CITADEL

November 6, 2018

Steven Maijoor
Chairman, ESMA

Re: ESMA Statistical Report on EU Derivatives Markets (October 2018)

Citadel[1] commends ESMA on the recent publication of its first annual statistical report on EU derivatives markets (the "Report").[2] This type of in-depth data-driven research and analysis is essential to understand market developments, evaluate the impact of policy decisions, and detect potential risks to market stability. For the OTC derivatives markets, the ability to leverage available EU Trade Repository data is particularly significant given the overall lack of transparency that existed prior to the implementation of EMIR and MiFID II.

We appreciate the comprehensive analysis that ESMA conducted to produce the Report, and its quality is a testament to the diligent work of ESMA staff. Nevertheless, as ESMA noted that it would welcome feedback in order to continue to improve the data and metrics presented, we would like to take the opportunity to provide several recommendations for enhancing how ESMA measures clearing rates for OTC derivatives in the EU. We believe clearing rates are a particularly important metric for measuring progress in implementing the EMIR clearing obligation.

Specifically, to enhance the measurement of clearing rates, we recommend that ESMA:

- **Include OTC derivatives trading activity that is conducted on MTFs or OTFs**. ESMA's current methodology excludes all of this trading activity, which leads to an inaccurate clearing rate, particularly as more trading activity transitions onto MTFs and OTFs under MiFID II (including pursuant to the derivatives trading obligation). The fact that certain interest rate swaps and credit default swaps are now cleared and may also be executed on an MTF or OTF should not result in these contracts (heretofore all classified as OTC derivatives) suddenly being reclassified as exchange-traded derivatives (or ETDs). The OTC derivatives market, whether cleared or uncleared, and whether executed bilaterally or on an MTF or OTF, remains distinct from the ETD market.

- **Include the trading activity of all uncleared OTC derivatives**. ESMA's current methodology only includes the trading activity of uncleared OTC derivatives that are considered to be "eligible for clearing." This overstates clearing rates and is inconsistent with the methodology used in other jurisdictions.

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[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, Dublin, Hong Kong, and Shanghai.

[2] *See* https://www.esma.europa.eu/press-news/esma-news/esma-data-analysis-values-eu-derivatives-market-%E2%82%AC660-trillion-central-clearing (the "Report").

- **Introduce a clearing rate measure that is based on transaction-by-transaction "flow" data**. ESMA's current methodology only uses "stock" data that reflects outstanding notional amounts at a given point in time. This leads to an inaccurate clearing rate given that such "stock" data does not measure the percentage of newly executed trades that are being cleared, includes legacy positions, and does not accurately account for the relative impact of compression activities in both the cleared and uncleared markets.

We close the letter by suggesting several additional metrics that would be helpful for ESMA to monitor in relation to EU derivatives markets, particularly in light of the recent implementation of MiFID II.

I. Enhancing ESMA's Methodology For Calculating Clearing Rates

A. Include OTC Derivatives Executed on a Trading Venue

ESMA's current methodology excludes OTC derivatives executed on an MTF or OTF when calculating the clearing rate.[3] This yields an inaccurate clearing rate given that significant trading volumes in both cleared and uncleared OTC derivatives occur on MTFs and OTFs. Further, this volume will only increase over time following the recent introduction of the MiFID II derivatives trading obligation.

Throughout the Report, ESMA appears to suggest that only exchange-traded derivatives ("ETDs") can be executed on an MTF or OTF.[4] This is incorrect, clearly demonstrated by the fact that the MiFID II derivatives trading obligation requires certain cleared OTC derivatives to be traded on MTFs and OTFs. The fact that an OTC derivative contract is now cleared and may also be executed on an MTF or OTF does not turn it into an ETD.

For example, consider a 10Y EUR interest rate swap. This OTC derivative is subject to both the EMIR clearing obligation and the MiFID II derivatives trading obligation. As a result, trading activity in this OTC derivative:

- may be cleared (if both parties are subject to the clearing obligation or voluntarily choose to clear) or uncleared (if one or both parties are not subject to the clearing obligation and choose not to voluntarily clear); and

- may be traded on an MTF or OTF (if both parties are subject to the trading obligation or voluntarily choose to transact on a trading venue) or can occur off-venue (if one or both parties are not subject to the trading obligation and choose to trade off-venue).

