The products included in the Determination satisfy the five statutory factors that the Commission is required to consider for clearing requirement determinations

A. Outstanding notional exposures, trading liquidity, and adequate pricing data

Data from BIS, DTCC, ODSG, Trioptima and LCH, which the Commission has reviewed and presented in the Determination, clearly demonstrate the existence of substantial outstanding notional exposures in the classes of CDS and IRS included in the Determination. The data on outstanding notional exposures and total open contracts, coupled with the weekly and monthly data on number of trades and total notional traded, together also demonstrate the high level of trading liquidity in the relevant classes of swaps.

It is further our experience that liquidity can, and for these purposes, should be determined on grounds other than trading activity alone. Specifically, current market depth, as evidenced by the number of dealers quoting two-way markets in a product, and the notional sizes of the quoted bids and offers, is an equally instructive indicator of trading liquidity. As a buy-side market participant in both CDS and IRS it is our experience that multiple dealers regularly quote two-way markets in the swaps covered by the Determination in meaningful sizes through a variety of mediums, including in periods of market stress. We therefore believe there is ample trading liquidity to support a clearing requirement for these classes of swaps.

⁵ In summary, the five factors are the (i) outstanding notional exposures, trading liquidity, and adequate pricing data; (ii) availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure; (iii) effect on the mitigation of systemic risk; (iv) effect on competition; and (v) legal certainty in the event of insolvency.

Our experience and observations regarding trading liquidity further lead us to conclude that there is sufficient data in the market for DCOs to perform required pricing of the classes of swaps included in the Determination. As the DCOs explained in their submissions and the Commission discusses in the Determination, the DCOs have processes in place to ensure they have access to adequate pricing data for their risk and default management procedures for all cleared swaps. Finally, access to reliable pricing data will only improve over time as the Dodd-Frank rules promoting pre- and post-trade transparency are implemented. For example, public dissemination of swap transaction pricing information is scheduled to begin in October of this year.

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

All of the swaps included in the Determination are already being cleared by registered DCOs in material volumes. We believe this provides clear evidence that there is the rule framework, capacity, operational expertise and resources, and credit support infrastructure necessary to clear each of the swaps that are the subject of the Determination. Further, since the registered DCOs are required to be in compliance on an on-going basis with the DCO core principles, they by definition have demonstrated to the Commission that they satisfy these requirements.

We further believe that the DCOs are capable of supporting the increased volume of swaps that will be cleared following implementation of the clearing mandate. The DCOs have been preparing for and anticipating this increased volume since the enactment of the Dodd-Frank Act, if not earlier. Client clearing volume has risen materially on a voluntary basis in 2012. Further, under the Commission's final rule on *Swap Transaction Compliance and Implementation Schedule: Clearing Requirement* (the "Clearing Implementation Schedule"),⁶ a 270 day period was provided to allow DCOs, customers, FCMs and all others engaged in the clearing process to test, ramp up clearing volumes voluntarily, and be in position to manage full production clearing volumes during the phase in. We believe the DCOs and FCMs are well prepared for a surge in clearing volumes and have the framework, capacity, expertise, resources and infrastructure to support it in a safe and sound manner. Our own firm's experience in commencing to clear on a voluntary basis confirms these observations.

C. Effect on the mitigation of systemic risk

The transition from an interconnected network of bilateral derivatives exposures to central clearing in supervised clearinghouses will materially mitigate systemic risk, a fact

⁶ 77 Fed Reg. 44441-44456 (July 30, 2012)

that has been well established⁷ and stands as a pillar of the Dodd-Frank Act. Central clearing eliminates the prospect of firms becoming too-interconnected-to-fail by virtue of their bilateral swap positions. It concurrently ensures that sufficient margin is reserved against each side of each transaction, while further mitigating any default event through mutualization funds, clearing member obligations, and the additional financial safeguards of the regulated clearinghouse.

The Determination takes the decisive step, which the market has long anticipated and prepared for, of making mandatory central clearing of the most liquid and standardized swaps a reality. By bringing the first cohort of those products that are currently clearable under the umbrella of a market-wide clearing requirement, the Determination ensures that the most liquid core of the OTC derivatives market will transition to central clearing over the next year. We are confident that this transition will support and incentivize the progressive expansion of the cleared product set, since it will be more economically efficient for market participants to hold as much as possible of their portfolios in a single margined basket at a clearinghouse. The Determination thus provides the certainty needed for market participants to transition more of their swap portfolios going forward from bilateral to cleared trades, thus substantially reducing or eliminating bilateral counterparty credit risk, and by extension, systemic risk in the financial system.

