CITADEL

February 5, 2010

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street NW
Washington DC 20581

Re: **Chicago Mercantile Exchange Revised Petition to Commingle Customer Funds Used to Margin Credit Default Swaps Cleared by CME with Other Funds Held in Segregated Accounts**

Dear Mr. Stawick:

Citadel Investment Group, L.L.C.("***Citadel***") submits this letter in response to the Commodity Futures Trading Commission's (the "***Commission***") request for comments on the Chicago Mercantile Exchange's (the "***CME***") revised petition dated December 21, 2009 (CME Submission #08-175R) (the "***CME Petition***"). The CME Petition requests the Commission to issue an order pursuant to Section 4d(a)(2) of the Commodity Exchange Act (the "***Act***") authorizing the CME clearing house ("***CME Clearing***") and futures commission merchants ("***FCMs***") clearing through CME Clearing to commingle customer funds used to margin credit default swap agreements ("***CDS***") with other funds held in customer segregated accounts maintained in accordance with Section 4d(a)(2) of the Act and Commission regulations ("***4d Accounts***").

Citadel appreciates the opportunity to support the CME Petition. The financial crisis has demonstrated that it is critical to establish properly structured central counterparty ("***CCP***") mechanisms for over-the-counter ("***OTC***") derivatives, including standardized CDS. Approval of the CME Petition would represent an important step in this regard.

Citadel is a global financial institution with a diverse business platform. Citadel has nearly two decades of experience in the OTC derivatives marketplace, and serves as a leading liquidity provider on, and member of, the principle equity, options and futures markets in the United States. In addition, Citadel is a leading buyside participant in the CDS markets. Citadel has always been a strong proponent of central clearing, transparency, and reduction of operational risk in these markets, and is one of several leading buy-side founding participants in CME's CDS clearing initiative. Citadel is also a self-clearing member of CME Clearing with respect to futures and options on futures.

131 South Dearborn Street
Chicago, Illinois 60603

Citadel is supportive of all efforts to provide buyside access to CDS central clearing; however, to provide genuine benefit to investors and to meaningfully reduce systemic risk, a CCP for CDS must, at a minimum, possess the following essential elements: (1) open access to all qualified participants based on sound risk management principles; (2) true customer protection of initial margin and positions, and portability of such margin and positions; (3) price transparency that facilitates participant risk management; (4) a robust and transparent margin methodology; and (5) default resources, including a mutualized default fund, that provide adequate protection.

Citadel supports the CME Petition because the clearing of CDS by CME Clearing through its risk management framework, which includes 4d Accounts: (a) is consistent with the public interests of reducing systemic risk, and promoting efficiency and transparency in trading of OTC derivatives contracts; (b) is beneficial for market participants because it will create a larger asset pool to support customer positions, will diversify risk of the CCP among many asset classes covered by CME Clearing's default fund, and will facilitate margin offsets, as appropriate, among contracts that over time may be cleared through CME Clearing; (c) promotes greater confidence in bankruptcy treatment of customer funds because clearing CDS in a 4d Account will bring CDS within the same customer protection mechanisms afforded to U.S. futures and options under the Act and Commission regulations, which provide a proven customer protection regime, with which customers are already familiar; and (d) satisfies the five essential elements of a CDS CCP noted above.

I. Background.

We believe the clearing of OTC contracts through central counterparties will significantly reduce credit exposures of counterparties and, accordingly, systemic risks in the U.S. economy as a whole. The futures model of clearing through Commission-regulated derivatives clearing organizations ("***DCOs***") has performed exceptionally well for decades and notably well during the recent financial crisis. Recognizing this performance, a key feature of the recently proposed legislation to reform trading in derivatives (collectively, the "***Derivatives Bills***") is mandatory clearing of standardized OTC derivatives, including CDS, through regulated CCPs.[1]

II. Importance of Clearing CDS in a 4d Account.

Section 4d of the Act and Commission regulations require FCMs and DCOs to keep customer property (customer positions, and initial and excess margin posted by customers) relating to

