CITADEL

February 2, 2016

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549–1090

Re: Completing the Commission's Security-Based Swap Rules (File Nos. S7-06-11, S7-05-12, S7-13-12 and S7-06-15)

Dear Mr. Fields:

Citadel LLC[1] ("Citadel") is a significant participant in the OTC derivatives markets and we care deeply about the successful implementation of the reforms prescribed in Title VII of the Dodd-Frank Act for security-based swaps ("SB Swaps"), including new requirements for clearing, trading, and transparency (the "Title VII reforms"). To date, the Securities and Exchange Commission (the "Commission") has proposed but has yet to finalize and implement many of these reforms. The single-name CDS market is now at a critical juncture, with liquidity and participation impaired due in part to the lack of a firm and predictable regulatory framework. We therefore write to supplement our prior comment letters to the Commission on its SB Swap rule proposals and to underscore the need to complete the rulemaking process in 2016.[2]

The need to prioritize the completion of the Commission's rules for SB Swaps was recently highlighted by Commissioner Piwowar[3] and by former Commissioners Gallagher[4] and Aguilar[5] prior to leaving the Commission. Meanwhile, a recent CPMI-IOSCO report noted the degree to which the Commission is lagging other global regulators in implementing the G20 objectives for OTC derivatives reform.[6]

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[1] Citadel is a global investment 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 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 the world's major financial centers, including Chicago, New York, San Francisco, Boston, London, Hong Kong, and Shanghai.

[2] *See* Appendix A for a list of Citadel's prior comment letters to the Commission on Title VII reforms.

[3] Statement Regarding Security-Based Swap Rules. Commissioner Daniel M. Gallagher and Commissioner Michael S. Piwowar (Sept. 25, 2015), available at: http://www.sec.gov/news/statement/gallagher-piwowar-security-based-swaps.html.

[4] *Id.*

[5] Finishing the Work of Regulating Security-Based Derivatives. Commissioner Luis A. Aguilar (Sept. 15, 2015), available at: http://www.sec.gov/news/statement/finishing-the-work-of-regulating-security-based-derivatives.html.

[6] "Assessment and review of application of Responsibilities for authorities." Committee on Payments and Market Infrastructures, Board of the International Organization of Securities Commissions (November 2015), available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD514.pdf. *See also* "SEC inaction on clearinghouses drags

The regulatory uncertainty caused by the lack of rule implementation has profoundly affected the single-name CDS market, with trading volumes decreasing and participation declining. In stark contrast, the implementation of the clearing and trading reforms in the U.S. interest rate swaps ("IRS") market has yielded significant improvements in pricing and liquidity, according to recent Bank of England research.[7]

In an effort to reinvigorate the market, industry participants have recently taken a series of voluntary steps aimed at increasing liquidity, including a recent commitment by 25 major buy-side firms to support voluntary clearing of single-name CDS.[8] However, notwithstanding these efforts, we fear liquidity and participation in the single-name CDS market will continue to languish unless the Commission finalizes and implements its SB Swap rules and provides a defined regulatory framework for market participants. Experience in other asset classes clearly demonstrates the importance of the Title VII reforms in not only promoting market safety, stability and integrity, but also improving conditions for investors through increased transparency, more competition, better pricing and new sources of liquidity. We therefore urge the Commission to:

- **Finalize the SB Swap Rules**. Completing the SB Swap rulemaking process and defining associated implementation timelines will provide the market with the regulatory certainty required to spur private investment in new solutions to enhance market resiliency, efficiency and liquidity, including platforms and service offerings related to reporting, clearing and trading.

- **Implement Mandatory Clearing for Liquid Single-Name CDS**. The most commonly traded single-name CDS (most importantly, the constituent names of the primary CDS indexes) are suitable for mandatory clearing, given their high degree of standardization, the significant existing volume of inter-dealer clearing activity, and the substantial client clearing offerings already approved by the Commission.

In finalizing the SB Swap rules, the Commission should also make certain targeted changes to the currently proposed framework to significantly enhance transparency and competition. In particular:

- **Straight-through-Processing Rules for Cleared SB Swaps Should be Adopted**. The Commission should recognize the international consensus developed by the Commodity Futures Trading Commission ("CFTC") and the European Securities and Markets Authority ("ESMA") around the importance of ensuring cleared transactions are actually submitted and

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down US financial stability ranking, report says," MLex (Dec. 9, 2015), available at: http://www.mlexfs-core.com/?r=EAAAAB%2FlOohrmEHH3KEOj%2FLaX4JBf40rjng4YfpnPJjdxNY3.

[7] *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.