D. Effect on competition

We are certain the Determination will have a strong positive impact on competition in the swaps market as well as in the market for clearing services, and we see such dynamics meaningfully at work even in anticipation of the launch of the clearing mandate.

Implementing mandatory central clearing for swaps under the framework established by the Commission promotes competition among swap dealers. In centrally cleared markets, counterparty credit risk no longer features as a consideration in the selection of execution counterparties. Thus, central clearing will remove a significant barrier to entry for alternative liquidity providers in the swaps market and will enable smaller swap dealers to compete on more equal terms with the current limited universe of large swap dealers who presently control the vast majority of liquidity in the swaps market. Central clearing also allows buy-side market participants to source competitive execution and liquidity from the widest range of potential execution counterparties. This increased competition yields myriad benefits to market participants, including narrower bid-ask spreads, improved access to best execution, and increased market depth and liquidity. In addition, mandatory central clearing is a prerequisite for the emergence of an all-to-all

⁷ See, among others, *Policy Perspectives on OTC Derivatives Market Infrastructure* by Duffie, Li, and Lubke (March 2010) at http://www.newyorkfed.org/research/staff_reports/sr424.pdf

market with electronic and/or anonymous execution, which provides for the most efficient and competitive price discovery process.

From the buy-side's perspective, central clearing's substitution of the DCO for the bilateral counterparty decouples execution from post-trade processing and settlement, while also eliminating bilateral counterparty credit risk as a factor in execution. This decoupling of execution from clearance and settlement establishes the conditions for competition for the unbundled clearing service. FCMs must now compete on a standalone basis based on the robustness, quality, and pricing of their clearing services. Further, when coupled with the Commission's final rule §39.12 *Participant and product eligibility*, which ensures that DCOs have objective, risk-based membership requirements, the Determination will facilitate new entrants in the markets for clearing services, further promoting competition among FCMs and improving clearing access and pricing for customers.

Having begun our own efforts to clear swaps voluntarily in advance of the implementation of the clearing requirement, we can attest firsthand to the beneficial effect on competition that the publication of the proposed Determination in conjunction with the Clearing Implementation Timetable have had. The certainty they have provided by defining "T" for the clearing countdown as fixed for no later than early November has given DCOs and particularly FCMs the confidence to invest in building out their client clearing offerings, and to compete actively for our business both on the quality and efficiency of their services as well as on price.

E. Legal certainty in the event of insolvency.

We agree with the Commission's analysis that reasonable legal certainty exists in the event of an insolvency of a DCO or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property in connection with the cleared swaps covered by the Determination.⁸

II. The Commission's approach to specifying the classes of IRS and CDS contracts subject to the clearing requirement is appropriate

In the Determination, the Commission has proposed a clearing requirement based on specific classes of swaps. We agree that this is appropriate, and preferable to attempting to establish clearing requirements on an individual product-by-product basis.

The class designation reflects the risk management approach utilized across the industry, and most importantly by DCOs (i.e., to determine necessary margin and other safeguards based on

⁸ See *Id.* Specifically, the analysis outlined II.D(e) and III.E(d) at 47185 and 47205 respectively

swap classes). The starting point for the approved classes is the groupings of swaps that are already approved for clearing by supervised DCOs. Their risk management approach applies consistently across the tenors and series of each class of instrument that they clear. Further, DCOs will only clear, and continue to clear, instruments that they can price with sufficient accuracy to ensure that they are adequately margined, and for which there is sufficient market capacity for risk management and liquidation upon a default event.

On this basis, and in view of the Commission's continuing strict oversight of DCO risk management, we believe that the class-based designation is appropriate. Furthermore, we support the procedure set out in §50.6 *Delegation of Authority* for applying the clearing requirement to subsequent swaps submitted by a DCO, including additional tenors and series, within a mandated class based on staff review and notice, rather than new rulemakings.

Different tenors, or series, of the same instruments, while displaying incrementally different characteristics, are priceable both based on market activity but also with reference to more liquid or on-the-run (or, as the case may be, already cleared) instances of the same instruments, and, as noted above, are risk managed utilizing the same risk management frameworks. Accordingly, new swaps within an approved class do not require new review procedures that would incur excessive delay. Additionally, exempting swaps from the clearing requirement that (i) otherwise share the same essential characteristics as swaps that are required to be cleared, and (ii) can be readily priced with reference to cleared swaps, could risk permitting a separate market that avoids the clearing requirement. It is essential that the Commission be able to move sufficiently quickly to bring such instruments into clearing when a DCO is prepared to clear them.

