CITADEL | Securities

May 15, 2017

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

Re: Capital Requirements of Swap Dealers and Major Swap Participants (RIN 3038–AD54)

Dear Mr. Kirkpatrick:

Citadel Securities[1] ("Citadel") appreciates the opportunity to provide comments to the Commodity Futures Trading Commission (the "Commission") on its proposal to establish capital requirements for certain swap dealers ("SDs") that are not subject to the capital rules of a Prudential Regulator (the "Capital Proposal").[2]

SD capital requirements are an important component of the OTC derivatives market reforms and are intended to promote market safety, stability, and integrity. The requirements nevertheless should be appropriately calibrated to the risks posed by a particular firm's dealing activities and should be flexible enough to permit a diverse array of SDs to serve the market. Absent such calibration and flexibility, there is a real risk that liquidity provision will be adversely affected (due to firms reducing the amount of capital deployed in the market) and that smaller firms will potentially exit the market (or refrain from entering it), concerns highlighted by Acting Chairman Giancarlo in his statement accompanying the Capital Proposal.[3] A SD ecosystem that includes both large and small players, along with a range of business models, will best meet the liquidity needs of all swap market participants and will ensure that risk is appropriately distributed across the market.

We commend the Commission for attempting to increase the flexibility of the Capital Proposal by including two different options for compliance for financial firms – the bank-based approach and the net liquid assets approach – but remain concerned that both of these options merely replicate legacy approaches to calculating capital requirements that in large part have been developed by other regulators, and specifically for other markets. We urge the Commission to consider targeted modifications to these legacy approaches that are designed to reflect its statutory mandate and the dramatic evolution of the swaps market, in particular the significant expansion of

[1] Citadel Securities is a leading global market maker across a broad array of fixed income and equity products. Our unique set of capabilities and tools are designed to drive down the cost of transactions, helping to meet the liquidity needs of asset managers, banks, broker-dealers, hedge funds, government agencies, and public pension programs. We strive to provide the most efficient execution and the highest caliber of services, making markets more fair and accessible for all.

[2] 81 Fed. Reg. 91252 (Dec. 16, 2016) (the "Capital Proposal").

[3] *See* Capital Proposal at 91334.

central clearing, which has mitigated systemic risk and reduced interconnectedness. Specifically, we recommend that:

- Standardized market risk and credit risk charges should be appropriately calibrated for cleared OTC derivatives;
- Standardized market risk charges for FX NDFs should reflect the liquidity characteristics of those instruments and should account for a broader range of hedging activities;
- Minimum capital requirements should maintain a level competitive playing field and should be appropriately calibrated for cleared OTC derivatives; and
- Implementation timeframes should accommodate the internal model approval process.

I. The Standardized Market Risk and Credit Risk Charges Should Be Appropriately Calibrated for Cleared OTC Derivatives

A. Market Risk Charges for Cleared OTC Derivatives

The Commission appears to propose that SDs calculate market risk charges for cleared swaps based on the amount of initial margin required by a clearing organization (a "CCP").[4] Specifically, SDs that are self-clearing members would take a charge equal to 100% of the applicable initial margin requirement, while other SDs would take a charge equal to 150% of the applicable initial margin requirement.[5] This approach would be consistent with the current treatment of futures under §1.17.

We strongly support calculating standardized market risk charges for cleared instruments by reference to the initial margin requirements of the relevant CCP. These margin requirements have been calculated using Commission-approved quantitative risk models and are specifically designed to accurately measure the risks associated with a cleared swap portfolio. We therefore urge the Commission to clarify that market risk charges for cleared swaps should be calculated by reference to CCP margin requirements *regardless* of whether a SD elects to use the bank-based approach or the net liquid assets approach.[6]

The Commission should also reconsider its proposal to apply a higher market risk charge to SDs that are not self-clearing members. All cleared OTC derivative positions, whether self-cleared by a SD or cleared through a clearing member, are secured by initial margin posted by the SD and benefit equally from the risk management and default management frameworks of the CCP. It should therefore be sufficient for all SDs to take a market risk charge equal to the CCP's initial margin requirement. The arbitrary application of higher market risk charges to SDs that are not

[4] *See* Capital Proposal, §1.17(c)(5)(x).

