

Citadel Derivatives Group (Europe) Ltd

Pillar 3 disclosures for the year ended 31 December 2008

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1. Introduction: Pillar 3

Basel II is structured around three 'pillars': Pillar 1 on minimum capital requirements; Pillar 2 on the supervisory review process; and Pillar 3 on market discipline.

Pillar 3 aims to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on a firm's capital resources, risk exposures and risk assessment process. The disclosures contained in this document cover the qualitative and quantitative disclosure requirements of Pillar 3 and are based on available data as at 31 December 2008.

These Pillar 3 disclosures have been prepared solely to comply with regulatory requirements to provide public information on the Company's risk management objectives and policies, its capital position, its approach to assessing the adequacy of its capital and its exposure to credit, market and operational risks.

The disclosures are made in accordance with the Company's disclosure policy and are not audited. They are reviewed and updated at least annually. Reference to the availability of the Pillar 3 report is made in the Company's financial statements; the Company does not have a website.

If you have any questions on this document, please write to the Company Secretary, Citadel Derivatives Group (Europe) Ltd, Moor House, 120 London Wall, London EC2Y 5ET.

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2. Risk Management framework and policies

Business Overview

Citadel Derivatives Group (Europe) Limited ("CDGE") is a full scope investment firm regulated by the FSA. The principal activity of the Company is proprietary trading in equities, futures and options on a high frequency algorithmic basis across various European exchanges. The Company has also developed an execution business which generates commission income from the execution of equities trades on behalf of a related party. The CDGE data shown in section 3 of this report is stated as at 31 December 2008. CDGE operates from a single location, in the City of London.

Risk Management framework

Risk Management is the process of identifying the principal risks to the group achieving its strategic objectives, establishing appropriate controls to manage those risks and ensuring that appropriate monitoring and reporting systems are in place to ensure that controls remain robust and evolve with the changing risk profile of the Company. The Company's risk management framework is set out below and seeks to minimise the potential adverse effects of business risks on financial performance.

CDGE is part of Citadel Investment Group, a global investment management business. A number of control functions, such as daily risk metrics and P&L measurement, are produced at a business or desk level, which can span multiple legal entities. Each desk monitors positions and risk factors through the firm's real time front office risk monitor. The view monitored using this tool is market-facing.

Overall risk is monitored by the Portfolio Construction Group ("PCG"), the global independent risk control function for Citadel. PCG runs a global monitoring tool by business line to allow business heads, portfolio managers, traders and risk managers to view risk measurements, scenarios and stress tests from the position level up to the global Citadel level.

At the legal entity level, no market risk is held in CDGE. All market risks, including interest rate risk and foreign exchange risk, are transferred to a related entity, Citadel Global Trading Sarl ("CGTS"), via a total return swap. The risks associated with the swap are monitored by the CDGE Business Unit Control ("BUC") function. BUC carries out various daily control functions including a daily trading P&L for the business. Risk is viewed through a combination of the PCG view and an external view provided by the prime broker (the prime broker is also the exchange clearing member). BUC monitors cash collateral margins on a daily basis against the counterparty credit exposure to CGTS, and adjusts margin on a daily basis as necessary through a global cash management tool.

Risk is also monitored by the Global Citadel Cash Management function in Chicago. Cash Management monitors cash collateral margins on a daily basis against the Prime broker. They verify external cash margin calls against Citadel risk calculation models.

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Risk Management framework (continued)

BUC verifies its internal risk measures using external views. The firm's prime broker independently calculates the risk on the firm's exposure (to the prime broker) on a daily basis using its own risk models. The firm uses this, the exchange margin, and the fully-reconciled portfolio current market value in its risk monitoring.

The Company has conducted a comprehensive operational risk identification exercise by risk category by function head across the business to ensure that all significant risks have been identified and captured by the risk management infrastructure. All significant risks have been documented, scored and level of exposure estimated using a matrix of parameters.

The Board of Directors has overall responsibility for the establishment and oversight of the Company's risk management framework. The Company's risk management policies are established to identify the risks faced by the Company, to set appropriate risk limits and controls, and to monitor risks. Risk management policies and systems are reviewed regularly to reflect changes in market conditions and the Company's activities.

The Board of Directors consists of the COO and CEO for Citadel Europe plus a non-executive director. The high level summary of the key risk assessments for CDGE is as follows:

Market risk

Market risk is the potential for changes in the value of investment positions due to market changes, including interest and currency rate movements as well as fluctuations in the prices of investment positions. Market risk is directly impacted by the volatility and liquidity in the markets in which the related underlying financial instruments are traded.

Interest rate risk is the risk of loss due to the fluctuation of interest rates. Interest rate is one of the components used to determine the price of an option therefore the value of the options in the portfolio is subject to interest rate risk.

Foreign exchange risk is the risk of loss due to the fluctuation of exchange rates. The valuation of the portfolio is subject to foreign exchange risk arising from non-US Dollar positions.

The Company has Total Return Swap agreements with CGTS whereby the market risks in the trading book, including interest rate risk and foreign exchange risk, are transferred to CGTS in exchange for payments as prescribed by these agreements.

In respect of non-trading assets and liabilities denominated in foreign currencies, the Company ensures that its net exposure is kept to an acceptable level by buying or selling foreign currencies at spot rates when necessary. Any non-trading foreign exchange gains and losses are included in the operating expenses of the company, which are also swapped to CGTS.

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Credit risk

Credit risk is the risk of financial loss due to the failure of a counterparty to perform according to the terms of a contract. CDGE adopts the Standardised approach to Credit risk and further information is presented in Section 4 of this report.

The credit quality of counterparties with whom CDGE transacts is monitored by the group Treasury function. All institutional counterparties are highly rated.

