

November 19, 2018

Mr. Eduardo A. Aleman  
Assistant Secretary  
Securities and Exchange Commission  
100 F Street NE  
Washington, DC 20549-1090

**Re: Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants (File Number S7-08-12)**

Dear Mr. Aleman:

Citadel Securities<sup>1</sup> appreciates the opportunity to provide comments to the Securities and Exchange Commission (the “Commission”) following its decision to re-open the comment period (the “Request for Additional Comment”)<sup>2</sup> on the proposal to establish capital, margin, and segregation requirements for security-based swap dealers (“SBSDs”) (the “2012 Proposal”).<sup>3</sup>

We strongly support the continued efforts of the Commission to finalize and implement reforms to the security-based swaps market. These reforms are designed to improve market safety and stability, while increasing transparency and competition for market participants. However, in order to fully realize these intended benefits, it is important that final Commission rules reflect current market conditions and seek to maintain consistency with approaches taken by other regulators overseeing global OTC derivatives markets.

Below, we detail several aspects of the 2012 Proposal that should be revised in order to take into account recent market developments. These include (a) harmonizing capital requirements with those proposed by the CFTC, as detailed in our prior comment letter,<sup>4</sup> (b) applying uncleared initial margin requirements to the inter-dealer market, (c) setting appropriate implementation timelines for the Commission’s SBSB framework, and (d) updating the economic analysis contained in the 2012 Proposal.

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<sup>1</sup> 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.

<sup>2</sup> 83 FR 53007 (Oct. 19, 2018).

<sup>3</sup> 77 FR 70214 (Nov. 23, 2012).

<sup>4</sup> See Citadel Securities Letter dated May 15, 2017, available at: <https://www.sec.gov/comments/s7-08-12/s70812-1752842-151916.pdf>.

## I. Harmonizing Capital Requirements for Nonbank SBSBs with the CFTC

The Request for Additional Comment indicates that the Commission is considering several changes to the proposed SBSB capital requirements set forth in the 2012 Proposal, some of which would increase harmonization with the CFTC's re-proposed capital requirements for swap dealers.<sup>5</sup> Given that many entities are expected to register with both the Commission and the CFTC, establishing consistent requirements should be expected to improve market functioning and liquidity.

We previously submitted comments to both the Commission and the CFTC highlighting areas where further harmonization would be helpful.<sup>6</sup> In particular, we urge the Commission to allow standardized market risk charges for cleared OTC derivatives to be based on the initial margin requirements of the relevant clearinghouse. These margin requirements have been established pursuant to Commission-approved quantitative risk models and are specifically designed to accurately measure the risks associated with cleared OTC derivatives. In addition, this approach would be consistent with the CFTC's re-proposal<sup>7</sup> and would avoid the possibility that Commission and CFTC rules assign different standardized market risk charges to a single position held by a dually-registered entity.

## II. Applying Uncleared Initial Margin Requirements to the Inter-Dealer Market

While the CFTC and prudential regulators have already applied initial margin requirements to inter-dealer transactions,<sup>8</sup> the Commission is considering providing an exemption to this important segment of the security-based swaps market.<sup>9</sup> This means that a nonbank SBSB regulated by the Commission would not be required to post or collect initial margin for uncleared security-based swaps entered into with another nonbank SBSB. The Request for Additional Comment also indicates that this exemption could be further broadened to include transactions with other entities such as broker-dealers, banks, futures commission merchants, foreign banks, and foreign dealers.<sup>10</sup>

We disagree with providing an exemption from uncleared initial margin requirements to the inter-dealer portion of the security-based swaps market. In light of the rules that have already been implemented by other regulators, providing such an exemption risks:

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<sup>5</sup> See, e.g., Request for Additional Comment at Question 1.

<sup>6</sup> See Citadel Securities Letter to the Commission dated May 15, 2017, available at: <https://www.sec.gov/comments/s7-08-12/s70812-1752842-151916.pdf> and Citadel Securities Letter to the CFTC dated May 15, 2017, available at: <https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=61219&SearchText=citadel>.

<sup>7</sup> See 81 Fed. Reg. 91252 (Dec. 16, 2016) at §1.17(c)(5)(x).

<sup>8</sup> See "OTC Derivatives Market Reforms: Thirteenth Progress Report on Implementation," FSB (Nov. 19, 2018) at Appendix D, available at <http://www.fsb.org/wp-content/uploads/P191118-5.pdf>.

<sup>9</sup> Request for Additional Comment at Question 8.