[8] 25 Investment Management Firms Commit to Single-Name CDS Clearing (Dec. 16, 2015), available at: http://www2.isda.org/news/25-investment-management-firms-commit-to-single-name-cds-clearing.

accepted for clearing as soon as technologically practicable following execution. At the moment, dealer counterparties consistently take over eight hours to submit executed single-name CDS trades for clearing, in stark contrast to the seconds it generally takes to clear index CDS trades. This significant delay creates uncertainty for market participants, reintroduces bilateral counterparty credit risk, perpetuates systemic risk, leads to regulatory asymmetry, and reduces transparency.

- **Impartial Access to SB SEFs Must be Required**. The Commission's proposed rules would allow a security-based swap execution facility ("SB SEF") to deny access to market participants that are not registered as a security-based swap dealer, major security-based swap participant, or broker.[9] In practice, this would permit a SB SEF to deny access to the vast majority of eligible contract participants and remain a closed, dealer-only trading venue in direct contradiction to the impartial access requirement specifically included in the Dodd-Frank Act.

- **The Clearing and SB SEF Trading Requirements Should Apply to the Activities of U.S.-based Personnel**. The clearing and trading requirements are critical in reforming the current opaque market structure and enhancing transparency and competition for market participants. Applying these requirements to SB Swaps that are arranged, negotiated or executed by U.S.-based personnel of non-U.S. entities will mitigate risk to the U.S. financial system while preventing the incumbent dealers from being able to use U.S. personnel to trade on behalf of their non-U.S. entities on trading platforms outside of the U.S. that are not subject to equivalent pre-trade transparency or impartial access requirements.

- **The Portfolio Margining Regime Should Reference the CCP's Margin Methodology**. The current requirement for each clearing member to have its own margin methodology in order to offer portfolio margining between single-name and index CDS to its clients undermines one of the fundamental benefits of central clearing, which is the ability for all market participants to rely on the same, fully vetted and approved margin methodology maintained by the clearinghouse.

I. The Single-Name CDS Market is Suffering from the Delay in Implementing Reforms

A. The Importance of the Single-Name CDS Market and Recent Deterioration in Liquidity and Participation

The single-name CDS market plays a fundamental role in facilitating capital formation by investors and is estimated to be approximately $9 trillion in notional value.[10] Single-name CDS are used by investors for a variety of reasons, including as a risk management tool to hedge credit exposure and to express investment views on companies that may not issue bonds often or may have bonds that are difficult to source.

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[9] *See* § 242.809(b) of the Proposed Rule on Registration and Regulation of Security-Based Swap Execution Facilities, 76 Fed. Reg. 10948, 11060 (Feb. 28, 2011), available at: http://www.gpo.gov/fdsys/pkg/FR-2011-02-28/pdf/2011-2696.pdf ("**SB SEF Proposal**").

[10] *See* Bank for International Settlements, Statistical release: OTC derivatives statistics at end-December 2014, at 15 (Table 1) (Apr. 2015), available at: http://www.bis.org/publ/otc_hy1504.pdf.

A healthy single-name CDS market is also integral to price discovery and fosters liquidity in related instruments, such as corporate bonds and index CDS. Corporate bond liquidity is bolstered by the use of single-name CDS for price discovery and as an effective hedging instrument. Meanwhile, index CDS liquidity suffers when investors are unable to separately trade underlying index constituents in order to isolate exposure to specific segments of the index.

Despite the importance of single-name CDS for investors, there has been visible deterioration in both liquidity and participation following the financial crisis. Since 2008, the notional amount of outstanding single-name CDS has decreased by over 60% according to data from the Bank for International Settlements.[11] Annual trading activity in North American corporate single-name CDS has declined from more than $6 trillion in 2008 to less than $3 trillion in 2014.[12] In addition, one of the largest market makers in the product announced its withdrawal from the market, after first attempting to focus more on cleared single-name CDS.[13] Other liquidity providers have reduced activity levels and concerns around current liquidity conditions are frequently expressed by those remaining in the market.[14] Current liquidity conditions in single-name CDS were also cited as a factor in the recent closure of the Lucidus high-yield credit fund.[15]

This decline is not irreversible. Single-name CDS is a highly standardized investment and risk management tool that, given the right market structure and regulatory framework, can and should play a valuable role in our financial markets. Market experience in index CDS demonstrates that regulatory certainty and central clearing provide the conditions for market participation to grow and for new liquidity providers to enter the market, to the benefit of investors.[16] According to recent Bank of England research, similar results have been observed following the clearing and trading reforms in the U.S. IRS market, with liquidity improving and transaction costs significantly declining for investors.[17]

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[11] *See* Bank for International Settlements, OTC derivatives market activity in the first half of 2008 (Nov. 2008), available at: http://www.bis.org/publ/otc_hy0811.pdf and Bank for International Settlements, OTC derivatives statistics at end-December 2014 (Apr. 2015), available at: http://www.bis.org/publ/otc_hy1504.pdf.