[1] "Wall Street Reform and Consumer Protection Act of 2009", H.R.4173, 111th Congress (2009); *see also*, discussion draft bill issued November 10, 2009, from Senator C. Dodd's Committee, "Restoring American Financial Stability Act of 2009" and similar draft bills introduced in the Senate and the House in 2009 that are consistent with H.R. 4173 in promoting the benefits of clearing of derivatives through clearing houses, such as CME Clearing.

trading in U.S. futures and options in segregated accounts separate from the assets of other customers in other account classes or from the assets of an FCM or DCO. The rationale for this treatment is to allow the immediate transfer of such segregated customer assets to a solvent FCM in the event of the carrying FCM's failure. Because customer assets in the 4d Account are not commingled with the FCM's assets, they do not become a part of the FCM's bankruptcy estate. The strength of this framework was well demonstrated during the 2008 collapse of Lehman Brothers, whereby Lehman's CME futures customer positions and margin were isolated from its parent's insolvency and rapidly transferred to solvent clearing members without market interruption.[2]

Under Section 4d(a)(2) of the Act, the Commission has the authority to allow commingling of assets relating to U.S. exchange-traded futures and options with any other type of customer property.[3] The Commission has exercised this authority on several occasions by issuing orders with respect to clearing of certain types of non-U.S. futures and OTC contracts in the 4d Account.[4] The CME Petition asks the Commission to allow similar commingling of assets related to cleared OTC CDS contracts with those relating to the products, such as futures and options, already cleared by CME.

The 4d Order requested by the CME will bring CME-cleared CDS within the same customer protection mechanisms provided to U.S. futures and options and other OTC cleared products under the Act and Commission regulations. We understand that segregation is a primary focus

[2] *See* Will Acworth, *The Lessons of Lehman: Reassessing Customer Protections*, Futures Industry (Jan–Feb 2009), online at http://www.futuresindustry.org/fi-magazine-home.asp?a=1297 (noting that "virtually all the futures and options contracts held by Lehman on behalf of its customers were safely transferred out of the company within a single week of the bankruptcy filing and the futures markets continued to function normally").

[3] Section 4d(a)(2) provides in pertinent part: "That in accordance with such terms and conditions as the Commission may prescribe by rule, regulation, or order, such money, securities, and property of the customers of such futures commission merchant may be commingled and deposited as provided in this section with any other money, securities, and property received by such futures commission merchant and required by the Commission to be separately accounted for and treated and dealt with as belonging to customers of such futures commission merchant."

[4] *See, e.g.,* Commission Order: (1) Pursuant to Section 4(c) of the Commodity Exchange Act, Permitting the Chicago Mercantile Exchange to Clear Certain Over-the-Counter Agricultural Swaps and (2) Pursuant to Section 4d of the Commodity Exchange Act, Permitting Customer Positions in Such Cleared-Only Contracts and Associated Funds to Be Commingled With Other Positions and Funds Held in Customer Segregated Accounts, March 24, 2009; *see also*, Commission Order: (1) Pursuant to Section 4(c) of the Commodity Exchange Act (a) Permitting Eligible Swap Participants to Submit for Clearing and ICE Clear U.S., Inc. and Futures Commission Merchants to Clear Certain Over-The-Counter Agricultural Swaps and (b) Determining Certain Floor Brokers and Traders to be Eligible Swap Participants; and (2) Pursuant to Section 4d of the Commodity Exchange Act, Permitting Certain Customer Positions in the Foregoing Swaps and Associated Property to be Commingled With Other Property Held in Segregated Accounts, Dec. 12, 2008; *see also* Commission Order: Treatment of Funds Held in Connection with the Clearing of Over-The-Counter Products by The Chicago Mercantile Exchange (regarding OTC Denatured Fuel Ethanol cleared-only contracts), Oct. 9, 2008; Commission Order: Treatment of Funds Held in Connection with the Clearing by the New York Mercantile Exchange, Inc. of Contracts Traded on the Dubai Mercantile Exchange Limited, Apr. 30, 2008.

of CME's regulatory audits of all of its clearing member firms. CME has represented that it strictly verifies that the customer-segregated assets are held properly in acceptable accounts and that each clearing member firm accurately computes its financial obligations to customers. We understand that these same protections will apply in the event that the CME Petition is granted (*i.e.*, CME's audits will cover all products in the customer origin, including CDS). This is critical from the perspective of a customer, such as Citadel, that posts significant margin with its clearing members, and should be important to regulators from the perspective of ensuring safety and soundness of a clearing system.

