CITADEL

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Re: The EMIR Refit Proposal

Citadel LLC[1] ("Citadel") appreciates the opportunity to provide comments to the European Commission (the "Commission") on the proposal to further refine and enhance the European Market Infrastructure Regulation (the "EMIR Refit" proposal).[2]

EMIR implements several of the G20 commitments to improve the safety, stability and transparency of the OTC derivatives markets, including (a) central clearing, (b) transaction reporting to trade repositories, and (c) margin requirements for uncleared OTC derivatives. These reforms are essential for a market that was notoriously concentrated, opaque, interconnected, and under-collateralized in the years preceding the financial crisis. However, many EMIR reforms have only been gradually phased-in since its adoption in 2012. For example, while central clearing is now required for the largest financial counterparties when transacting in certain interest rate and credit derivatives, central clearing requirements for more than 90% of EU financial counterparties have been deferred until June 2019.[3]

As implementation of the EMIR reforms continues, we support efforts by the Commission to comprehensively review progress thus far, with a view to simplifying requirements and eliminating disproportionate costs where possible. However, at the same time, we agree with the Commission that is important to ensure that the policy objectives of the EMIR reforms, including mitigating systemic risk and increasing market transparency, are not undermined by changes to the regulatory framework. With these considerations in mind, we provide our feedback below on the Commission's proposals regarding (i) amending the scope of counterparties subject to the clearing

[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* https://ec.europa.eu/info/law/better-regulation/initiatives/com-2017-208_en.

[3] Both "Category 1" and "Category 2" entities are subject to the clearing obligation for certain interest rate derivatives denominated in EUR, GBP, USD, or JPY. "Category 1" entities (and "Category 2" entities from 9 August 2017) are also subject to the clearing obligation for certain interest rate derivatives denominated in NOK, PLN, and SEK, and for certain index credit derivatives. Category 1 entities are clearing members for at least one of the relevant classes of derivatives subject to the clearing obligation. Category 2 entities are (a) financial counterparties or (b) alternative investment funds that are classified as non-financial counterparties, in each case that exceed the notional amount threshold of EUR 8 billion in uncleared OTC derivatives exposure. For the number of financial counterparties in "Category 3", see ESMA Consultation Paper on the Clearing Obligation for Financial Counterparties with a Limited Volume of Activity (July 13, 2016), available at: https://www.esma.europa.eu/press-news/consultations/consultation-clearing-obligation-financial-counterparties-limited-volume.

obligation for OTC derivatives, and (ii) improving the quality of data that is reported to trade repositories. In particular, we believe it is critical that any proposal to narrow the scope of the EU clearing obligation for OTC derivatives is carefully calibrated based on data analysis showing both (a) the amount of *daily trading activity* and (b) the *number of financial counterparties* that would be eligible for the proposed exemption.

I. The Scope of the Clearing Obligation for OTC Derivatives

A central pillar of the G20 reforms is moving trading activity in standardized OTC derivatives into central clearing. Central clearing of derivatives mitigates systemic risk and improves conditions for *all* market participants by protecting customers and enhancing pricing, liquidity, and transparency. The risk mitigation and customer protection benefits of central clearing go far beyond introducing disciplined collateralization of trades, reforms that are also gradually being phased-in for uncleared OTC derivatives. In particular, central clearing greatly simplifies an otherwise complex, interconnected web of bilateral counterparty credit exposures. It protects market participants from the default of their trading counterparties, and safeguards customer collateral, which is held at a CCP rather than on the balance sheet of trading counterparties. Open positions are managed in accordance with risk management and default management frameworks that must satisfy strict regulatory requirements relating to stress testing, model back testing, and available financial resources. CCPs also facilitate multilateral netting and compression, improve collateral management and trade reconciliation, and increase transparency around end-of-day pricing, all of which serve to reduce systemic risk.

