CITADEL | Securities

May 15, 2017

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

Re: Capital Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants (RIN 3235-AL12)

Dear Mr. Aleman:

Citadel Securities [1] ("Citadel") appreciates the opportunity to provide comments to the Securities and Exchange Commission (the "Commission") on its proposal to establish capital requirements for certain security-based swap dealers ("SBSDs") that are not subject to the capital rules of a Prudential Regulator (the "Capital Proposal").[2]

SBSD 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 SBSDs 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). A SBSD ecosystem that includes both large and small players, along with a range of business models, will best meet the liquidity needs of all market participants and will ensure that risk is appropriately distributed across the market.

Much has changed since the Commission's initial Capital Proposal in November 2012. Central clearing of OTC derivatives has dramatically increased, both for swaps regulated by the Commodity Futures Trading Commission (the "CFTC")[3] and security-based swaps regulated by the Commission.[4] In addition, new liquidity providers have entered the market as a result of this growth in central clearing, increasing price competition, lowering execution costs for investors and enhancing overall market liquidity.[5] In response to these changes and feedback from market

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

[3] *See* http://www.swapsinfo.org/.

[4] *See, e.g.,* Buy side fuels boom in single-name CDS clearing, Risk.net (Apr. 10, 2017), available at: http://www.risk.net/derivatives/credit-derivatives/4720996/buy-side-fuels-boom-in-single-name-cds-clearing.

[5] *See, e.g.,* New players break into credit derivatives, FT (Nov. 17, 2015), available at: http://www.ft.com/intl/cms/s/0/22b83fa4-8c6e-11e5-8be4-3506bf20cc2b.html#axzz3rj5MtwiI.

participants, the CFTC recently re-proposed its capital rules for swap dealers.[6] We urge the Commission to increase harmonization with the CFTC re-proposal, while ensuring that its capital requirements are appropriately calibrated to reflect its statutory mandate and recent developments in the OTC derivatives market, such as the significant expansion of central clearing. Otherwise, the Commission risks significantly disrupting the market and adversely impacting market participants.

Specifically, we recommend that:

- Standardized market risk and credit risk charges, and minimum capital requirements, should be appropriately calibrated for cleared OTC derivatives;
- Market participants should not be subject to conflicting capital requirements from the Commission and the CFTC with respect to the same instrument; 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's Capital Proposal should be amended to allow standardized market risk charges for cleared OTC derivatives to be based on the initial margin requirements of the relevant clearinghouse ("CCP"). These margin requirements have been established pursuant to Commission-approved quantitative risk models and are specifically designed to accurately measure the risks associated with a cleared security-based swap portfolio.

The Commission's Capital Proposal instead calculates standardized market risk charges for both cleared and uncleared security-based swaps in the same manner, based on a percentage of notional value. This proposed approach yields disproportionately high charges for cleared security-based swaps and does not accurately reflect the risk mitigating benefits of central clearing. For example, CCPs operate in accordance with an ongoing set of regulatory requirements and responsibilities, including with respect to financial resources, stress testing, and model back testing, that serve to distinguish the risk management of cleared positions from uncleared positions. In addition, CCPs facilitate multilateral netting and compression, increase efficiency with respect to collateral management and trade reconciliation, and provide market participants with increased transparency around end-of-day pricing. Treating both cleared and uncleared positions in the same manner for calculating standardized market risk charges does not take into account these important differences. Notably, the statutory language of the Securities Exchange Act only specifically cites the risks associated with uncleared security-based swaps when requiring the establishment of margin requirements.[7]

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[6] 81 Fed. Reg. 91252 (Dec. 16, 2016) (the "CFTC Proposal").

[7] Securities Exchange Act of 1934, section 15F(e)(3).

Permitting standardized market risk charges for cleared OTC derivatives to be calculated by reference to the initial margin requirements of the relevant CCP would be consistent with both the CFTC re-proposal,[8] and the approach that the Commission has historically taken to determine market risk charges for futures contracts.[9] In contrast, the Commission's initial Capital Proposal may inhibit the market's transition to central clearing by applying excessive standardized market risk charges that are far greater than the risk-sensitive margin requirements calculated by CCPs pursuant to Commission-approved quantitative risk models.