<sup>10</sup> *Id.*

- **Creating an unlevel playing field that negatively impacts nonbank SBSB liquidity.** Promoting the liquidity of nonbank SBSBs was cited as a main policy consideration underlying the Commission’s proposal to exempt inter-dealer transactions from initial margin requirements.<sup>11</sup> However, the 2012 Proposal does not take into account the impact of CFTC and prudential margin rules that apply a “collect-only” approach to uncleared OTC derivatives entered into between two “covered swap entities.” This approach is based on the assumption that both covered swap entities (regardless of regulator) will be subject to harmonized rules and therefore a two-way exchange of initial margin will result. However, consider an uncleared security-based swap entered into between a nonbank SBSB (subject to Commission rules) and a bank SBSB (subject to prudential rules). The bank SBSB would be required to collect initial margin from the nonbank SBSB pursuant to prudential rules, but the nonbank SBSB would not be required to collect initial margin from the bank SBSB pursuant to Commission rules. It is unclear how this would promote the liquidity of the nonbank SBSB.
- **Reducing the likelihood of achieving substituted compliance determinations with other regulators, both domestically and internationally.** Failure to achieve substituted compliance may negatively impact SBSBs regulated by the Commission as they could be subject to overlapping and inconsistent regulatory frameworks, while other types of regulated entities may be able to benefit from a more straightforward substituted compliance process given the internationally-harmonized rules adopted by other regulators.

Further, exempting the inter-dealer portion of the security-based swaps market from uncleared initial margin requirements undermines the regulatory objectives of mitigating systemic risk and promoting central clearing. During the financial crisis, under-collateralized bilateral OTC derivatives, including security-based swaps, served as a source of contagion and transmitted risk throughout the financial system.<sup>12</sup> Ensuring uncleared OTC derivatives were appropriately collateralized was a key element of the G20 reforms,<sup>13</sup> and both the CFTC and prudential regulators specifically concluded that, in order to effectively mitigate systemic risk, it was necessary to apply initial margin requirements to uncleared inter-dealer transactions.<sup>14</sup> The 2012 Proposal does not explain how the Commission could reach a different conclusion.

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<sup>11</sup> 2012 Proposal at 70267.

<sup>12</sup> See, e.g., Shanuka Senarath, “Reframing Credit Default Swaps (CDSs) as Quasi-Insurance,” (August 12, 2014), available at: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2479733](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2479733).

<sup>13</sup> G20, Cannes summit final declaration, available at: <http://www.g20.utoronto.ca/2011/2011-cannes-declaration-111104-en.html>.

<sup>14</sup> See 79 FR 59898 (Oct. 3, 2014) at 59907 (“Recognizing that SDs and MSPs pose greater risk to the markets and the financial system than other swap market participants [. . .] under the mandate of section 4s(e)(3)(C) to preserve the financial integrity of markets trading swaps and to preserve the stability of the United States financial system, the Commission is proposing to require SDs and MSPs to collect initial margin from, and to post initial margin with, one another.”); and 76 FR 27564 (May 11, 2011) at 27571 (“Non-cleared swaps transactions with counterparties that are themselves swap entities pose risk to the financial system because swap entities are large players in swap and security-based swap markets and therefore have the potential to generate systemic risk through their swap activities. Because of their interconnectedness and large presence in the market, the failure of a single

The 2012 Proposal also states that the proposed uncleared margin requirements are intended to promote central clearing of sufficiently standardized products.<sup>15</sup> However, the Commission does not explain how providing an exemption for uncleared inter-dealer transactions is consistent with this regulatory objective. Data shows that voluntary clearing rates increased for inter-dealer transactions following the implementation of uncleared initial margin requirements by other regulators.<sup>16</sup> In contrast, data also shows that bilateral trading is less costly than central clearing if there is an available exemption from the uncleared initial margin requirements.<sup>17</sup> As a result, the Commission’s proposed exemption can be expected to create a disincentive to centrally clear. Even though the Securities Exchange Act of 1934 (“Exchange Act”) affirms that uncleared OTC derivatives pose a “greater risk” to the financial system,<sup>18</sup> only cleared inter-dealer transactions would be subject to initial margin requirements if the Commission were to finalize the proposed exemption, creating an unlevel playing field that discourages central clearing.