Additionally, the ability to commingle customer property in a 4d Account facilitates efficient margin offsets, where appropriate, between different types of negatively risk-correlated contracts held in a 4d Account. As the policy goal of global regulators and industry participants of having a material portion of OTC derivatives centrally cleared is achieved, current and future cross-product netting will provide both beneficial efficiencies and material systemic risk reduction. A range of experts, including the authors of the recently published NY Fed Staff Report on OTC Derivatives Reform, have emphasized that maximum systemic risk reduction will be achieved through multi-product clearing.[5]

CME initiated clearing of customer CDS trades on December 15, 2009 through Commission regulation 30.7 accounts ("***30.7 Accounts***"). While 30.7 Accounts have been extensively used for cleared OTC derivatives to afford protections to buyside participants,[6] clearing CDS in a 4d Account rather than in a 30.7 Account is more desirable because of the greater certainty offered in the treatment of customer assets in a 4d Account in the event of an FCM insolvency. The Commission has recently published an interpretation wherein it clarified that cleared OTC derivatives that are carried in a 4d Account pursuant to a Commission 4d Order will be treated as "commodity contracts" for purposes of calculating a customer's net equity claim.[7] To the extent buyside customer confidence may be enhanced by the 4d Order, one perceived obstacle to the full roll-out of CDS clearing would be removed. Buyside customer trades are considered to

[5] *See* Darrell Duffie, Ada Li & Theo Lubke, *Policy Perspectives on OTC Derivatives Market Infrastructure* (Federal Reserve Bank of New York Staff Reports, Staff Report No. 424, Jan, 2010), at 13: "Whenever different types of derivatives are cleared with the same CCP, rather than at distinct CCPs, counterparty exposures are further reduced, on average, through the netting of positive position values in some derivative types against negative position values in others. Market participants may therefore prefer a single CCP, at least within a particular asset class, in order to have more efficient risk reduction and collateral allocation." *See also*, Darrell Duffie and Haoxiang Zhe, *Does a Central Clearing Counterparty Reduce Counterparty Risk?*, July 1, 2009, http://www.stanford.edu/~duffie/DuffieZhu.pdf

[6] For example, since 2002 OTC energy swaps have been cleared, initially by LCH in its DCO capacity, and more recently by ICE Clear Europe, which is a business unit of Intercontinental Exchange Inc., a CFTC-regulated DCO, with margin held in Commission regulated 30.7 accounts. https://www.theice.com/markets_otc.jhtml

[7] FR Doc E8-26199, Nov. 4, 2008 (Vol. 73, Number 214), pages 65514-65516. Commodity Futures Trading Commission Interpretative Statement Regarding Funds Related to Cleared-Only Contracts Determined To Be Included in a Customer's Net Equity.

represent half of the CDS market, and therefore half of the CDS risk.[8] The granting of the 4d Order would therefore remove a key obstacle in reducing substantial systemic risk in uncleared OTC markets.

III. Commingling Cleared CDS with Exchange-Traded Futures Will Not Dilute the DCO's Default Resources.

As a potential significant buyside user of the CME-cleared CDS offering, we have carefully reviewed the risk framework to ensure that our capital, margins and positions will be well protected from FCM defaults and those of other customers. We have concluded that CME's framework is well designed and robust. CME has established product-specific financial safeguard standards for CDS that it has represented are based on comprehensive analysis of CDS default risks, back-tested over the most stressful scenarios, including the Lehman default. For CDS clearing members, CME rules and its safeguards package provide for significantly increased capital, margin, guaranty fund deposit and other risk management requirements as compared to clearing member requirements for futures.

