CITADEL

Citadel Response to the Financial Stability Board's Consultation on the Proposed Framework for Post-Implementation Evaluation of the Effects of the G20 Financial Regulatory Reforms

May 11, 2017

Citadel LLC[1] ("Citadel") appreciates the opportunity to provide comments to the Financial Stability Board (the "FSB") as it develops a framework for evaluating the effects of the G20 financial regulatory reforms.[2]

Citadel is a significant participant in global financial markets. Managing in excess of $26 billion in investment capital, our hedge funds are meaningful investors in a wide range of asset classes, including equities, fixed income, and commodities. In turn, our separate Citadel Securities business is a leading market maker across both the equities and fixed income asset classes, including for credit default swap indices, interest rate swaps, and U.S. Treasuries.

We have a strong interest in the integrity, transparency, efficiency, and stability of global financial markets. As such, we support efforts to comprehensively review the implementation of global financial regulatory reforms. Many of these reforms focused on the OTC derivatives markets, given that these markets were notoriously concentrated, opaque, interconnected, and under-collateralized in the years preceding the financial crisis. Reforms implemented since 2008 have substantially improved the safety and stability of the OTC derivatives markets and have begun to make these markets more fair, open, competitive, and transparent. However, in order to ensure that these objectives are in fact achieved, it is critical to continually assess implementation progress and market impact. This analysis will allow policymakers and regulators to refine and enhance the regulatory framework where appropriate.

Below, we provide our thoughts on the general framework for evaluating the effects of the G20 OTC derivatives reforms. We then provide suggestions on how to apply that framework when evaluating specific components of the reform agenda, including (a) central clearing, (b) trading on regulated trading venues, (c) post-trade transparency, and (d) margin requirements for uncleared OTC derivatives.

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

[2] *See* http://www.fsb.org/2017/04/fsb-consults-on-framework-for-post-implementation-evaluation-of-the-effects-of-the-g20-financial-regulatory-reforms/.

I. The Framework for Evaluating the G20 OTC Derivatives Reforms

When evaluating the implementation of the G20 OTC derivatives reforms, it is important to take into account all of the overarching policy objectives of these reforms, including:

- Mitigating systemic risk
- Enhancing safety and stability
- Improving transparency
- Increasing competition
- Preventing market abuse

Progress towards achieving each of these objectives should be assessed when evaluating specific OTC derivatives reforms. In doing so, it is important to consider not only *whether* a particular market reform has been implemented, but also *how* it has been implemented, and whether differences in implementation have resulted in different outcomes across G20 jurisdictions. By examining areas of divergence across G20 jurisdictions with respect to implementation, policymakers and regulators can start to assess whether a particular approach has been more effective in achieving the objectives detailed above. This type of analysis will be critical in informing future refinements and enhancements to the regulatory framework.

We also recommend that global policymakers and regulators continue to focus on improving the quality of data reporting. Accurately assessing the impact of G20 regulatory reforms requires accurate data, including both transaction-level data and aggregate market data (such as statistics showing the percentage of *new* interest rate swaps that are cleared vs. uncleared by type of market participant). We strongly support efforts to increase harmonization across G20 jurisdictions with respect to data reporting.[3]

II. Applying the Framework to Specific OTC Derivatives Reforms

A. Central Clearing

<u>*Policy Objectives*</u>

Requiring market participants to centrally clear standardized OTC derivatives is intended to accomplish several objectives. One fundamental objective is mitigating systemic risk by reducing interconnectedness and replacing the complex web of bilateral counterparty credit exposures with a simple model where all market participants face a clearinghouse, or central counterparty ("CCP"). Investors are protected from the default of their trading counterparties by the CCP's risk management and default management frameworks, as well as by having their collateral held at the CCP rather than on the balance sheets of their trading counterparties.

[3] *See, e.g.*, Harmonisation of critical OTC derivatives data elements (other than UTI and UPI) – second batch, CPMI-IOSCO (October 2016), available at: http://www.bis.org/cpmi/publ/d153.pdf.