[5] *Id.*

[6] We note that proposed §23.103(b) refers to both §1.17 and §240.18a-1, which may create an inconsistency if different capital charges are specified for the same instrument, as discussed further below.

self-clearing members will likely disproportionately impact smaller SDs, which are less likely to be self-clearing members of a CCP. There is no requirement in the Commodity Exchange Act or Commission rules that a SD must be a self-clearing member of a CCP, and the de facto creation of such a requirement – by placing non-self clearing SDs at a material competitive disadvantage from a market risk charge perspective – risks undermining the diversity of SDs serving the swaps market.

Finally, we urge the Commission to ensure that SDs also registering with the Securities and Exchange Commission ("SEC") as security-based swap dealers are not subject to conflicting requirements with respect to standardized charges. The SEC's initial capital proposal for security-based swap dealers (the "SEC Proposal")[7] appears to propose different and substantially more onerous market risk charges for cleared swaps that are regulated by the Commission than those in §1.17.[8] In order to reduce the potential for conflicting regulation, it must be clear that for both Commission registered SDs and dual registrants, §1.17 governs the treatment of cleared swaps. This would be similar to the approach that the SEC has historically taken to determine market risk charges for futures contracts.[9]

The SEC's divergent approach to standardized market risk charges will also impact dual registrants that portfolio margin cleared swaps and cleared security-based swaps ("SB swaps"), such as index CDS and single-name CDS. Portfolio margining permits a market participant to post an amount of initial margin that reflects the net risk of the combined portfolio of swaps and SB swaps. Under the Commission's approach, the standardized market risk charge for cleared swaps included in this portfolio would be based on the applicable initial margin requirement for the entire portfolio. However, the SEC's proposed standardized market risk charge for cleared SB swaps is based on a percentage of notional value, which is not risk sensitive and thus far more onerous.[10] Applying a notional-based market risk charge in addition to the initial margin-based market risk charge that a firm has already taken for the same positions is excessive and undermines the benefits of portfolio margining. This will discourage SDs from trading instruments that are natural hedges for cleared swaps, such as single-name CDS, negatively impacting overall market liquidity. This approach is also at odds with the statutory requirement for the Commission and the SEC to "adopt rules to ensure that such transactions and accounts are subject to comparable requirements."[11] As a result, we urge the Commission to apply the §1.17 framework for calculating standardized market risk charges to cleared SB swaps held in a portfolio margining account subject to Commission jurisdiction.

[7] 77 Fed. Reg. 70214 (Nov. 23, 2012) (the "SEC Proposal").

[8] *See id.*, §240.18a-1b.

[9] *See* SEC Rule §240.15c3-1, Appendix B.

[10] SEC Proposal, §240.18a-1(c)(1)(vi).

[11] 7 U.S.C. 6d(h).

B. Credit Risk Charges for Cleared OTC Derivatives

The Capital Proposal permits a SD to include receivables from a CCP, a futures commission merchant ("FCM"), or a securities broker in its calculation of net capital, notwithstanding the general requirement to take credit risk charges for unsecured receivables.[12] We support the Commission's decision to retain this aspect of the FCM capital rule and to conform the treatment of receivables from FCMs in respect of cleared swaps.[13] This approach correctly treats margin in respect of cleared swaps and futures as a risk mitigant, recognizing the additional safeguards associated with CCP risk management practices and customer margin segregation requirements.

For the same reasons, the Commission should ensure that funds or securities held at an FCM or CCP in respect of cleared SB swaps can also be included when calculating a firm's net capital. We urge the Commission to coordinate with the SEC to ensure that dual registrants are not subject to conflicting requirements in this regard.