B. Credit Risk Charges for Cleared OTC Derivatives

The Capital Proposal appears to permit a SBSD to include receivables from a CCP or a securities broker in its calculation of net capital, notwithstanding the general requirement to take credit risk charges for unsecured receivables.[10] We urge the Commission to make this absolutely clear, as it correctly treats margin in respect of cleared security-based swaps as a risk mitigant, and recognizes 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 a CCP or securities broker in respect of cleared swaps regulated by the CFTC can also be included when calculating a firm's net capital. We urge the Commission to coordinate with the CFTC to ensure that dual registrants are not subject to conflicting requirements in this regard.

II. The Minimum Capital Requirements Should Be Appropriately Calibrated for Cleared OTC Derivatives

Under the Capital Proposal, the minimum capital requirement for a SBSD that wishes to use an internal model increases from $20 million in net capital to $100 million in tentative net capital.[11] This proposed additional capital requirement for SBSDs using internal models appears to originate from Commission rules that date back to 1998 regarding the use of internal models by Commission registrants.[12]

In our view, the Commission should reconsider whether it is appropriate to replicate this legacy approach, particularly for a SBSD that only deals in cleared security-based swaps. Dealing in cleared security-based swaps should not implicate the same concerns about the use of internal models that originally led to the establishment of this higher threshold. We note that, under the

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[8] *See* CFTC Proposal, §1.17(c)(5)(x).

[9] *See* §240.15c3-1, Appendix B.

[10] *See* §240.15c3–1(c)(2)(iv).

[11] Capital Proposal at 70226.

[12] *Id.*

CFTC's re-proposal, the minimum capital requirement for swap dealers using the "bank-based approach" is $20 million, regardless of whether an internal model is used.[13]

III. Market Participants Should Not Be Subject to Conflicting Requirements From the Commission and the CFTC With Respect to the Same Instrument

The Commission's Capital Proposal appears to propose different and substantially higher market risk charges for cleared swaps regulated by the CFTC, such as cleared interest rate swaps and cleared index CDS, than those required under CFTC rules.[14] While the CFTC re-proposal would allow standardized market risk charges to be calculated by reference to the initial margin requirements of the relevant CCP, the Commission's proposal requires that a notional-based market risk charge also be taken for the same positions. Instead of seeking to override CFTC rules, we urge the Commission to work with the CFTC to harmonize applicable requirements for cleared swaps that are regulated by the CFTC.

This approach would recognize that many market participants trade both security-based swaps and swaps, and therefore are likely to be dual registrants. These dual registrants should not be subject to conflicting requirements for the same instrument, an outcome the Commission has sought to avoid for futures contracts by harmonizing with CFTC capital requirements.[15] Increasing harmonization will also promote the portfolio margining of cleared security-based swaps and cleared swaps, consistent with the statutory requirement to "adopt rules to ensure that [portfolio margining] transactions and accounts are subject to comparable requirements."[16]

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 SBSDs to develop internal models and for the Commission or the Financial Industry Regulatory Authority ("FINRA") to approve such models. This will ensure that the Commission's compliance schedule does not create competitive disparities between SBSDs.

The Capital Proposal permits SBSDs to compute market risk and credit risk charges using approved internal models.[17] Approved internal models allow a SBSD to compute its capital requirements in a more risk-sensitive manner, taking into account risk offsets across related products. A SBSD using an internal model will therefore, in many cases, have a material competitive advantage from a capital requirement perspective over a SBSD using the standardized schedule.

We expect that it could take several years for the Commission and FINRA to complete the required reviews of internal models, given the large number of SBSDs likely to seek model

[13] CFTC Proposal at 91310.

[14] *See* Capital Proposal, §240.18a-1b.

[15] *See* §240.15c3-1, Appendix B.

[16] 15 U.S.C. 78o(c)(3).

[17] Capital Proposal at 70226.

approval and the unique features of each SBSD's model. The increased complexity of internal models will likely make this review more time-consuming and resource-intensive than the recent review of industry-standard initial margin models for uncleared swaps. By way of illustration, it took over three years after the Commission adopted its broker-dealer alternative net capital regime for the largest broker-dealers to obtain model approval.[18] The SBSD model review and approval process could take at least as long.

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 SBSD is provisionally approved to use an internal model, subject to continued oversight by the Commission and FINRA, if it has submitted a complete application within one year of the effective date of a final rule. This provisional approval process would encourage SBSDs to submit their applications on a timely basis, without unduly delaying the effectiveness of capital requirements or penalizing SBSDs if Commission or FINRA 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

[18] *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).