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**Testimony before the Sub-Committee on Securities, Insurance and Investment, U.S.
Senate Committee on Banking, Housing and Urban Affairs
Hearing on Over-the-Counter Derivatives: Modernizing Oversight to Increase
Transparency and Reduce Risk
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Chairman Reed, Senator Bunning, Members of the Committee, I am Kenneth Griffin, President and CEO of Citadel Investment Group. I appreciate the opportunity to testify and share our views regarding effective oversight of the over-the-counter derivatives market.

Citadel's nearly two decades of experience in the OTC marketplace, as well as its role as a leading liquidity provider in the equity markets and the options market in the United States, give us insights into the benefits of appropriate market structure. Sadly, it now also gives us insights into the wreckage that can be wrought by opaque and unregulated markets.

As one of the largest alternative asset managers, Citadel has a vested interest in the safety and soundness of our financial markets and in fostering fair, orderly and transparent markets. As an American taxpayer, I have a vested interest in ensuring that the financial crisis that we have experienced never happens again.

To be clear, Citadel also has an economic interest in the outcome of this issue as a partner with CME Group in the development of a neutral, open access, central counterparty clearing solution for credit default swaps. CME is also supported by other institutional investors and alternative asset managers in this initiative.

For many years, Citadel has advocated for central counterparty clearing. I am confident that if OTC derivatives were cleared through a properly structured and transparent central counterparty, the impact of AIG and Lehman Brothers would have been much different. Without a central counterparty clearing framework in place, their failures have contributed to the loss of hundreds of thousands of jobs and the use of hundreds of billions of dollars of taxpayer money.

Citadel is committed to maintaining the benefits of credit default swaps products while reducing the systemic risk they present to the market, to the economy as a whole and to American taxpayers. We wholeheartedly support a comprehensive framework for over-the-counter derivatives and the realignment of capital incentives as an immediate, tangible undertaking to realize these goals. We stand ready to help this Committee meet these goals.

Derivatives and Their Benefits

Credit default swaps and other derivatives play a crucial role in helping American businesses prudently manage their balance sheets as well as their interest rate and credit exposure. When used and overseen properly, credit default swaps and other derivatives play a vital role in helping our economy function smoothly and grow.

Examples of the benefits of derivatives abound.

- Institutional investors, such as pension funds, 401k managers, foundations and endowments make frequent use of derivatives to achieve their portfolio objectives and to manage risk.
- A regional bank may use credit default swaps to buy credit protection on its loan portfolio. By transferring credit risk, the bank can free up capital and make more loans at a time of contracting credit availability.
- Manufacturers use these instruments to hedge the risk that their key suppliers might go bankrupt and not fulfill outstanding obligations. Suppliers may protect against the risk that their customers might fail to pay.

The imprudent use of these instruments, however, when coupled with (1) an antiquated and opaque market structure, (2) the lack of comprehensive margin and capital requirements, and (3) the absence of a central counterparty clearing framework can have devastating consequences. This is an issue of profound importance to our capital markets and the American people.

Reform Measures Essential to the Market

The derivatives market has grown because of its utility. Between 2003 and 2008, it is estimated the market for credit default swaps grew from \$3.8 trillion to nearly \$40 trillion, and has become highly liquid and standardized. At the end of 2008, it was estimated there were approximately \$325 trillion in gross notional value of interest rate swaps outstanding. Yet the derivatives market today largely functions as it did three decades ago.

The current market structure is characterized by the notable absence of certain structural safeguards that are the hallmark of mature and efficient markets: a central counterparty, segregation of margin deposits and positions, price transparency and appropriate capital requirements for all market participants, including dealers and highly rated counterparties. In the current market structure:

- Dealers are generally not obligated to post margin to initiate a trade.
- Customers are often required to post initial margin to their dealer counterparties to initiate a trade. These funds are held by the dealers in accounts that are commingled with the dealers' own funds. Because customer margin is not segregated, customer funds could be lost in a dealer default. In times of stress, customers will rush to close out positions to recover their margin. This can intensify a liquidity crisis, and may precipitate bankruptcy, as we saw with Lehman Brothers.
- Market data, such as transaction prices, is closely held and not published. As a result, many market participants cannot accurately value their portfolios nor prudently manage their investments. Had there been objective and real time price

transparency and a uniform margin methodology available last fall, the AIG fiasco may never have happened.

The Right Incentives

Today, the vast majority of credit default and interest rate swap contracts have standard terms similar to equity options, and trade in large daily volumes. The same parties that trade credit default and interest rate swap contracts participate in other markets that benefit from central clearing, transparent and consistent margins, and account segregation.

In the absence of one or more central clearinghouses available to all market participants, a tremendous amount of risk is concentrated with a handful of financial institutions. These financial institutions earn extraordinary profits from the lack of transparency in the marketplace and from the privileged role they play as credit intermediaries in almost all transactions. Unfortunately, we have seen the cost borne by our broader economy when one of these highly interconnected institutions fails.

Capital requirements on the trading of over-the-counter derivatives should reflect the significant systemic risk they create. We should also consider the imposition of a requirement for financial institutions to use clearinghouses for the most commonly traded over-the-counter derivatives.

This problem has an international dimension. We must work to coordinate our actions with foreign regulators. Otherwise, we face the risk of cross-border capital and regulatory arbitrage.

We are hopeful that once appropriate capital requirements are established, trading of over-the-counter derivatives will naturally flow to regulated clearinghouses with mutualized risk and natural netting capabilities. And with it, price transparency, reduction of systemic risk, and continued evolution of the core market will follow.

The status quo cannot be allowed to continue. We must work together to drive market structure reform that fosters orderly and transparent markets, facilitates the growth and strength of the American economy and protects taxpayers from losses such as those we have witnessed in the last year.

Thank you for the opportunity to testify today. I would be happy to answer your questions.