We recommend that the Commission reconsider the proposal to exempt the inter-dealer portion of the security-based swaps market from uncleared initial margin requirements. Instead, the Commission should maximize harmonization with those rules already implemented by the CFTC and prudential regulators, as directed by the Exchange Act.<sup>19</sup>

### III. Implementing the Commission’s SBSB Framework

The Request for Additional Comment seeks input on establishing an appropriate implementation timeline for the Commission’s regulatory framework for SBSBs.<sup>20</sup> Finalizing capital, margin, and segregation requirements for SBSBs moves the Commission one step closer to triggering the compliance date for entities to register as SBSBs.<sup>21</sup> Once registered, SBSBs

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*swap entity could cause severe stress throughout the financial system. Accordingly, it is the preliminary view of the Agencies that all non-cleared swap transactions with swap entities should require margin.”).*

<sup>15</sup> 2012 Proposal at 70318.

<sup>16</sup> Incentives to centrally clear over-the-counter (OTC) derivatives: A post-implementation evaluation of the effects of the G20 financial regulatory reforms (Nov. 19, 2018) at Figure C.7 (page 21), available at: <http://www.fsb.org/wp-content/uploads/R191118-1-1.pdf> (the “DAT Report”).

<sup>17</sup> DAT Report at pages 36-37.

<sup>18</sup> Exchange Act Section 15F(e)(3)(A).

<sup>19</sup> See Exchange Act Section 15F(e)(3)(D).

<sup>20</sup> Request for Additional Comment at Question 15.

<sup>21</sup> The “SBS entities registration compliance date” has been defined as “the later of: Six months after the date of publication in the Federal Register of final rules establishing capital, margin and segregation requirements for SBS Entities; the compliance date of final rules establishing recordkeeping and reporting requirements for SBS Entities; the compliance date of final rules establishing business conduct requirements under Sections 15F(h) and 15F(k) of the Exchange Act; or the compliance date for final rules establishing a process for a registered SBS Entity to make an application to the Commission to allow an associated person who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on the SBS Entity’s behalf.” Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, 81 FR 29960, 30081 (May 13, 2016). Of the rules listed above, only the rule covering business conduct standards has been finalized.

would be subject to the full suite of regulatory requirements, unless compliance dates are further phased-in by the Commission.

We agree that an extended compliance timeline is warranted for certain specific requirements. For example, before requiring compliance with new capital rules, the Commission should provide sufficient time for all types of SBSDs to develop internal models and for the Commission or the Financial Industry Regulatory Authority to approve such models. This will ensure that the Commission's capital rules do not create competitive disparities between SBSDs.

However, we do not believe the Commission should further delay compliance with regulatory reporting rules for security-based swaps. A key goal of the post-crisis reforms is to provide regulators with timely access to comprehensive data regarding OTC derivatives trading activity. This data will improve market oversight and monitoring and surveillance capabilities, and will enable regulators to more accurately design and evaluate the expected impact of other regulatory reforms.

In order to smoothly implement the regulatory reporting framework under Regulation SBSR, we recommend that the Commission (a) delay, or grant relief from, Rule 906(a), which would require non-reporting parties to separately provide information directly to SDRs, (b) put SDRs in charge of applying any reporting delays, instead of individual market participants, and (c) set block trade thresholds (which could also be used to cap the reported notional amounts of block trades) as quickly as possible. These steps are necessary to reduce friction with existing CFTC rules and will allow the Commission's reporting framework to be implemented as soon as possible.

#### IV. Updating the Economic Analysis in the 2012 Proposal

The Request for Additional Comment seeks input on areas where the "Baseline of Economic Analysis" contained in the 2012 Proposal should be updated to reflect recent developments impacting the security-based swaps market.<sup>22</sup> We provide examples for each of the three main topics covered in the 2012 Proposal:

- **Capital Requirements.** Following the 2012 Proposal, the CFTC re-proposed its capital rules for swap dealers in response to feedback from market participants.<sup>23</sup>

The economic analysis of the Commission's capital requirements for SBSDs should take into account these re-proposed rules, including identifying areas of divergence and assessing the potential impact of conflicting rules on entities that are dual-registered with both the Commission and the CFTC.

- **Uncleared Margin Requirements.** Following the 2012 Proposal, the BCBS-IOSCO Working Group on Margining Requirements ("WGMR") finalized international standards

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<sup>22</sup> Request for Additional Comment at Question 16.