[12] 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. 27444, 27452 (May 13, 2015) ("**SEC Cross-Border Proposal**").

[13] *See* Deutsche pullback shows CDS challenges, Reuters (Oct. 13, 2014), available at: http://www.reuters.com/article/2014/10/13/deutsche-cds-leverage-idUSL6N0S828A20141013#YU3IEFvfCYRjsUzq.97 and Deutsche Bank Ends Most CDS Trade, WSJ (Nov. 17, 2014), available at: http://www.wsj.com/articles/deutsche-bank-ends-trade-in-most-corporate-credit-swaps-1416241426.

[14] *See* Single-name CDS seeks revival, Reuters (May 5, 2015), available at: http://www.reuters.com/article/2015/05/05/cds-bonds-idUSL5N0XW2I520150505#WxMQh9xXHqiV4LfD.97.

[15] *See* Lucidus Has Liquidated $900 Million Credit Funds, Plans to Shut, Bloomberg (Dec. 14, 2015), available at: http://www.bloomberg.com/news/articles/2015-12-14/lucidus-has-liquidated-900-million-credit-funds-plans-to-shut.

[16] *See* 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#axzz3rj5MtwiI.

[17] *See supra* note 7.

B. Industry Participants Are Seeking to Revive Single-Name CDS Liquidity

Against the headwinds of regulatory uncertainty, several targeted private industry initiatives have been pursued in an effort to revive liquidity in the single-name CDS market. However, without Commission action to finalize the regulatory framework, we fear that these voluntary efforts alone will not be sufficient to establish the conditions necessary for investors to benefit from greater transparency, better pricing, and new sources of liquidity. The industry initiatives include:

- **Voluntary Central Clearing**: In a recent announcement jointly issued by the Managed Funds Association, SIFMA's Asset Management Group and ISDA, 25 buy-side firms pledged to support voluntary clearing of single-name CDS.[18] Citadel was one of the firms that committed to this effort, and we have been working closely with dealer counterparties, clearing members and clearinghouses to increase the percentage of our new U.S. single-name CDS trades that we clear to over 90%.

- **Differentiated Pricing for Cleared vs. Uncleared**: Several liquidity providers are also moving to differentiate pricing between cleared and uncleared single-name CDS transactions, reflecting the lower costs associated with cleared transactions.[19]

- **Revising Roll Date Frequency**: Market participants have recently switched from quarterly to semi-annual roll dates for single-name CDS in order to lower capital costs by reducing the number of contracts outstanding and better align the product with index CDS.[20]

These industry initiatives clearly demonstrate the fundamental importance of the single-name CDS product to fixed income market participants. Market participants are actively searching for ways to preserve and revive the single-name CDS market, but need the Commission to provide a firm and predictable regulatory framework.

C. Finalizing the SB Swap Rules and Implementing Mandatory Clearing Can Reinvigorate the Single-Name CDS Market

Finalizing the SB Swap Rules

The Title VII reforms are collectively designed to mitigate systemic risk and promote the safety, stability and integrity of the SB Swap market, while also improving conditions for investors through increased transparency, competition, and access. Experience in other asset classes demonstrates that the Title VII reforms – including enhanced pre-trade and post-trade

[18] *See supra* note 8.

[19] *See* Credit Suisse, Goldman Said Mulling Plan to Promote CDS Clearing, Bloomberg (Nov. 9, 2015), available at: http://www.bloomberg.com/news/articles/2015-11-10/credit-suisse-goldman-said-mulling-plan-to-promote-cds-clearing.

[20] *Id.*

transparency and the requirement for certain liquid standardized instruments to be executed on centralized trading platforms and cleared – have improved market participation and liquidity for investors. For example, multiple new liquidity providers have recently entered both the index CDS and interest rate swaps markets as a result of the implementation of the Title VII reforms, deepening liquidity and enhancing price competition for investors.[21] In addition, a recent Bank of England study found that the CFTC's implementation of the trading mandate for interest rate swaps led to a significant improvement in liquidity and an enormous reduction in execution costs, with market participants saving as much $20 million - $40 million *per day*, of which $7 million - $13 million was being saved by market end-users alone *per day*.[22]

In contrast, the single-name CDS market continues to be characterized by a trend of increasing concentration [23] and declining trade volumes. We urge the Commission to prioritize the completion of its SB Swap rules to unleash the myriad of benefits of the Title VII reforms in this market that is so integral to fixed income investors. Providing the market with regulatory certainty will also spur private investment in new solutions to enhance market resiliency, efficiency and liquidity, including platforms and service offerings related to reporting, clearing and trading.