These higher requirements are summarized as follows:

	Futures	**CDS**
Clearing member requirements	$5 million in net regulatory capital (or the CFTC minimum net capital requirement); and a minimum $500,000 default fund contribution	$500 million in net regulatory capital; and a $100 million default fund contribution if such member's net regulatory capital is less than $1 billion, otherwise a $50 million default fund contribution
Target margin coverage	99% coverage for 1-2 day price moves	99% coverage for 5-day price moves, plus liquidation cost
Guaranty fund deposits	Cash or cash equivalent equal to 2.25% of margin, plus calls of 275% of cash or cash equivalents (or ~6% of margin)	Cash or cash equivalent equal to 9% of margin, plus calls of 275% of cash or cash equivalents (or ~25% of margin)
Clearing member stress tests	No requirement comparable to that for CDS	Sufficient net regulatory capital to cover losses stressed at 150% of current margin levels

[8] See Bank of International Settlements, *OTC derivative market activity in the first half of 2009*, http://www.bis.org/publ/otc_hy0911.pdf?noframes=1

These increased safeguards provide Citadel with confidence that support will exist for CDS commensurate with their risk and the safeguards will provide additional reserves that will be available to support a default arising from exchange-traded futures and options cleared by CME Clearing.

With integration of CDS in current 4d Accounts, Citadel believes that diversification of CME Clearing's risk across many asset classes backed by the combined resources of a single guaranty fund is beneficial. For example, CDS indices, which comprise about half of the net notional CDS exposure outstanding, demonstrate low correlation to a range of future products currently cleared by CME. Thus, Citadel believes that in the aggregate the assets relating to customer futures, options and CDS positions will constitute a more diversified pool of assets with less systemic risk.

Based on our understanding of the risk management systems that CME has developed for its cleared CDS, we believe the addition of CDS to the CME guaranty fund will not adversely impact the safety and soundness of CME Clearing. CME has worked closely with CDS participants, including Citadel, to develop a 7-factor margin methodology specifically for CDS. That margin methodology has been closely scrutinized and approved by a number of regulators, and it reflects the specific risks of CDS, including jump-to-default and the consequences of a liquidity event caused by the defaults. CME has represented that it will recalibrate the margin factors daily to ensure that the parameters provide the required coverage and that it will also perform ongoing stress tests to ensure the capital adequacy of its clearing members under stressed market conditions. We have extensively tested CME's margin methodology with Citadel's own portfolios, and find it to yield results that exceed the high coverage standards defined by CME.

Over and above the CDS margin methodology, we believe CME has adapted its financial safeguards package to address the unique demands of CDS clearing.[9] To accomplish this, guaranty fund deposits have been subdivided (*i.e.*, "tranched") by product class to ensure a commensurate assumption of risk by the clearing members that clear each separate product. We understand that the tranching procedure of the guaranty fund is designed to provide that the capital is reserved equitably for CDS losses and to adequately account for any delays in crystallization of such losses. The 5-day margin coverage for CDS products is further intended to protect against the potentially longer time required to ascertain losses from CDS products. CME Clearing represents that its financial safeguards package will continue to be tested and measured monthly to ensure that the minimum coverage criteria are always met – *i.e.*, that the default of CME Clearing's two largest net debtors will be always covered. This standard appears

[9] *See* CME Rule 802.

to be fully consistent with the standards historically applied by the Commission and the stringent approach recommended by the NY Fed Staff Report referenced earlier.[10]

In addition, CME has represented that it will clear only CDS that are sufficiently liquid to permit satisfactory daily pricing for margining purposes, and, critically, to permit liquidation with appropriate timeframes in the event of a default. Given the size and daily trading volumes of the CDS market, cleared liquid and highly-standardized CDS contracts should be readily offset or hedged.[11]

Further, under CME's rules, CME Clearing's Risk Committee and CDS Product Advisory Board must approve each product cleared by CME Clearing. These bodies are made up primarily of clearing members whose default fund capital is at risk in the event of default. They would be strongly incentivized to approve only those CDS exposures for which sufficient margin can be assured and which can be promptly offset by CME Clearing in the event of a default. In addition, CME has placed strict requirements on the applicable margin and risk calculations, including meeting the 99%/5-day coverage noted above. This clearing member approval power should act as a constant restraint as CME Clearing determines whether particular CDS contracts are appropriate for clearing and should serve to protect the interests of clearing members and their customers and the integrity of the default fund.