The obligation to centrally clear standardized OTC derivatives is also fundamental to achieving the objectives of increasing transparency and competition in the OTC derivatives markets. The ongoing counterparty credit exposure inherent in uncleared OTC derivatives requires bilateral trading and credit support documentation to be entered into by each and every pair of trading counterparties in the market. The cost and complexity of entering into these agreements limits access to, and choice of, trading counterparties. Central clearing eliminates the need for such documentation, as trading counterparties do not have ongoing counterparty credit exposure to each other. As a result, investors can access cleared markets more easily and enjoy a greater choice of trading counterparties. Eliminating complex and burdensome documentation also removes a material barrier to entry in the market, improving competition.

The clearing obligation is also interlinked with the trading obligation for OTC derivatives, which is designed to transition the trading of standardized OTC derivatives onto regulated, transparent, and competitive trading venues. In order to be a subject to the trading obligation, an OTC derivative must first be subject to the clearing obligation in a particular jurisdiction. As a result, the scope of a jurisdiction's clearing obligation directly impacts the degree to which transparency and competition can be increased through the implementation of other G20 reforms.

Evaluating the Success of the Reforms

When evaluating the effects of a particular jurisdiction's clearing obligation, and whether it has achieved the objectives detailed above, it is important to consider both (i) the scope of counterparties covered and (ii) the scope of the instruments covered. In this regard, we note that:

- The EU has recently delayed the implementation of its clearing obligation for "smaller financial counterparties" until June 2019 [4] and has separately proposed permanent exemptions for certain of these counterparties.[5] These proposed exemptions are materially broader than existing exemptions under US rules for financial counterparties.[6]

- The scope of the EU clearing obligation is narrower than in the US, including with respect to (a) the covered credit default swap indices (e.g. CDX), and (b) the covered currencies for interest rate swaps (e.g. AUD, CAD, MXN).

In order to assess the significance of any divergence with respect to implementation, it would be helpful to collect data regarding (i) number of new transactions that are cleared vs. uncleared by market participant type, (ii) average daily notional amounts that are cleared vs. uncleared by market participant type, and (iii) number of active bilateral trading relationships for uncleared OTC

[4] *See* Commission Delegated Regulation (EU) 2017/751 of March 16, 2017, available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0751&from=EN.

[5] *See* Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 648/2012 (May 4, 2017), available at: http://europa.eu/rapid/press-release_IP-17-1150_en.htm.

[6] US rules provide an exemption for smaller credit institutions with less than $10 billion in assets. The US framework also has a separate end-user exemption, but that only applies to non-financial entities that are hedging or mitigating commercial risk. *See* End-User Exception to the Clearing Requirement for Swaps, 77 FR 42560 (July 19, 2012), available at: http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2012-17291a.pdf.

derivatives that continue to exist. This type of data can help to assess whether systemic risk is being effectively mitigated and whether the clearing obligation is effectively supporting the market's transition to more transparent and competitive trading.

B. Trading on Regulated Trading Venues

Policy Objectives

Prior to the financial crisis, the OTC derivatives markets were opaque, the price discovery process was cumbersome and inefficient, and bid-ask spreads were disproportionately wide. Further, the market was largely concentrated among a handful of too-big-to-fail incumbent dealers. As a result, a key element of the G20 reforms was to transition the trading of standardized and liquid OTC derivatives onto transparent and competitive trading venues.[7] The US market's transition began in early 2014 when certain interest rate swaps and credit default swaps were required to be transacted on swap execution facilities.

Evaluating the Success of the Reforms

Similar to the clearing obligation, it is important to consider both (i) the scope of counterparties covered and (ii) the scope of the instruments covered when evaluating the effects of a particular jurisdiction's trading obligation. In this regard, we note that:

- The implementation timing for the EU trading obligation remains unclear.
- The scope of counterparties covered by the trading obligation in a given jurisdiction is linked to the scope of counterparties subject to the clearing obligation, as discussed above.
- ESMA's initial proposal regarding the scope of instruments covered by the EU trading obligation was significantly narrower than the current US trading obligation.[8]

It is also important to consider whether there are any other differences in a particular jurisdiction's implementation that could affect whether the trading obligation has been successful in achieving its stated objectives. For example, the continued presence of discriminatory access barriers on trading venues in a particular jurisdiction may hinder the entry of new liquidity providers, impacting overall market competition and liquidity. In addition, allowing market participants the flexibility to execute transactions away from trading venues and to merely report them into trading venues post-execution may reduce the extent to which the OTC derivatives trading obligation actually improves price transparency and competition.