II. The Standardized Market Risk Charges for FX NDFs Should Reflect the Liquidity Characteristics of Those Instruments and Account for a Broader Range of Hedging Activities

The Capital Proposal would effectively apply a higher standardized market risk charge to uncleared FX non-deliverable forwards ("NDFs"), equal to 20% of notional. This is because FX NDFs do not reference the five foreign currencies that have been granted the lower 6% notional charge.[14] However, in other contexts, the Commission has identified the top 31 currencies (by volume) described in the Bank for International Settlements' Triennial Central Bank Survey report on global foreign exchange market activity ("BIS 31") as exhibiting high levels of liquidity.[15] We do not believe that the liquidity profiles of the five reference currencies noted in the Capital Proposal and the other BIS 31 currencies justify such disparate treatment. Further, in the Commission's final rule on margin requirements for uncleared swaps, the standardized initial margin schedule does not differentiate between uncleared FX derivatives based on the reference currency, and instead applies a 6% notional charge to all. We urge the Commission to streamline its treatment of FX NDFs by expanding the reference currencies eligible for the 6% capital charge to include all BIS 31 currencies.

The Commission should also ensure that SDs are permitted to take into account risk mitigating hedging transactions – whether these are futures (including futures transacted on foreign markets), swaps, or SB swaps[16] – if and when the hedging position partially or fully offsets the market risk of the FX NDF.

[12] Capital Proposal, §1.17(c)(2)(ii)(C).

[13] Capital Proposal, §1.17(c)(2)(ii)(D).

[14] Capital Proposal, §1.17(c)(5)(iii)(C)(ii). The standardized market risk charge for uncleared currency swaps depends on the reference currency, with a charge equal to 6% of notional for euros, British pounds, Canadian dollars, Japanese yen, or Swiss francs, and a charge equal to 20% of notional for any other foreign currency.

[15] *See* Letter 13-12 (May 1, 2013).

[16] Capital Proposal, §1.17(c)(5)(ii)(E)-(G).

III. The Minimum Capital Requirements Should Maintain a Level Competitive Playing Field and Should Be Appropriately Calibrated for Cleared OTC Derivatives

A. The Commission Should Not Penalize "Net Liquid Asset" SDs

The Capital Proposal permits a SD that is not an FCM to choose between the bank-based approach and the net liquid assets approach. For each, the Capital Proposal establishes a minimum threshold of $20 million in net capital. However, under the net liquid assets approach, this minimum threshold increases to $100 million in tentative net capital for a SD that wishes to use an internal model.[17] There is no similar increase under the bank-based approach.

This proposed additional capital requirement for SDs using the net liquid assets approach appears to originate from SEC rules that date back to 1998 regarding the use of internal models by SEC registrants.[18] We do not believe that replicating this legacy SEC approach is appropriate for any Commission-regulated SD, and perhaps most notably for a SD that does not deal in any uncleared swaps. More stringent requirements relating to internal model methodologies, as reflected in the Commission's Capital Proposal,[19] coupled with the overall increased use of cleared swaps, should serve to alleviate concerns about the use of internal models. The Commission should ensure that a level competitive playing field is maintained across registered SDs, regardless of whether they choose the bank-based approach or the net liquid assets approach. Imposing a higher minimum capital threshold on SDs electing the net liquid assets approach will impede their ability to use internal models and compete fairly with other SDs in the market.

B. The 8% Margin Requirement Should Not Cover Proprietary Positions in Cleared OTC Derivatives

The bank-based approach and the net liquid assets approach both require a SD to maintain minimum capital equal to at least 8 percent of the sum of the initial margin required for its positions in futures, cleared swaps, cleared SB swaps, uncleared swaps and uncleared SB swaps (the "8 Percent Rule"). The 8 Percent Rule is intended to "serve as a proxy for the level of risk associated with the SD's swap activities and proprietary trading."[20]

We believe that the Commission should exclude futures and cleared OTC derivatives held in a proprietary account from the 8 Percent Rule, given both Commission precedent and the statutory language in the Commodity Exchange Act. This exclusion would be consistent with the treatment of futures under current §1.17, whereby the Commission excluded futures in proprietary accounts from the existing 8 Percent Rule for FCMs "because such positions currently are included in the calculation of adjusted net capital to the extent that uncovered proprietary positions result in a charge or 'haircut' to net capital based on clearinghouse or exchange margin requirements." [21] In addition, as Acting Chairman Giancarlo noted in his statement on the Capital Proposal, the statute

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[17] Capital Proposal, §23.101(a)(1)(ii)(applying the tentative net capital requirements under the SEC Proposal).