Implementing Mandatory Clearing

Central clearing is a fundamental cornerstone to open, fair and transparent markets. In a centrally cleared market, participants all face the clearinghouse and bilateral counterparty credit exposure to other participants is eliminated. This allows any two counterparties in the market to trade with each other without putting in place the complex bilateral documentation that is currently required to transact uncleared products, such as most single-name CDS today. By removing complex bilateral documentation and associated counterparty credit risk assessments, which act as a significant barrier to participation and interaction, central clearing allows for market structure innovations to occur, such as trading solutions that enable investors to transact directly with other investors, as well as the opportunity for new liquidity providers to enter the market.

Many single-name CDS instruments are suitable for the application of the clearing requirement. First, current clearing offerings are extensive, with ICE Clear Credit launching single-name CDS clearing back in 2009 and now accepting 410 different North American and European corporate reference entities and 21 sovereign reference entities for client clearing.[24] For each of these reference entities, ICE Clear Credit has determined that they are sufficiently liquid in order to be robustly priced and margined and safely cleared. As of January 1, 2016, ICE Clear Credit has cleared a total of $4.41 trillion gross notional of single-name CDS.[25]

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[21] *See supra* note 16.

[22] *See supra* note 7.

[23] *See* SEC Cross-Border Proposal at 27452.

[24] *See* ICE Clear Credit, Volume of ICE CDS Clearing, available at: https://www.theice.com/clear-credit.

[25] *Id.*

Second, single-name CDS is a highly standardized product, with market participants tending to utilize industry standard contracts rather than bespoke arrangements. This is illustrated by the Commission's findings that the vast majority of new single-name CDS activity is eligible to be cleared.[26]

Third, market participants are familiar with the clearing workflow and, in many cases, are already set up to clear as a result of clearing requirements in other asset classes. Since both single-name and index CDS are frequently executed as part of a single strategy,[27] many participants in single-name CDS are already familiar with the implementation of mandatory clearing requirements for index CDS.

While not all single-name CDS instruments are suitable for mandatory clearing, a core group of more commonly traded reference entities are (including, most importantly, the constituent names of the primary CDS indexes), demonstrated by the current client clearing offerings and the large amount of inter-dealer clearing that already occurs. In fact, the Commission found that nearly 80% of new clearing eligible inter-dealer single-name CDS transactions were actually cleared between July 2012 and December 2013.[28] We urge the Commission to prioritize the implementation of the mandatory clearing requirement for these standard and liquid single-name CDS instruments. As part of that process, the Commission should, without delay, perform a full review of all of the instruments that clearing agencies currently accept for clearing (rather than just reviewing instruments cleared prior to the enactment of the Dodd-Frank Act, given the amount of time that has elapsed since that date).[29]

II. Targeted Changes to the Commission's Proposed Framework for SB Swaps Are Needed to Enhance Transparency and Competition

A. The Commission Should Adopt Straight-through-Processing Rules for Cleared SB Swaps

As we have previously commented to the Commission,[30] it is critical to ensure cleared transactions are actually submitted and accepted for clearing as soon as technologically practicable in order to reduce systemic risk, improve transparency, and support competition in the SB Swap market. Unfortunately, this is not the case today in our experience voluntarily clearing single-name CDS. On average, dealer counterparties consistently take over eight hours

[26] *See* SEC Cross-Border Proposal at 27454.

[27] *Id.* at 27458.

[28] *Id*. at 27455.

[29] The Commission's Policy Statement is unclear regarding the timing for reviewing all of the single-name CDS instruments that clearing agencies currently accept for clearing. *See* Statement of General Policy on the Sequencing of the Compliance Dates for Final Rules Applicable to Security-Based Swaps Adopted Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act, 77 Fed. Reg 35625, 35636 (June 14, 2012).

[30] Please see our Letter to the Commission dated August 13, 2012, available at: http://www.sec.gov/comments/s7-05-12/s70512-14.pdf ("**August 2012 Letter**") and our Letter to the Commission dated July 19, 2013, available at: http://www.sec.gov/comments/s7-05-12/s70512-19.pdf ("**July 2013 Letter**") for further discussion of the benefits of straight-through-processing for cleared SB Swaps.

to submit executed trades for clearing, while one of the largest dealers still takes over sixteen hours. Among other adverse consequences, this leads to a material percentage of trades failing to clear until the following day. On a market-wide basis, this construct creates significant uncertainty and unnecessary bilateral counterparty credit risk exposure as market participants are unable to ascertain when and if the transaction will successfully clear.

