

MEMORANDUM

TO: File No. S7-27-10
File No. S7-39-10
File No. S7-43-10
File No. S7-44-10

FROM: Andrew Bernstein, Division of Trading and Markets

RE: Meeting with representatives from Citadel LLC

DATE: January 20, 2011

On January 20, 2011, Robert Cook, James Burns, Brian Bussey, Thomas McGowan, Haimera Workie, Kim Allen, Marta Chaffee, Peter Curley, Catherine Moore, Andrew Bernstein and Andrew Blake of the Securities and Exchange Commission met with Adam Cooper and Randall Costa of Citadel LLC (“Citadel”).

At the meeting, the Citadel representatives provided the attached document and expressed their views and observations regarding central clearing in the context of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and discussed, among other topics, views with respect to the following rule proposals:

- Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps under Regulation MC (File No. S7-27-10);
- Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant” (File No. S7-39-10);
- End-User Exception to Mandatory Clearing of Security-Based Swaps (File No. S7-43-10); and
- Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations (File No. S7-44-10).

[No agenda available for this meeting.]

Central Counterparty Clearing: Key CCP Features, Systemic Risk Benefits, and Impacts on Buyside and Sellside Participants

Introduction

The OTC derivatives reforms sought by the buyside are the same as those sought by global regulators. The features of reform that are designed to eliminate systemic risk will equally represent dramatic improvements in the buyside's ability to manage counterparty and operational risks. At the same time, these reforms will increase efficiency, transparency and competition, all highly beneficial to and sought after by the buyside. Collectively these improvements translate to lower costs and safer, more liquid markets.

The table that follows sets out the key market improvements that can be achieved through clearing through CCPs, these improvements' systemic risk benefits, and the changes these improvements will bring about in efficiency and the respective incentives and economics of the buyside and sellside. These improvements can be implemented in ways that advance efficiency, or alternatively, that may narrowly offer specific benefits, but maintain current barriers to efficiency or to further evolution of market structure. For example, there are product standardization approaches that will promote efficiency (e.g., that support straight-through-processing and clearing, automatic trade compression, or electronic trading), and approaches that will still require individual bi-lateral documentation and processing steps that limit efficiency and competition. Similarly there are clearing approaches that provide narrow segregation benefits, but require buyside participants to transact with only a limited group of dealers to receive these benefits, or are unsuitable for evolution to electronic trading, in either case maintaining barriers to improved price discovery and competition.

A significant portion of the OTC derivatives markets is clearing-eligible, and is prepared to operate much like other more efficient markets such as listed futures or exchange-traded equity options. When the reforms set out in the following table are implemented, transaction costs for the buyside will be significantly reduced, even as critical gains will be achieved in risk management.

These improvements will also reduce per transaction revenue for dealers versus the current market, but there will also be offsetting benefits for dealers: The increased safety and efficiency of these markets will attract new liquidity, offering competitive market makers the opportunity to offset reductions in spreads with increased trading volumes. Dealers should also benefit from improved capital efficiencies with clearing, since CCPs increase the opportunities for compression of dealer portfolios and CCPs represent more favorable counterparties for purposes of calculating counterparty credit risk capital than the dealers' current bi-lateral counterparties (including other dealers). Straight-through-processing models will lead to operational risk reductions and cost and capital savings. Not least, it cannot be forgotten that the market disruptions of 2008 were extremely costly to dealers. These costs would have risen to catastrophic levels for the dealers had governments not provided direct and indirect aid. The market reforms associated with CCPs are designed to prevent a reoccurrence of the events of 2008, while ensuring that risks associated with OTC derivatives are fully internalized by the market participants who benefit from their use.