Given these unique and superior risk mitigating benefits of central clearing, it is critical that any proposal to narrow the scope of counterparties subject to the EU clearing obligation for OTC derivatives is closely scrutinized. Data shows that, although the scope of instruments covered by the EU clearing obligation is materially similar to the US, the EU significantly lags the US in terms of the percentage of trading activity in these instruments that is actually cleared. According to the FSB, "the clearing rate for new interest swaps has reached 87% in the US, while the comparable figure for the EU as a whole is 62%."[4] For credit, the clearing rate for new index CDS is estimated at 80% in the US, while the clearing rate for OTC credit derivatives is only 37% in the EU.[5]

These statistics reflect the fact that the EU clearing obligation, as phased-in to date, applies to *many fewer* market participants than the US clearing obligation, since many financial counterparties are not yet required to clear in the EU. Implementing broad new exemptions from the EU clearing obligation for smaller financial counterparties risks making this divergence permanent, as the US framework only contains a narrow exemption for credit institutions with less than $10 billion in assets (and does not exempt other types of financial counterparties, such as investment funds, asset managers, and insurance companies).[6]

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[4] *See* FSB Review of OTC derivatives market reforms: Effectiveness and broader effects of the reforms (June 29, 2017) at page 12, available at: http://www.fsb.org/wp-content/uploads/P290617-1.pdf.

[5] *Id.*

[6] We note that 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.

While the introduction of limited exemptions from the clearing obligation may be warranted for proportionality reasons, any such exemptions should be carefully calibrated based on data analysis showing both (a) the amount of new *daily trading activity* (or turnover) and (b) the *number of financial counterparties* that would be eligible for the proposed exemption. This data analysis is necessary to fully evaluate the impact of the proposal, as systemic risk can arise not only from the volume of new trading activity that remains uncleared, but equally from the number of bilateral counterparty credit exposures that persist. While any single "small financial counterparty" is extremely unlikely to raise concerns from a systemic risk perspective in isolation, the sheer number of bilateral counterparty credit exposures that persist can be a source of systemic risk when considered in aggregate, something that the Commission has noted from the financial crisis.[7]

Unfortunately, much of the data considered in the EMIR Refit proposal appears to be borrowed from an ESMA analysis that utilized data from 2015, which is before the EU clearing obligation went into effect.[8] This data fails to show how much ongoing daily trading activity would be covered by the proposed exemptions, an important omission given the difference in clearing rates between the EU and US cited above.[9] In turn, the data does show that a large number of financial counterparties may be eligible for the proposed exemptions, as for example, more than 5,000 entities are classified as "small financial counterparties" trading interest rate derivatives.[10]

We urge the Commission to further refine the analysis by leveraging data from trade repositories and CCPs in order to obtain clarity on the amount of daily trading activity and the number of financial counterparties that would be eligible for any exemptions to the EU clearing obligation. In the absence of more accurate data, we believe the Commission should adopt a cautious approach when defining the scope of additional exemptions, and focus increased attention on improving market participants' access to clearing. Below we provide suggestions for adopting a more cautious approach with respect to the proposed exemptions, along with further ideas for improving customer access to clearing.

A. Limiting Permanent Exemptions to Very Small Financial Counterparties

With respect to the proposed exemptions from the EU clearing obligation for "small financial counterparties" ("SFCs"), we support several aspects of the EMIR Refit proposal, including:

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[7] *See, e.g.,* Communication from the Commission on further changes to EMIR, available at: https://ec.europa.eu/info/sites/info/files/170504-emir-communication_en.pdf ("The financial crisis demonstrated that the lack of transparency in the derivatives sector and the complex interdependence between financial market participants increased uncertainty in times of stress and posed risks to global financial stability").

[8] *See* Impact Assessment accompanying the EMIR Refit proposal at page 31, available at: https://ec.europa.eu/info/law/better-regulation/initiatives/com-2017-208_en.

[9] We note that the ESMA data instead looked at outstanding notional amounts on a given date, which is a much different analysis. Please see our comment letter to ESMA explaining why we believe ESMA's analysis significantly understated the trading activity of smaller financial counterparties (available at: https://www.esma.europa.eu/press-news/consultations/consultation-clearing-obligation-financial-counterparties-limited-volume).