[33] Report at page 29 ("only records with 'Venue of execution' "XXXX" or "XOFF" (respectively the MIC codes for OTC and off-exchange transactions for listed instruments) have been retained").

[4] *See, e.g.,* Report at pages 9 and 22. We note that in other areas of the Report, ESMA correctly differentiates between futures (ETDs) and swaps/FRAs (see Report at page 35, ASRD-S.16). Calculating clearing rates by contract type could be one potential way of addressing the misclassification issue identified herein.

As shown, trading activity in OTC derivatives can be grouped into four buckets: (1) executed on-venue and cleared, (2) executed on-venue and uncleared, (3) executed off-venue and cleared, and (4) executed off-venue and uncleared. All of this trading activity in OTC derivatives must be taken into account when calculating statistics such as clearing rates. There is no basis for excluding OTC derivatives trading activity that occurs on MTFs and OTFs.

Finally, ESMA's current methodology also would appear to result in *off-venue* trading activity conducted with a systematic internaliser ("SI") being incorrectly classified as *on-venue* trading, since SIs are assigned MIC codes much like trading venues. This is significant as nearly all of the off-venue trading activity in OTC derivatives should now be executed with an SI following the implementation of MiFID II.[5] Going forward, ESMA's methodology should ensure that OTC derivatives trading activity with SIs is not classified as on-venue trading.

B. Include All Trading Activity in Uncleared OTC Derivatives

ESMA's current methodology for calculating the clearing rate only takes into account the trading activity of uncleared OTC derivatives that are considered to be "eligible for clearing".[6] This methodology overstates the clearing rate, since a significant amount of trading activity in uncleared OTC derivatives is excluded from the denominator in the calculation.[7] We recommend instead that ESMA calculate the clearing rate by taking into account all OTC derivatives trading activity in a particular asset class, consistent with established calculations in other jurisdictions.[8] This will ensure that all trading activity in OTC derivatives is analyzed and will provide a more accurate clearing rate that can be tracked over time as more market participants and instruments gradually transition into central clearing.

This revision to ESMA's current methodology will solve two additional challenges as well:

- First, in order to accurately define the universe of uncleared OTC derivatives that are "eligible for clearing", ESMA would be required to maintain an up-to-date list of each type of OTC derivative that can be cleared at any EEA or non-EEA CCP accessible to EU market participants and then apply that list in a granular manner to the EMIR data set used to calculate clearing rates. We note that ESMA's "Public Register for the Clearing Obligation under EMIR" is not sufficient for these purposes, as ESMA itself has noted that the current

[5] Indeed, the current MIC list referenced in the Report includes over 200 systematic internalisers (See Report at footnote 35; https://www.iso20022.org/10383/iso-10383-market-identifier-codes).

[6] Report at page 28.

[7] For example, in 2017, nearly 78% of the outstanding notional of uncleared interest rate derivatives was in products other than fixed-to-floating swaps, basis swaps, FRAs, or OIS. *See* "Actual Cleared Volumes vs. Mandated Cleared Volumes: Analyzing the US Derivatives Market," ISDA (July 2018) at Chart 12 on page 13, available at: https://www.isda.org/a/6yYEE/Actual-Cleared-Volumes-vs-Mandated-Cleared-Volumes.pdf (the "ISDA Study").

[8] *See, e.g.,* BIS Statistical release: OTC derivatives statistics at end-December 2017 (3 May 2018) at page 4, available at: https://www.bis.org/publ/otc_hy1805.pdf; and ISDA Study at Table 1 on page 3.

notification procedures result in an incomplete public register.[9] The breadth of such a potential list (which will include many more instruments than are covered by the EMIR clearing obligation), and ensuring such a list remains up-to-date, present significant challenges.