Under the Dodd-Frank Act, the CFTC has adopted straight-through-processing rules that establish minimum standards around the execution-to-clearing workflow in order to ensure timely submission and acceptance of swaps for clearing.[31] As a result of these rules, index CDS positions are generally submitted and successfully cleared within seconds of execution. The contrast between the speed and robustness of the execution-to-clearing workflow for cleared index CDS vs. cleared single-name CDS is stark, especially given that market participants typically clear both types of transactions at the same clearinghouse and through the same clearing members.

Meanwhile, pursuant to MiFIR/MiFID II, ESMA has submitted final rules to the European Commission for approval that are nearly identical to the current CFTC requirements.[32]

Both sets of straight-through-processing rules establish the overarching standard that intended-to-be-cleared transactions must be submitted and accepted for clearing as soon as technologically practicable. For cleared transactions executed on a regulated trading venue (such as a SB SEF under the Commission's framework), the straight-through-processing rules require (i) pre-trade credit checks against clearing member limits to ensure available capacity, (ii) prompt submission to, and acceptance or rejection by, the clearinghouse, and (iii) voidance of the trade in the rare event it is rejected by the clearinghouse in order to prevent the reintroduction of bilateral counterparty credit risk.[33]

A regulatory framework that permits intended-to-be-cleared transactions to remain in an uncertain, pending state for hours or days after execution undermines systemic risk mitigation, reduces transparency for investors and hinders the ability of new liquidity providers to enter the market. Importantly, the market infrastructure necessary to implement straight-through-processing already exists in the U.S. for both credit default swaps and interest rate swaps as a result of the CFTC rules and will be extended to Europe as a result of the rules under MiFIR/MiFID II.

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[31] *See* CFTC Final Rule on Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management, 77 Fed. Reg. 21278 (April 9, 2012), available at: http://www.cftc.gov/LawRegulation/DoddFrankAct/Dodd-FrankFinalRules/ssLINK/2012-7477a; and CFTC Staff Guidance on Swaps Straight-Through Processing (September 26, 2013), available at: http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/stpguidance.pdf;.

[32] *See* ESMA Regulatory technical and implementing standards- Annex I at Chapter 8 (Sept. 28, 2015), available at: http://www.esma.europa.eu/system/files/2015-esma-1464_annex_i_-_draft_rts_and_its_on_mifid_ii_and_mifir.pdf.

[33] *See supra* notes 31 and 32.

We note the Commission stated in its final rule on Clearing Agency Standards that it would continue to consider whether to propose specific rules around straight-through-processing.[34] We urge the Commission to prioritize the issuance of these rules in order to enhance the financial integrity of the execution-to-clearing workflow for SB Swaps and maintain consistency with the international consensus developed by the CFTC and ESMA when implementing clearing for OTC derivatives. The failure of the Commission to adopt straight-through-processing rules would result in vastly different execution-to-clearing requirements across swap instruments and jurisdictions, increasing systemic risk, reducing efficiency and creating challenges in reaching equivalence determinations with foreign regulators.

B. Impartial Access to SB SEFs Must be Required

The Dodd-Frank Act included a requirement for SB SEFs to provide impartial access to all market participants in order to create a level playing field in the SB Swap market.[35] To realize this goal, all market participants that meet the statutory threshold of an "eligible contract participant" should be able to join and fully participate on the new regulated venues where SB Swaps will be traded. As other commenters have noted,[36] this will also enable new liquidity providers to enter the market, increasing market depth and reducing execution costs for investors.

However, the Commission's proposed rules for SB SEFs would allow a trading venue to deny access to market participants that are not registered as a security-based swap dealer, major security-based swap participant, or broker.[37] In practice, this would permit a SB SEF to deny access to the vast majority of eligible contract participants. As an indication of the magnitude of the issue, the Commission has estimated that more than 4,000 entities engaged in single-name CDS activity in 2013, but only approximately 50 may be required to register as security-based swap dealers and only 0 to 5 may be required to register as major security-based swap participants.[38]

The Commission's proposal to limit impartial access to registered entities may be partly based on its experience in other asset classes, such as equities, where agency execution arrangements are common and, therefore, direct participation is not required in order to access a trading venue. However, agency execution is not commonly used to transact SB Swaps and we continue to see minimal use of agency execution on CFTC-regulated SEFs after more than two years of operation. Furthermore, the Commission's proposal does not even require SB SEFs to

[34] 77 Fed. Reg. 66220, 66256 (November 2, 2012), available at: http://www.gpo.gov/fdsys/pkg/FR-2012-11-02/pdf/2012-26407.pdf.