Finally, Citadel is currently a clearing member of CME Clearing with respect to futures and options on futures, although not with respect to CDS. Accordingly, Citadel understands that its futures margin and default fund deposit will be commingled with the margin and default fund deposits of clearing members that clear CDS, and that all clearing members benefit from the larger pool of margin funds and default fund resources available to CME Clearing to mitigate a default arising out of any product cleared by CME Clearing. Citadel is satisfied that CME's risk management procedures described above are sufficiently robust to manage the potential risk that another clearing member that clears CDS will default on its CDS positions and potentially reach

[10] Darrell Duffie, Ada Li & Theo Lubke, *Policy Perspectives on OTC Derivatives Market Infrastructure* (Federal Reserve Bank of New York Staff Reports, Staff Report No. 424, Jan, 2010), at 8: "Regulators should ensure that a CCP's risk management design and financial resources are robust enough to allow the CCP to withstand extreme but plausible loss scenarios."

[11] The International Swaps and Derivatives Association (ISDA) estimates that as of the end of June 2009, the aggregate notional amount of outstanding CDS contracts was approximately $31.2 trillion. ISDA Mid-Year 2009 Market Survey Shows Credit Derivatives at $31.2 Trillion, (Sept. 15, 2009), http://www.isda.org/media/index.html Current trading in CDS appears to run between $2.5 trillion and $5 trillion notional per month. Jacob Gyntelberg, Karsten von Kleist & Carlos Mallo, The Size of the Global CDS Market, BIS Quarterly Review, Dec. 2009, at 24-25, http://www.bis.org/publ/qtrpdf/r_qt0912y.htm Review of transaction data available on the DTCC Trade Information Website indicates that the bulk of this activity is in the most liquid subset of CDS that is the target group for clearing, namely the most recent index series and the most highly liquid single names. http://www.dtcc.com/products/derivserv/data_table_ii.php Note also that ICE Trust and ICE Clear Europe have cleared in excess of $5 trillion notional in liquid CDS index contracts and the most liquid single names, since starting clearing in March 2009. http://ir.theice.com/releasedetail.cfm?ReleaseID=439697

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Citadel's default fund contribution, and believes the benefits of commingling assets in 4d Accounts well outweigh this managed risk.

IV. Conclusion.

We submit that permitting commingling of the assets relating to CDS and futures and options positions cleared by CME Clearing and held in the customers' 4d Accounts is consistent with the Act and Commission regulations and furthers the public policy concerns sought to be addressed in the Derivatives Bills in response to the recent financial crisis.

We strongly support the Petition because the clearing of CDS by CME Clearing and the commingling of customers' funds relating to CDS with funds relating to customers' futures and options in 4d Accounts reduces systemic risk and increases market transparency and competitiveness by promoting clearing of CDS contracts in a well-regulated, well-managed, and time-tested clearing system. The commingling relief requested in the CME Petition represents an important step in securing the benefits of clearing of CDS and Citadel urges that it be approved without delay.

Thank you for affording us the opportunity to submit these comments. If you have any questions about our comments, please do not hesitate to contact me at (312) 395-3067.

Very truly yours,

Adam C. Cooper
Senior Managing Director and Chief Legal Officer
Citadel Investment Group, L.L.C.

cc: Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott O'Malia, Commissioner

Division of Clearing and Intermediary Oversight
Ananda Radhakrishnan, Director
Robert B. Wasserman, Associate Director