CITADEL

April 23, 2018

ESMA Risk Analysis and Economics Department
103, Rue de Grenelle
FR-75007 Paris

Re: ESMA Report on Trends, Risks and Vulnerabilities No. 1, 2018 – Suggestions Regarding Analysis of the OTC Derivatives Market

Citadel[1] appreciates ESMA's continued focus on analyzing available market data to identify trends, detect potential risks to market stability, and evaluate the impact of policy decisions, including through its reports on trends, risks, and vulnerabilities in EU financial markets. The most recently published report (the "ESMA 2H17 TRV Report") covered the period from 1 July 2017 to 31 December 2017,[2] meaning that subsequent reports will be able to leverage the market data now available as a result of the January 2018 implementation of MiFID II. The newly implemented transaction reporting requirements under MiFID II should provide a wealth of additional information, particularly for the previously opaque OTC derivatives market that proved to be a significant source of systemic risk during the financial crisis.

We provide below several suggestions for how to effectively utilize this additional data in order to increase transparency regarding market practices and trends in the OTC derivatives market.

I. Quantifying the Size of the OTC Derivatives Market in the EU

It is important to accurately quantify the size of the OTC derivatives market in the EU for a variety of reasons, including in order to monitor systemic risk and to evaluate the impact of recently implemented regulatory reforms.

The first step in this process is to accurately define the financial instruments that are considered to be OTC derivatives, and to clearly distinguish them from other instruments, such as exchange traded derivatives ("ETDs"). ETDs include interest rate and foreign exchange futures and options that have always been traded on exchanges, including on Regulated Markets in the EU. In contrast, OTC derivatives are instruments that historically were transacted over-the-counter on a bilateral uncleared basis, such as interest rate swaps and credit default swaps. Many of these instruments are now transitioning to both central clearing and trading on regulated trading venues, such as MTFs and OTFs, as a result of the implementation of the G20 reforms to the OTC derivatives markets.

---

[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 ESMA Report on Trends, Risks and Vulnerabilities No. 1, 2018, available at: https://www.esma.europa.eu/sites/default/files/library/esma50-165-538_report_on_trends_risks_and_vulnerabilities_no.1_2018.pdf.

The most recent ESMA 2H17 TRV Report appears to conflate ETDs and OTC derivatives by classifying all instruments traded on a regulated trading venue (i.e. a Regulated Market, MTF, or OTF) as an ETD, even if the instrument is an interest rate swap or credit default swap.[3] Classifying some interest rate swaps or credit default swaps as ETDs and others as OTC derivatives (a) is contrary to established market practice, (b) is inconsistent with the approach taken by global policymakers, such as the Bank for International Settlements ("BIS"),[4] and (c) hinders efforts to evaluate the impact of recently implemented regulatory reforms across the entire OTC derivatives market. In order to comprehensively assess trends, risks, and vulnerabilities in the OTC derivatives market, it is important to analyze these instruments on a holistic basis, taking into account transactions that are both cleared and uncleared, and that are entered into both on-venue and off-venue.

The second step in the process of accurately quantifying the size of the OTC derivatives market in the EU is to distinguish between and measure both outstanding notional amounts and daily trading volumes. The transaction reporting requirements under MiFID II should assist in analyzing daily trading volume. However, it is important to note that these transaction reporting requirements only apply to OTC derivatives that are considered to be "traded on a trading venue" and therefore will not cover many types of OTC derivatives that are still traded bilaterally off-venue.

II. Evaluating the G20 OTC Derivatives Reforms Implemented by EMIR and MiFID II

Assessing trends, risks, and vulnerabilities in the OTC derivatives market includes evaluating the impact of recently implemented G20 reforms in the EU, including (a) central clearing, (b) the derivatives trading obligation, and (c) pre-trade and post-trade transparency requirements.

A. Central Clearing

A key 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. It is therefore important to track the percentage of daily trading volume in specific types of OTC derivatives, such as interest rate swaps and credit default swaps, that is now cleared.

The most recent ESMA 2H17 TRV Report includes some analysis regarding clearing rates for OTC derivatives.[5] However, this analysis appears to be based largely on data from US swap data repositories.[6] Given that US swap data repositories will not have information regarding transactions between two EU counterparties, this data is only estimated to cover approximately 15% of total trading volume in OTC derivatives predominantly traded in the EU, such as EUR interest

---

[3] See ESMA 2H17 TRV Report at page 51, FN 68.

[4] See "About our data sets", BIS, available at: https://www.bis.org/statistics/about_derivatives_stats.htm ("The exchange-traded derivatives statistics cover the turnover and open interest of **foreign exchange and interest rate futures and options**.").

[5] See ESMA 2H17 TRV Report at page 24.

[6] See ESMA 2H17 TRV Report at page 110, tables A.187 and A.188.

rate swaps.[7] As a result, it is critical that US data is supplemented by data covering all trading activity in the EU.

The transaction reporting requirements under MiFID II should assist in analyzing daily trading volume in the EU, and will indicate whether a particular transaction is cleared or uncleared. As noted above, these transaction reporting requirements only apply to OTC derivatives that are considered to be "traded on a trading venue," and not all OTC derivatives subject to the EMIR clearing obligation meet that standard at the moment. Therefore, it may make sense to initially focus any analysis on those OTC derivatives that are also subject to the MiFID II derivatives trading obligation, as those are all considered "traded on a trading venue" and therefore subject to MiFID II transaction reporting requirements.

B. Derivatives Trading Obligation

The MiFID II derivatives trading obligation implements a key G20 reform that is designed to promote market stability and integrity while improving conditions for investors through increasing market transparency and competition. We recommend that ESMA track, for those OTC derivatives that are subject to the trading obligation, how much daily trading volume is actually occurring on MTFs or OTFs. Initial assessments indicate that a large percentage of daily trading volume in those instruments may still be occurring off-venue.[8] This could indicate that "Category 3" financial counterparties account for more trading volume than previously estimated since these entities are not yet subject to either the clearing obligation or the derivatives trading obligation.

More generally, it would also be useful to market participants for ESMA to provide statistics on monthly trading volumes by MTF or OTF venue and by asset class of OTC derivatives.

C. Pre-Trade and Post-Trade Transparency

MiFID II aims to increase market transparency, benefiting market participants by removing information asymmetries and facilitating more accurate assessments of execution quality. We recommend that ESMA analyze the implementation of the MiFID II pre-trade and post-trade transparency requirements for OTC derivatives. In order to assess whether the current framework is appropriately calibrated, useful metrics should include the percentage of daily trading volume that is receiving either (a) a waiver from pre-trade transparency requirements, or (b) a deferral from post-trade transparency requirements. In addition, it would be useful to assess how much of the OTC derivatives market remains outside of the MiFID II transparency framework entirely due to the instrument not being considered "traded on a trading venue."

* * * * *

[7] "MiFID II: What Should Transparency Look Like?" (July 25, 2017), Clarus Financial Technology, available at: https://www.clarusft.com/mifid-ii-what-should-transparency-look-like/.

[8] "Tradeweb and Bloomberg MTF Market Share" (Feb. 6, 2018), Clarus Financial Technology, available at: https://www.clarusft.com/tradeweb-and-bloomberg-mtf-market-share/.

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