III. The inclusion of iTraxx indices in the Determination is warranted

The inclusion of iTraxx products in the Determination has garnered attention during the comment period since as of today no DCO has an approved and available client clearing offering. Nonetheless, we believe, and understand there to be broad industry consensus, that the iTraxx products meet the five statutory factors that the Commission is required to consider during its process for review of swaps for mandatory clearing. We therefore believe that iTraxx should be included in the Commission's final Determination, but suggest that the effectiveness of any clearing requirement with respect to iTraxx can be appropriately synchronized with the availability of a client clearing offering.

We understand that ICE Clear Credit Europe and/or ICE Clear Credit US expect to have client clearing solutions for iTraxx approved and available prior to the effectiveness of any Commission clearing requirement (given the windows provided in the Clearing Implementation Schedule). We encourage the Commission to work together with these and other DCOs to ensure that approvals for such client clearing offerings can be obtained in time. However, to the extent there is a timing mismatch (i.e. the clearing requirement becomes effective before or shortly after a

client clearing offering becomes available), then the Commission should consider offering clients a reasonable window to perform operational testing through voluntary clearing before the clearing requirement is enforced. We believe 60 days should be sufficient.

Beyond accommodating this timing issue, we do not believe there are any substantive reasons why iTraxx should not be included in the Determination. The re-structuring process related to iTraxx and the prospect of spinning out a new cleared single-name CDS does not present any new issues for market participants. If there was a credit event, we understand that ICE would make the single name CDS available for clearing. Once ICE's pending portfolio margining petition is approved, clients could hold both swaps in a 4(d)f account. If ICE's portfolio margining petition were not then approved, ICE would petition the SEC for a limited exemption to hold the spun-off single name CDS in 4(d)f account. In any event, market participants who trade iTraxx indices are already familiar with the restructuring aspect of the product, and further, since the product is already cleared on a dealer-to-dealer basis, DCOs have processes to accommodate this and market participants and regulators are comfortable with them.

IV. The Determination is justified by a cost-benefit analysis

In the sections above we have outlined the substantial systemic risk mitigation benefits of requiring the transition of the bulk of the current bilateral OTC derivative contracts to central clearing. For the swaps covered in the Determination, the bulk of dealer-to-dealer exposure is already cleared, so there is no impact with regard to these. For dealer-to-customer exposures, we note that:

- The clearing requirement provides the necessary certainty to ensure sufficient clearing services and competition for those services.
- The industry has been preparing for four years for the clearing requirement to apply, and such efforts have been accelerated since the publication in July of this year of the Determination and Clearing Implementation Timetable, so a substantial part of the infrastructure needed to support the transition is in place. The incremental cost for the buy-side to clear is more than outweighed by its risk mitigation, competitive, and transparency benefits.
- The Clearing Implementation Schedule allows more than sufficient time for cleared volumes to ramp up in a planned and careful manner, and through the Schedule's phase-in, to reach outward from the most active users to less active participants.

With respect to both dealer-to-dealer and dealer-to-customer clearing, the Determination strikes the right balance in terms of product scope:

- On the one hand, there is no doubt that the products included are sufficiently standardized,



priceable, and liquid for further clearing, since they have already been proven as a viable cleared product through dealer-to-dealer clearing;

- On the other hand, the product set is wide enough to embrace the liquid core of each asset class, creating an environment where there is now the incentive to clear associated products not in the initial product set, but suitable for clearing, in order for participants to maximize their portfolio margining and risk management benefits, and to maximize compression of counterparty credit exposures and offsetting margin payments.

Finally, accomplishing the implementation of the core clearing requirement of the Dodd-Frank Act the G-20 Commitments sets the foundation for the transparency and trading objectives of OTC derivatives reform. This increased transparency, and also the increased depth of market and price competition through the entrance of new liquidity providers made possible by clearing, will have lasting systemic risk benefits and cost benefits to buy-side market participants that far outweigh the transition costs for clearing.

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We appreciate the opportunity to provide comments on the Proposed Rules. 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

cc: The Hon. Gary Gensler, Chairman
The Hon. Mark P. Wetjen, Commissioner
The Hon. Bart Chilton, Commissioner
The Hon. Jill E. Sommers, Commissioner
The Hon. Scott D. O'Malia, Commissioner