<sup>23</sup> 81 Fed. Reg. 91252 (Dec. 16, 2016).

for uncleared margin requirements.<sup>24</sup> Domestically, both the CFTC and the prudential regulators finalized rules consistent with these international standards and implementation began in 2016.<sup>25</sup>

The economic analysis of the Commission's uncleared margin requirements for SBSBs should take into account market experience with those margin rules that already have been implemented by other regulators. For example, uncleared OTC derivatives markets continued to function smoothly as variation margin requirements came into force and initial margin requirements were introduced for inter-dealer transactions.<sup>26</sup> Data also shows that voluntary clearing rates increased for inter-dealer transactions in certain instruments following the implementation of uncleared initial margin requirements, consistent with the regulatory objective of reducing systemic risk.<sup>27</sup> Whereas the 2012 Proposal contained speculation regarding the potential impact of uncleared margin requirements on SBSBs,<sup>28</sup> the Commission can now incorporate actual market experience and revisit underlying assumptions.

- **Segregation Requirements.** Following the 2012 Proposal, voluntary clearing of single-name CDS has significantly increased.<sup>29</sup> This voluntary clearing typically occurs along with CFTC-regulated index CDS positions pursuant to the portfolio margining exemption issued by the Commission for dually registered broker-dealers and futures commission merchants.<sup>30</sup>

The economic analysis of the Commission's segregation requirements for SBSBs should take into account market experience with voluntary clearing and portfolio margining, and the potential impact of diverging from the CFTC's "legally segregated; operationally commingled" margin segregation approach for cleared transactions.

More generally, the CFTC has now fully implemented most all of the statutorily-required reforms to the OTC derivatives markets under its jurisdiction. As the Commission proceeds with finalizing largely identical reforms for the security-based swaps market, it should take into account market experience under the new CFTC regulatory framework. For example, academic research shows that as market transparency increases due to the introduction of real-time public reporting,

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<sup>24</sup> See BCBS-IOSCO Margin requirements for non-centrally cleared derivatives (March 2015), available at: <https://www.bis.org/bcbs/publ/d317.pdf>.

<sup>25</sup> See "OTC Derivatives Market Reforms: Thirteenth Progress Report on Implementation," FSB (Nov. 19, 2018) at Appendix D, available at <http://www.fsb.org/wp-content/uploads/P191118-5.pdf>.

<sup>26</sup> In contrast to the discussion in the 2012 Proposal at 70267.

<sup>27</sup> DAT Report at Figure C.7 (page 21).

<sup>28</sup> See, e.g., 2012 Proposal at 70267 and 70322.

<sup>29</sup> See, e.g., 25 Investment Management Firms Commit to Single-Name CDS Clearing (Dec. 16, 2015), available at: <http://www2.isda.org/news/25-investment-management-firms-commit-to-single-name-cds-clearing> and clearing statistics at ICE (<https://www.theice.com/clear-credit>).

<sup>30</sup> See Release No. 34-68433 (Dec. 14, 2012), available at: <https://www.gpo.gov/fdsys/pkg/FR-2012-12-19/pdf/2012-30553.pdf>.



central clearing, and organized trading, market liquidity improves.<sup>31</sup> In turn, increased market transparency and liquidity leads to the entry of new liquidity providers, as they are now able to compete on a level playing field with the incumbent dealers.<sup>32</sup>

These observed effects of the CFTC’s OTC derivatives reforms are specifically relevant to the economic analysis contained in the 2012 Proposal, as they provide an indication of the types of firms that are likely to register as SBSBs. In finalizing capital and margin requirements, the Commission should ensure that it is considering the potential impact of these rules on various types of SBSBs, not just those “affiliated with or within large commercial banks.”<sup>33</sup>

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We appreciate the opportunity to provide comments on the Commission’s capital, margin, and segregation requirements for SBSBs. Please feel free to call the undersigned at [REDACTED] with any questions regarding these comments.

Respectfully,

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

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<sup>31</sup> See, e.g., Loon, Y. C., Zhong, Z. K. 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 (2014), available at: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2176561](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2176561); Loon, Y. C., Zhong, Z. K. Does Dodd-Frank affect OTC transaction costs and liquidity? Evidence from real-time CDS trade reports. *Journal of Financial Economics*, 119 (3), 645–672 (2016), available at: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2443654](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2443654); Benos, E., Payne, R., and Vasios, M., Centralized trading, transparency and interest rate swap market liquidity: evidence from the implementation of the Dodd-Frank Act, Bank of England Staff Working Paper, May 2018, available at: <https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2018/centralized-trading-transparency-and-interest-rate-swap-market-liquidity-update>.

<sup>32</sup> See, e.g., “New players break into credit derivatives”, FT (Nov. 17, 2015), available at: <https://www.ft.com/content/22b83fa4-8c6e-11e5-8be4-3506bf20cc2b>.

<sup>33</sup> 2012 Proposal at 70300.