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[7] *See* "G20 Leaders Statement: The Pittsburgh Summit," Sept. 25, 2009, available at: http://www.g20.utoronto.ca/2009/2009communique0925.html ("All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate").

[8] *See* Discussion Paper on the trading obligation for derivatives under MiFIR, available at: https://www.esma.europa.eu/sites/default/files/library/2016-1389_dp_trading_obligation_for_derivatives_mifir.pdf.

In order to assess the significance of any divergence with respect to implementation of the trading obligation, it would be helpful to collect data regarding (a) bid-ask spreads, (b) implicit and explicit transaction costs, and (c) the availability of streaming prices to investors from liquidity providers. In the US market, for example, we have observed more than a 50% decrease in bid-offer spreads in USD interest rate swaps since January 2015 *(see Annex 1)*. We also note the Bank of England research finding that US clearing and trading reforms led to a significant improvement in liquidity and a material reduction in execution costs, with end-users saving as much as $7 million - $13 million per day.[9] More research in this regard would be helpful in continuing to assess the market impact of the trading obligation for OTC derivatives.

C. Post-Trade Transparency

Policy Objectives

The G20 reforms also sought to address the opacity of the OTC derivatives markets by increasing post-trade transparency. This increases investor confidence by providing the information necessary to better assess execution quality and spurs increased competition by minimizing information asymmetries.

Evaluating the Success of the Reforms

When evaluating the effects of a particular jurisdiction's post-trade transparency regime, it is important to consider (i) the scope of transactions covered and (ii) available exemptions or deferrals. In this regard, we note that it appears that deferrals of up to 4 weeks will be granted under the EU regulatory framework for instruments (a) that are not considered to be "liquid" or (b) that are above a certain size threshold.[10] This contrasts with the US framework, where a maximum delay of 15 minutes is allowed for large trades above a certain size threshold.[11]

In order to assess the significance of any divergence with respect to implementation, it would be helpful to collect data regarding (i) common liquidity measures, such as bid-ask spreads and price impact, for OTC derivatives covered by real-time reporting requirements, and (ii) total trading activity in instruments that benefit from reporting deferrals. For example, research in the US market suggests that increased post-trade transparency has contributed to improvements in liquidity.[12]

[9] *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 (July 2016), available at: http://www.bankofengland.co.uk/research/Documents/workingpapers/2016/swp580.pdf.

[10] *See, e.g.*, https://www.fca.org.uk/publication/policy/ps17-05.pdf.

[11] *See* Real-Time Public Reporting of Swap Transaction Data, 77 FR 1182 (Jan. 9, 2012), available at: http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2011-33173a.pdf.

[12] *See, e.g.*, Loon, Y. C., Zhong, Z. K., 2014. The impact of central clearing on counterparty risk, liquidity, and trading: Evidence from the credit default swap market. Journal of Financial Economics 112 (1), 91-115; Loon, Y. C., Zhong, Z. K., 2015. Does Dodd-Frank affect OTC transaction costs and liquidity? Evidence from real-time CDS trade reports. forthcoming, Journal of Financial Economics.

D. Margin Requirements for Uncleared OTC Derivatives

Policy Objectives

Not all OTC derivatives are appropriate for central clearing and trading on regulated trading venues. As a result, the G20 reforms imposed higher capital and margin requirements on uncleared OTC derivatives in order to mitigate the greater risk associated with these instruments.[13] Following extensive consultation with market participants regarding how to appropriately calibrate and implement these rules, global regulators started to implement margin requirements for uncleared OTC derivatives in late 2016.