Liquidity risk

The Company's approach to managing liquidity is to ensure, as far as possible, that it will have sufficient liquidity to meet its liabilities when due, without incurring unacceptable losses or risking damage to the Company's reputation.

Liquidity risk on derivatives positions is not managed on the basis of contractual maturity as they are frequently settled on demand at fair value. The Company has a low risk appetite and has consistently generated trading profits resulting in positive cash flows back to the business. Cash positions are monitored and reconciled daily by the Global Citadel Cash Management function.

Operational Risk

Operational risk is the inherent risk of material loss or other adverse impact resulting from inadequate internal processes, people or systems or from external events. CDGE has a low operational risk appetite and has in place a robust systems and controls framework, as evidenced by the OQ2+ group operational risk rating received from Moody's.

This various risks associated with employees are addressed by human resource policies to ensure that the Company recruits and retains staff with the appropriate skills, by offering an attractive work place environment and highly competitive remuneration packages.

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3. Capital Resources and Capital Adequacy

The table below summarises the regulatory capital position of CDGE as at 31 December 2008 (Pillar 1):

| Capital resources | Notes | 31 December 2008 USD 000s |
|---|-------|------------------------------|
| Share Capital | | 8,000 |
| Audited retained profits | 1 | 28,040 |
| Core Tier 1 Capital | | 36,040 |
| Total regulatory capital | 2 | 36,040 |
| Credit risk capital component | | 1,728 |
| Counterparty risk capital component | | 6 |
| Market risk capital requirement | 3 | - |
| Operational risk capital requirement | 4 | 3,849 |
| Total variable capital requirement | | 5,583 |
| Surplus of Capital Resources | 5 | 30,457 |

Notes on capital resources table above

1. Audited retained earnings include USD 19,854K in respect of the year ended 31 December 2008, which was audited subsequent to that date.
2. The Company has no tier 2 capital, or any deductions from core tier 1 capital.
3. Market Risk is transferred to CGTS through a total return swap.
4. Operational risk is calculated using the Basic Indicator approach.
5. Stated before any internal capital allocations arising from the ICAAP.

Pillar 1 capital resources

The Company's policy is to remain well capitalised and soundly financed. CDGE will maintain a strong capital base to support the development of the business and to ensure regulatory capital requirements are met at all times. At 31 December 2008, including the audited 2008 results and up-to-date Operational risk calculations, the surplus of capital resources was USD 30,457K.

There are no current or foreseen material practical or legal impediments to the prompt transfer of capital resources or repayment of liabilities. There are no plans to distribute retained earnings to the parent entity by way of dividends.

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4. Credit Risk

CDGE adopts the Standardised approach to Credit risk. The credit risk associated with the swap to CGTS is mitigated by the holding of 100% cash collateral from the swap counterparty, CGTS. The collateral is calculated daily and is based on the market value of the positions transferred to CGTS. Collateral is adjusted on a daily basis as necessary through a global cash management tool.

Counterparty risk capital component

Counterparty credit risk is the risk of loss as a result of a party to a transaction defaulting before the final settlement of the transaction's cash flows. The Company clears its options and equity securities transactions through a highly rated clearing broker, which also maintains the Company's positions. In addition the clearing broker provides the majority of the financing for these securities. This can result in a concentration of credit risk with the clearing broker. However credit risk in the trading book is small as all trading is carried out electronically on-exchange with regulated counterparties, and the risk profile is flattened out at the end of each day. Furthermore the exchange margin is reconciled daily with adjusting cash flows being closely controlled on a daily basis. Consequently, on the grounds of materiality, no further information on the counterparty risk capital component is presented in this report.

Credit risk capital component

The Company places excess cash with highly rated institutions, in short term (24-hour) deposit or money market accounts. As stated above, cash placed with prime brokers is reconciled and controlled daily. There are no other material credit exposures to report.

External credit assessments provided by Moody's are used to assign exposures a credit quality step and calculate credit risk capital requirements under the standardised approach. The table below shows the exposure classes and amounts associated with the credit quality steps and the relevant risk weightings at 31 December 2008:

| Exposure class | Credit Quality Step | Risk Weight | Exposure USD 000s |
|--------------------------------------|---------------------|-------------|---------------------|
| Claims on institutions (< 90 days) | 1 | 20% | 83,278 |
| Claims on institutions (< 90 days) | 2 | 20% | 24,152 |
| Claims on institutions | | | <u>107,430</u> |
| Corporates | 3 | 100% | 109 |
| Corporates | | | <u>109</u> |
| Credit risk capital component | | 8% | <u>1,728</u> |

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Credit risk capital component (continued)

The above analysis gives the breakdown of credit risk by asset class; no further industry analysis of the credit risk capital requirement is considered necessary.

The geographical analysis of credit exposures by asset class is as follows:

| Asset class | UK USD 000s | USA USD 000s | Rest of World USD 000s |
|------------------------|----------------|-----------------|------------------------------|
| Claims on institutions | 8,453 | 98,977 | - |
| Corporates | - | - | 109 |
| | <u>8,453</u> | <u>98,977</u> | <u>109</u> |

Claims on institutions have a residual maturity of less than 90 days, there being no material amounts falling due after 90 days.

The Company has no financial assets which are past due or impaired.

5. Other Pillar 3 disclosures

Interest rate risk in the non-trading book

The Company does not carry any material interest rate risk in its non-trading book.

Pillar 2: Internal capital adequacy assessment process ("ICAAP")

CDGE has carried out its internal capital adequacy assessment. The ICAAP forms an integral part of the Company's risk management processes. The ICAAP is co-ordinated locally by the COO and head of the legal and compliance function. The ICAAP is updated at least annually and reviewed by the Board of Directors of CDGE.