[35] *See* Dodd-Frank Act Section 763(c) at Core Principle 2.

[36] *See* Comment Letter submitted by the Managed Funds Association to the Commission dated Dec. 19, 2014, available at: http://www.sec.gov/comments/s7-06-11/s70611-160.pdf.

[37] *See* SB SEF Proposal at 11060.

[38] *See* SEC Cross-Border Proposal at 27452 and Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information; Final Rule, 80 FR 14563, 14693 (March 19, 2015), available at: https://www.gpo.gov/fdsys/pkg/FR-2015-03-19/pdf/2015-03124.pdf.

offer, and market participants to provide, agency execution services if they choose to arbitrarily exclude categories of market participants from direct membership.

As a result, the Commission's current proposal would allow some SB SEFs to remain closed, dealer-only trading venues that other market participants are completely unable to access, in direct contradiction to the impartial access requirement in the Dodd-Frank Act that applies to all market participants. The Commission specifically acknowledges this concern, stating: "If SB SEFs are controlled by a small group of dealers who also dominate trading in the market for SB swaps, the dealers may have economic incentives to exert undue influence to restrict the level of access to SB SEFs and thus impede competition by other market participants in order to increase their ability to maintain higher profit margins."[39]

Unsurprisingly, the incumbent dealers also resisted the CFTC's implementation of impartial access, seeking to justify the exclusion of other market participants from SEFs based on concerns such as counterparty credit risk. However, for cleared transactions in particular, these pretexts for access restrictions lack any validity, as market participants face the clearinghouse and do not have bilateral counterparty credit risk to each other. As a result, the CFTC specifically provided that, in accordance with Dodd-Frank's impartial access requirement, any eligible contract participant can demonstrate financial soundness for purposes of SEF participation by either (i) being a self-clearing member or (ii) having a clearing arrangement in place with a clearing member.[40]

Recent developments with respect to the implementation of the similar requirement for non-discriminatory access to regulated trading venues under MiFID II suggest that the EU is adopting an equivalent approach, with ESMA prepared to provide additional guidance as necessary.[41] In addition, both the UK's Fair and Effective Markets Review and the IMF's Global Financial Stability Report highlight the critical importance of impartial access to regulated trading venues in the development of a fairer and more robust OTC derivatives market.[42]

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[39] SB SEF Proposal at 10961.

[40] *See* Core Principles and Other Requirements for Swap Execution Facilities, 78 Fed. Reg. 33476 (June 4, 2013) at 33508.

[41] *See* ESMA Final Report – Draft Regulatory and Implementing Technical Standards MiFID II/MiFIR (Sept. 28, 2015) at page 316, available at: https://www.esma.europa.eu/sites/default/files/library/2015-1858_-_final_report_-_draft_implementing_technical_standards_under_mifid_ii.pdf.

[42] *See* Fair and Effective Markets Review Final Report (June 2015), available at: http://www.bankofengland.co.uk/markets/Documents/femrjun15.pdf ("But it is important to ensure that access to these markets is appropriate, and free from artificial barriers. Access criteria should only exclude participants where absolutely necessary to ensure the effective functioning of the market. Open access requirements should help to remove unnecessary barriers, and support moves to more all-to-all trading."); and IMF Global Financial Stability Report (Oct. 2015), available at: https://www.imf.org/External/Pubs/FT/GFSR/2015/02/index.htm ("Important obstacles to trade automation and the emergence of new market makers remain. New U.S. regulations for over-the-counter (OTC) derivatives markets require that trading platforms provide impartial and open "all-to-all" access. However, some interdealer platforms have resisted inviting nondealers to participate or have required high fees, which may act as a barrier to entry for alternative market makers.").

These same principles are true for SB Swaps – impartial access is critical to improving market conditions and investors should not be excluded from executing cleared transactions on SB SEFs if they are set-up to clear those transactions. We urge the Commission to modify its proposed SB SEF rules to appropriately reflect the Dodd-Frank Act's mandate for impartial access for all market participants. Closed, incumbent dealer-only trading venues make it extremely difficult for new liquidity providers to compete with these incumbents on *any* trading venue, as they do not have access to the same pools of liquidity for pricing and hedging purposes. This ultimately harms investors through reduced liquidity and higher execution costs, and is exactly the result the Commission should strive to avoid.