[10] *See* supra note 8.

- Applying the clearing obligation in full to an SFC as long as it exceeds the relevant threshold for at least one asset class. Once an SFC exceeds a single threshold, it will be required to obtain access to clearing and enter into a clearing agreement, which it should then be able to utilize for other types of OTC derivatives that must be cleared. We note the Commission should clarify that, similar to how the clearing thresholds are applied to non-financial counterparties, SFCs should calculate trading activity on a gross basis, including both cleared and uncleared OTC derivatives.

- Expanding the financial counterparty definition to include alternative investment funds ("AIFs") that are organized in the EU.[11] This will help ensure a level playing field for entities engaged in financial activities.

However, we believe the Commission should further refine the proposed exemptions to ensure that they only apply to very small financial counterparties. This will help prevent the development of a bifurcated market for standardized OTC derivatives, which was a concern noted in the Commission's impact assessment.[12] One example would be further calibrating how the proposed exemptions apply to investment funds managed by the same investment manager. Applying the relevant thresholds to each fund individually does not accurately reflect the aggregate trading activities of the investment manager. Experience with implementing the US clearing obligation shows that investment managers and their investment funds were able to successfully obtain access to clearing. Modifications that would more accurately reflect the role of the investment manager include (a) calculating the thresholds at the manager level, or (b) applying the clearing obligation in full to a group of funds of a given manager as long as one fund is independently subject to the clearing obligation. Otherwise, the proposed exemptions risk excluding a material amount of daily trading activity and a large number of financial counterparties.

B. Shortening the Temporary Exemption for Pension Scheme Arrangements

EMIR Refit proposes to extend the temporary exemption from the EU clearing obligation for pension scheme arrangements by three years, with a possible further extension of another two years. While we support a temporary extension in lieu of a permanent exemption, we are concerned that the additional delay of up to five years is too long to properly incentivize the investment of resources necessary to develop a clearing solution for pension schemes. A shorter implementation timeline provides the commercial rationale for CCPs, clearing members, and service providers to invest in expanding their clearing offerings, given the increased clearing activity that can be expected to occur in the near term.

C. Improving the Clearing Obligation Procedure

While the scope of the EU clearing obligation in terms of instruments covered is very similar to the US clearing obligation, there is one notable exception. For credit derivatives, the EU clearing obligation only includes one of the two major index groups - iTraxx and not CDX. This

[11] We note the current drafting in the EMIR Refit proposal should be clarified to avoid inadvertently capturing all alternative investment funds, regardless of domicile.

[12] *See* supra note 8 at page 110.

is because no European CCP was authorized to clear CDX at the time ESMA conducted its initial assessment of credit default swap indices.[13]

LCH SA subsequently introduced clearing for certain CDX indices. However, due to issues with the formal process for notifying ESMA of additional instruments cleared by EU CCPs, this expanded offering by LCH SA has only recently been reflected in the ESMA Public Register.[14] ESMA highlighted its concerns to the Commission regarding the current process for updating the public register,[15] and we urge that this be addressed as part of EMIR Refit.

We do not believe, however, that any significant changes are required to how the classes of OTC derivatives are defined for purposes of the EU clearing obligation. The product characteristics used to specify the classes of derivatives subject to the clearing obligation provide the appropriate level of granularity and closely replicate those used by the CFTC for purposes of defining the US clearing obligation.[16] Increasing the level of granularity to include additional contractual specifications would create opportunities for evasion.

D. Enhancing Access to Clearing

We strongly support efforts by policymakers and regulators to expand client access to clearing. As such, we commend the Commission on proposing revisions to the leverage ratio that will recognize the exposure reducing effect of client initial margin. Clearing members have indicated that this change should have a significant positive impact on their commercial metrics.[17]

In addition, we support the proposed requirement that clearing members must provide clearing services on fair, reasonable, and non-discriminatory ("FRAND") commercial terms. FRAND requirements have been used in a variety of contexts, such as licensing arrangements, to provide appropriate constraints on the commercial terms imposed by firms that may have a dominant market position or a patent that is essential for broader use.[18] While we do not believe that this requirement should be interpreted to prohibit clearing members from taking into account firm-specific credit or risk considerations when negotiating clearing arrangements, requiring clearing

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[13] *See* ESMA Consultation Paper: Clearing Obligation under EMIR (no. 2) (July 11, 2014) at page 11, available at: https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-800.pdf.