[18] SEC Proposal, 77 Fed. Reg. at 70226.

[19] Capital Proposal, Appendix A to § 23.102.

[20] 81 Fed. Reg. 91289.

[21] 68 Fed. Reg. 40835, 40838 (July 9, 2003).

"only cites the risk of uncleared swaps in setting standards for capital."[22] We further note that the Commission previously indicated an intent to consider "reduced capital requirements" for SDs that "execute swaps only on exchanges, using only proprietary funds."[23] Finally, this approach would also be consistent with the SEC Proposal, which excludes cleared SB swaps held in a proprietary account from its version of the 8 Percent Rule.

Central clearing mitigates systemic risk and reduces interconnectedness in the swaps market. The calculation of minimum capital requirements should reflect the distinction between cleared and uncleared swaps.

IV. Implementation Timeframes Should Accommodate the Internal Model Approval Process

The Commission should adopt a compliance schedule that provides sufficient time for all types of SDs to develop internal models and for the Commission or the National Futures Association ("NFA") to approve such models. The Capital Proposal permits SDs to compute market risk and credit risk charges using internal models that are approved by the Commission or the NFA.[24] Approved internal models allow a SD to compute its capital requirements in a more risk-sensitive manner, taking into account risk offsets across related products. A SD using an internal model will therefore, in many cases, have a material competitive advantage from a capital requirement perspective over a SD using the standardized schedule.

We expect that it could take several years for the Commission and the NFA to complete the required reviews of internal models, given the large number of SDs likely to seek model approval and the unique features of each SD's model. The increased complexity of internal models will likely make this review more time-consuming and resource-intensive than the Commission's recent review of industry-standard initial margin models for uncleared swaps.[25] By way of illustration, it took over three years after the SEC adopted its broker-dealer alternative net capital regime for the largest broker-dealers to obtain model approval.[26] The SD model review and approval process could take at least as long.

We note that the Commission has stated that it will seek to leverage model approvals of other regulators, including the SEC, the Federal Reserve and home-country regulators for non-U.S. SDs that receive a comparability determination. Although this approach could help speed-up the model review process, the Commission should ensure that its compliance schedule does not create competitive disparities between SDs that are using models approved by other regulators, on the

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[22] *See* 81 Fed. Reg. at 91333 (emphasis added); Commodity Exchange Act, section 4s(e)(3)(A).

[23] *See* 77 Fed. Reg. 30596, 30610, note 199 (May 23, 2012). We read this statement as intending to apply to all cleared swaps that are executed on an exchange *or* a swap execution facility.

[24] Capital Proposal, §23.102(a).

[25] *See* 81 Fed. Reg. at 91334.

[26] *See* SEC Release No. 57039 (Dec. 21, 2007) (approving JPMorgan Securities Inc.'s internal model to calculate net capital over three years after the SEC's final rule was adopted).

one hand, and those that are seeking model approval for the first time from the Commission and the NFA, on the other hand.

We therefore recommend that the Commission adopt a compliance date that is at least two years from the effective date of a final capital rule. The Commission should also provide that a SD is provisionally approved to use an internal model, subject to continued oversight by the Commission and NFA, if it has submitted a complete application to the Commission or the NFA within one year of the effective date of a final rule. This provisional approval process would encourage SDs to submit their applications on a timely basis, without unduly delaying the effectiveness of capital requirements or penalizing SDs if Commission or NFA resource constraints delay the model review process.

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We appreciate the opportunity to provide comments on the Commission's Capital Proposal. Please feel free to call the undersigned at (646) 403-8235 with any questions regarding these comments.

Respectfully,

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