- Second, the current methodology will impair analysis of clearing trends over time, as the above list of OTC derivatives "eligible for clearing" continually evolves, yielding a different subset of in-scope uncleared trading activity for the clearing rate calculation at each point in time.

C. Introduce a Clearing Rate Based on "Flow" Data

The Report calculates clearing rates solely based on "stock" measures of outstanding notional amounts on a given date.[10] As acknowledged in the Report, "stock" measures suffer from several drawbacks, as these figures (i) include legacy positions entered into before the EMIR clearing obligation went into effect, and (ii) do not take into account the ongoing compression activities for both cleared and uncleared derivatives that significantly reduce outstanding notional amounts.[11] These limitations make it difficult to use a "stock"-based clearing rate to fully evaluate the implementation of the EMIR clearing obligation, as changes over time could simply reflect terminations of, or amendments to, legacy positions or compression activities, all of which are unrelated to the EMIR clearing obligation.

Clearing rates are therefore typically measured using "flow" data on new trading activity over a defined period of time.[12] In fact, the term "clearing rate" is commonly understood to mean the flow-based measure of the percentage of new derivatives transactions that are centrally cleared, while the term "clearing level" is instead commonly used for the stock-based measure of the percentage of outstanding notional amount that is centrally cleared.[13] We recommend that ESMA conform to this market convention by referring to the measure currently included in the Report as the "clearing level" and by introducing a flow-based "clearing rate" measurement.

The use of "flow" data would enable ESMA to calculate the percentage of new OTC derivatives transactions that are centrally cleared and to better track trends over time. A recent ESRB working

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[9] *See* EMIR Review Report no.4, "ESMA input as part of the Commission consultation on the EMIR Review," (13 August 2015) at Section 4.3, 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.

[10] Report at page 14.

[11] Report at pages 10 and 14. We note that while the Report specifically mentions multilateral compression at CCPs, multilateral compression also takes place for uncleared derivatives, significantly reducing uncleared outstanding notional amounts. For example, see https://www.trioptima.com/media/filer_public/31/f1/31f14682-5137-4ef1-80af-e8bb09835dce/trireduce_general_factsheet.pdf.

[12] *See, e.g.,* ISDA Study.

[13] *See, e.g.,* Incentives to centrally clear over-the-counter (OTC) derivatives: A post-implementation evaluation of the effects of the G20 financial regulatory reforms (7 Aug 2018) at page 17, available at: http://www.fsb.org/wp-content/uploads/P070818.pdf; and BIS Statistical release: OTC derivatives statistics at end-December 2017 (3 May 2018) at page 7, available at: https://www.bis.org/publ/otc_hy1805.pdf.

paper took this approach, finding that less than 50% of new interest rate derivatives and approximately 20% of new credit derivatives entered into in the EU are being centrally cleared.[14] We urge ESMA to validate these ESRB findings and track this measure over time.

II. Additional Recommended Metrics for Monitoring

We recommend that ESMA monitor the following additional metrics in light of the recent implementation of MiFID II:

- **Derivatives Trading Obligation**
  - For each asset class, what percentage of total trading volume occurs on a trading venue?
  - For those OTC derivatives subject to the derivatives trading obligation, what percentage of total trading volume is transacted on an MTF or OTF?
- **Derivatives Transparency**
  - For each asset class, what percentage of total trading volume is subject to pre-trade transparency requirements (i.e. does not receive a waiver)?
  - For each asset class, what percentage of total trading volume receives a deferral from post-trade transparency requirements?
  - What percentage of total trading volume is completely outside of the MiFID II transparency regime due to not being considered "traded on a trading venue"?

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We appreciate the opportunity to provide feedback to ESMA. 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

cc: Verena Ross, Executive Director, ESMA

Steffen Kern, Head of Risk Analysis and Economics Department, ESMA

[14] "Clearinghouse-Five: determinants of voluntary clearing in European derivatives markets," Pawel Fiedor (March 2018) at Figures 1 and 2 on pages 11-12 and accompanying text, available at: https://www.esrb.europa.eu/pub/pdf/wp/esrb.wp72.en.pdf?87d519a1fd278d359b6d5a33499d0e26.