C. The Clearing and SB SEF Trading Requirements Should Apply to the Activities of U.S.-based Personnel

The Commission has proposed to apply many of its SB Swap rules to swaps arranged, negotiated or executed by personnel located in the United States, regardless of whether the transaction is booked to a non-U.S. entity.[43] This approach makes eminent sense and indicates that the Commission has jurisdiction over those activities under the Dodd-Frank Act, an outcome that is supported by Commission action in other contexts, such as the Volcker Rule[44] and Regulation S.[45]

However, as detailed in our previous comment letter to the Commission,[46] we believe the current proposal to exempt transactions between two non-U.S. persons that are arranged, negotiated, or executed by personnel located in the United States but booked to a non-U.S. entity from the clearing and SB SEF trading requirements is misguided and unsupported by Commission precedent and Congressional intent. In addition to mitigating risk to the U.S. financial system, the clearing and trading requirements enable greater pre-trade price transparency and competition, ultimately yielding lower execution costs and more choice for investors. In its rule proposal on SB SEFs, the Commission states "The current market for SB swaps is opaque, with little, if any, pretrade transparency [. . .] A key goal of the Dodd-Frank Act is to bring trading of SB swaps onto regulated markets."[47] Despite these clear policy objectives and the requirement for the Commission to consider effects on competition as part of its cost-benefit analysis, there is little discussion in the cross-border proposal regarding the competitive impact of exempting these transactions from the clearing and trade execution requirements.

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[43] *See* SEC Cross-Border Proposal. For example, the Commission has proposed to apply the regulatory reporting, public dissemination and business conduct requirements to transactions arranged, negotiated, or executed by U.S. personnel of non-U.S. entities.

[44] *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536, 5655 (Jan. 31, 2014), available at: http://www.gpo.gov/fdsys/pkg/FR-2014-01-31/pdf/2013-31511.pdf.

[45] To qualify for the Regulation S exclusion from the Section 5 registration requirements of the Securities Act of 1933, the securities offering must be made outside the U.S. without any directed selling efforts in the U.S. and the physical location of buyers is taken into account.

[46] Please see our Letter to the Commission dated July 13, 2015, available at: http://www.sec.gov/comments/s7-06-15/s70615-25.pdf .

[47] *See* SB SEF Proposal at 10949.

If the cross-border rule is adopted as proposed, the incumbent dealers will have the ability to use U.S. personnel to trade on behalf of non-U.S. entities on trading platforms outside of the U.S. that may not be subject to equivalent pre-trade transparency or impartial access requirements. This will drain liquidity from SB SEFs and make it more difficult for smaller U.S. dealers and other U.S. market participants to enter the market and compete with the incumbent dealers on a level playing field, as they will not have the same capabilities to access the offshore pools of liquidity for pricing and hedging purposes.[48]

Without providing a detailed analysis of the competitive impact of its cross-border proposal, the Commission asserts that the proposal protects non-U.S. persons from the "significant burden" of having to enter into an arrangement to allow them to clear at a U.S. clearinghouse.[49] We urge the Commission to reconsider the significance of any such burden, given that the market participants most likely to benefit from the current proposal are the incumbent dealers that already have clearing arrangements in place in the U.S. In addition, any such burden should decrease over time as more and more jurisdictions around the world implement mandatory clearing requirements and market participants establish relationships with clearing members covering multiple products and clearinghouses globally.

We urge the Commission to reconsider its proposal and avoid granting wide-ranging exemptions that affect all SB Swaps, even those single-name CDS instruments that are sufficiently standardized and liquid in order to be subject to mandatory clearing, as detailed in Section I(C) above. Any questions relating to the scope of an eventual mandatory clearing or trading requirement for certain SB Swaps should be addressed in the context of those specific rulemakings, rather than in an overarching cross-border rule. Retaining jurisdiction over the activities of U.S. personnel of non-U.S. entities provides the Commission with the necessary flexibility to make targeted decisions down the road and will help ensure the core principles of pre-trade transparency and impartial access remain relevant as the global swaps market continues to evolve.

D. The Portfolio Margining Regime Should Reference the CCP's Margin Methodology

Finally, we believe the Commission should revise its current approach with respect to portfolio margining between single-name and index CDS. As noted in prior comment letters,[50] the Dodd-Frank Act specifically intended to establish an effective portfolio margining regime as

[48] *See, e.g.*, SEC Cross-Border Proposal at 27449 ("To the extent that the large interdealer market shifts in significant part to non-U.S. dealers as a result of current rules, security-based swap activity in the United States could consist of one very large pool of transactions unregulated under Title VII (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.").