Evaluating the Success of the Reforms

It is important to note that initial margin requirements for uncleared OTC derivatives only apply to a handful of the largest counterparties in the market at this time. Therefore, while data can be obtained regarding the effects on select counterparties, a more holistic market-wide perspective will only be able to be obtained once additional counterparties become subject to initial margin requirements. The vast majority of bilateral OTC derivative trading relationships will not be covered by the requirements until 2019 or 2020 according to the internationally agreed upon phase-in schedule.

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We appreciate the opportunity to provide our perspective to the FSB. Please feel free to call the undersigned at +1 (646) 403-8235 with any questions regarding these comments.

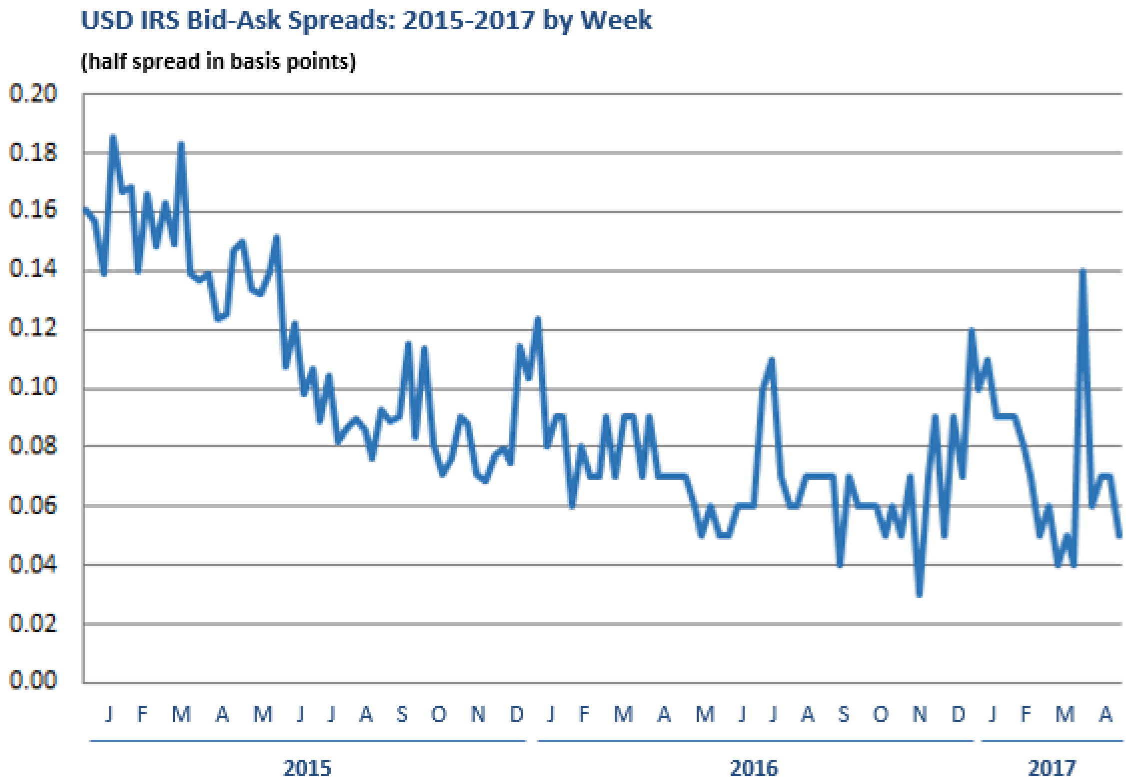
Respectfully,

/s/ Stephen John Berger
Managing Director, Government & Regulatory Policy

[13] *See supra* note 7 and "Margin requirements for non-centrally cleared derivatives" BIS-IOSCO, available at: http://www.bis.org/bcbs/publ/d317.htm.

Annex 1: Bid-Ask Spread Compression in USD Interest Rate Swaps

Since the beginning of 2015, we have witnessed more than a 50% decrease in bid-offer spreads in USD fixed-to-floating interest rate swaps that are subject to the clearing obligation and trade on swap execution facilities (SEFs).



Sources: 2015 data represents weekly average half spread (mid to executed level) from competitors for all Citadel Securities observed RFQs. 2016 and 2017 data represents the weekly average half-spread (including Citadel Securities) for all Citadel Securities observed RFQs.