[14] *See* Public Register for the Clearing Obligation under EMIR (last update June 1, 2017) at page 20, available at: https://www.esma.europa.eu/sites/default/files/library/public_register_for_the_clearing_obligation_under_emir.pdf.

[15] *See* EMIR Review Report no.4 (August 13, 2015) at pages 13-14, available at https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2015-1254_-_emir_review_report_no.4_on_other_issues.pdf.

[16] *See, e.g,* "CFTC Announces that Mandatory Clearing for Category 2 Entities Begins Today" (June 10, 2013), available at: http://www.cftc.gov/PressRoom/PressReleases/pr6607-13.

[17] *See, e.g.*, "FIA Global requests segregated margin be excluded from Basel III Capital Requirements" (Nov. 20, 2014), available at: https://fia.org/articles/fia-global-requests-segregated-margin-be-excluded-basel-iii-capital-requirements.

[18] *See, e.g.*, J. Gregory Sidak, The Meaning of FRAND, Part I: Royalties, 9 J. COMPETITION L. & ECON. 931, (2013), available at http://www.criterioneconomics.com/meaning-of-frand-royalties-for-standard-essential-patents.html.

members to comply with core principles relating to fairness and non-discrimination is helpful in mitigating potential conflicts of interest. Given that the firms currently offering clearing services for OTC derivatives are exclusively banks, it is important to consider that the commercial interests of a bank's trading business may not be aligned with those of its clearing business. In particular, given the higher profit potential on *uncleared* trades, trading businesses may not be incentivized to support an expansion of client clearing offerings. Imposing a FRAND requirement will help to mitigate these potential conflicts.

An additional step to mitigate these conflicts is to ensure that a firm's clearing business is actually operating independently of its trading business. This requirement has been successfully implemented in the US, with the CFTC specifically prohibiting bank trading personnel from directly or indirectly attempting to influence clearing personnel regarding whether to offer clearing services to a particular customer or the associated commercial terms.[19] We urge the Commission to consider adopting similar requirements in order to remove potential impediments that are impacting client access to clearing.

Finally, we note that providing broad permanent exemptions from the clearing obligation, however well-intentioned, may do more harm than good by undermining efforts to improve client access to clearing. By reducing anticipated growth in clearing volumes, broad permanent exemptions may dis-incentivize CCPs, clearing members, and service providers from investing in expanding their offerings.

II. Improving Data Quality in Trade Repositories

We strongly support efforts by policymakers and regulators to improve the efficiency and accuracy of data reporting. Ensuring timely access to accurate and comprehensive data assists with analyzing specific market events and trends, informing policy decisions, and improving general monitoring and surveillance. Therefore, we commend the Commission for proposing changes to streamline the EMIR reporting rules, including designating CCPs as responsible for reporting exchange-traded futures transactions and reducing the reporting burdens for non-financial counterparties. In this regard, we urge the Commission to consider whether further steps could be taken to streamline the reporting obligations of financial counterparties, such as by designating one counterparty as responsible for the reporting obligations.

We also support requiring trade repositories to have appropriate policies and procedures relating to data quality, validation, and reconciliation. Therefore, we agree that trade repositories should grant market participants access to data reported on their behalf in order to allow for a verification of its accuracy. We note that, in the event a trade was executed anonymously, this data verification should not include any data that would identify the other counterparty.[20]

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[19] §23.605(d), 77 Fed. Reg. 20128 at 20211, available at: http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2012-5317a.pdf.

[20] See the CFTC rule on "Swap Data Repositories - Access to SDR Data by Market Participants", 79 Fed. Reg. 16672, available at: http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2014-06574a.pdf.

We appreciate the opportunity to provide our comments to the Commission. 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