[49] *See* SEC Cross-Border Proposal at 27482.

[50] Please see our comment letter to the CFTC on the ICE Clear Credit portfolio margining petition, available at: http://www.cftc.gov/stellent/groups/public/@rulesandproducts/documents/ifdocs/citadelltr122211.pdf and the four comment letters submitted by MFA to the Commission, available at: http://www.sec.gov/comments/s7-13-12/s71312.shtml.

part of transitioning more OTC derivatives to clearing.[51] However, the Commission's current construct – which requires each clearing member to establish its own margin methodology that is different from the margin methodology of the clearinghouse – compromises investors' transparency into margin calculations, undermines a core operational benefit of central clearing, and creates a barrier to entry for new clearing members seeking to provide clearing services to investors.

The requirement for separate clearing member margin methodologies creates significant hurdles for market participants attempting to clear both single-name and index CDS, as there is reduced transparency around the applicable margin methodology and the ability to anticipate and verify margin calls. Clearinghouses provide market participants with the necessary transparency regarding their margin methodologies and tools to estimate future margin changes and to verify margin calls. This degree of transparency is lacking with respect to proprietary clearing member-specific models that all diverge from each other.

The requirement for each clearing member to have its own margin methodology also undermines one of the fundamental benefits of central clearing, which is the ability for all market participants to rely on the same, fully vetted and approved margin methodology maintained by the clearinghouse that utilizes its comprehensive data set of cleared transactions across the market. As stated by IOSCO, one of the main operational benefits of central clearing is the "Elimination of model risk since all counterparties use the CCP's risk model instead of brokers applying their own bespoke models to determine margin requirements."[52] This significant benefit is lost in the Commission's current construct.

Furthermore, the requirement for each clearing member to have its own margin methodology creates a barrier to entry that may dissuade new clearing members from entering the market at a time when overall numbers are declining.

We urge the Commission to use the clearinghouse's vetted and approved margin methodology as the baseline, with clearing members able to collect additional margin as they deem appropriate according to their assessment of a clearing client's credit risk. This will increase transparency and reduce operational risk by allowing all market participants to reference the same margin methodology, lower barriers to entry for new clearing members, and incentivize greater clearing of single-name CDS.

III. Conclusion

The single-name CDS market – which plays a valuable role in our financial markets in terms of capital formation, risk management, and price discovery – is at a critical juncture, with participation and liquidity declining. While industry participants are taking significant steps to attempt to preserve and reinvigorate this critical market, the Commission must move forward and promptly finalize the regulatory framework by completing its SB Swap rules and implementing

[51] *See* Section 713 of the Dodd-Frank Act.

[52] *See* IOSCO's Securities Markets Risk Outlook 2013-2014 at page 55, available at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD426.pdf.

the mandatory clearing requirement for the most commonly traded single-name CDS instruments. In addition, the Commission should make targeted changes to its currently proposed framework with respect to straight-through-processing, impartial access, cross-border application and portfolio margining.

The Title VII reforms – including the reporting, clearing and trading requirements – are critical to improving market conditions for investors in the single-name CDS market. These same reforms have already contributed significant benefits to the index CDS and IRS markets, where investors now benefit from increased transparency, deeper liquidity and lower execution costs. We look forward to these same benefits being unleashed in the single-name CDS market.

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We appreciate the opportunity to provide comments on the Commission's proposed rules for SB Swaps. Please feel free to call the undersigned at [redacted] with any questions regarding these comments.

Respectfully,

/s/ Adam C. Cooper

Senior Managing Director and Chief Legal Officer

cc: The Hon. Mary Jo White, Chairman

The Hon. Michael S. Piwowar, Commissioner

The Hon. Kara M. Stein, Commissioner

Stephen Luparello, Director, Division of Trading and Markets

Appendix A

Prior Citadel Comment Letters to the Commission on Title VII Reforms

Date	Subject	Link
June 3, 2011	Implementation timeline and mandatory clearing of single-name CDS	N/A
August 13, 2012	Implementation timeline, mandatory clearing of single-name CDS, straight-through-processing rules and portfolio margining	http://www.sec.gov/comments/s7-05-12/s70512-14.pdf
July 19, 2013	Implementation timeline, mandatory clearing of single-name CDS and straight-through-processing rules	http://www.sec.gov/comments/s7-05-12/s70512-19.pdf
August 21, 2013	Cross-border proposal	http://www.sec.gov/comments/s7-02-13/s70213-47.pdf
July 13, 2015	Cross-border proposal	http://www.sec.gov/comments/s7-06-15/s70615-25.pdf