**Central Counterparty Clearing: Key CCP Features, Systemic Risk Benefits,
and Impacts on Buyside and Sellside Participants**

Key CCP Feature	Systemic Risk Benefits	Trading Structure Change from Bi-lateral Market	Buyside/Sellside Economics Impact
Segregation	Investor positions and margin are isolated from the insolvency of dealer counterparty/clearing member; eliminates a key contributor to “too interconnected to fail” by having the buyside participant effectively face the CCP and not be at risk to the dealer clearing member (“CM”)	In the bi-lateral market cash and securities collateral posted by the buyside to dealer counterparties is taken into dealer working capital or otherwise available to the dealer for rehypothecation in support of dealer activities; isolation of this collateral from the dealer balance sheet protects it from dealer insolvency, but eliminates a significant source of low-cost dealer financing	Buyside isolated from dealer counterparty/CM counterparty risk and insolvency Dealer no longer has low-cost financing through customer margin deposits
Portability	Segregated positions and margin of investor may be promptly moved from insolvent CM to solvent one – no disruption in buyside liquidity in default event; even without a default event, investor may freely transfer positions together with margin to a competing clearing member, allowing investors to ensure optimal risk compression	In the bi-lateral market when a buyside participant wishes to transfer a derivatives position to a different dealer counterparty, such transfer requires the consent of the original dealer to either assign or close out; dealers have historically assessed an “unwind fee” for such a transfer or close-out; in the cleared context, a CCP may enable the transfer through a simple book entry to an accepting alternative clearing member, without an unwind fee	In crisis, buyside able to immediately move its positions to a solvent CM from a defaulting CM without disruption in liquidity; in ordinary course, buyside able to transfer its positions and margin to a competing CM without unwind fee, thus fostering competition for CM services Dealer no longer able to demand a fee for assignments or close-outs, and must meet greater competition
Natural Compression	Instantaneous netting of offsetting cleared contracts reduces net exposures; instantaneous netting reduces counterparty exposure for both buyside participants and dealers, and reduces interconnectedness overall Instantaneous netting requires complete fungibility of contracts within the same CCP; true compression minimizes open interest and simplifies resolution of defaults versus bi-lateral frameworks	As with transfers or assignments, in the bi-lateral market if a buyside participant requests its original dealer counterparty to reduce or close out a position, the dealer will assess an “unwind fee”; to avoid this, investors have historically entered into offsetting transactions with other dealers – while the investor is left with reduced or zero market risk on the instrument, it has effectively doubled its counterparty risk; with cleared products that are structured to be fungible within the CCP, offsetting contracts are instantaneously, naturally netted, thereby eliminating counterparty risk in the system; note that some CCPs may require an extra step, and allow dealers to charge a fee, for such netting	Buyside no longer pays an unwind fee for collapsing or closing out exposure, and at all times has minimum net counterparty exposure without needing to take affirmative steps, and also if it is assessed fees based on its cleared positions, these fees will be based on the lower net amount of its collapsed exposure; efficient compression minimizes “interconnected” risks and overall leads to efficient risk management Dealer loses ability to assess unwind fee; or if the Dealer is acting as CM to charge clearing or other fee on the basis of gross exposures, since all exposures are naturally netted to the minimum

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Price Transparency	Publication of end-of-day settlement prices provides significantly more accurate risk assessment than in current bi-lateral market – assures sufficient margin because margin is assessed on real market values and facilitates marking of existing books to support better risk management and public disclosure; eliminates margin disputes; enhances regulatory risk oversight; allows CCPs to assess prices for a wider range of products not yet cleared, to prepare to risk manage these products and move them into clearing	In the current OTC derivatives markets, there is no source of actual transaction prices; by contrast in cleared markets, CCPs daily or more frequently establish prices on all instruments for which they hold open interest, in order to establish appropriate risk margin levels; CCPs establish these settlement prices based on actual transaction prices, auctions, and analysis of a range of other price data sources, and communicate these settlement prices to their users; depending on the CCP model, CCPs also publish these prices, providing a significant source of price transparency for the entire market. Price transparency naturally reduces the informational advantages held by large dealers in historically opaque markets, leading to bid-offer compression, i.e. reduction in dealing profits	Buyside has greater ability to ascertain current market values, reducing dealer informational advantages and bid-offer spreads Bid-offer spread compression reduces dealer per transaction trading revenues
Straight-Through-Processing (“STP”) to CCP – No Bi-Lateral Exposure	Eliminates bi-lateral exposure of buyside participant to its executing broker and instead ensures that all exposures are immediately only to the CCP, not to the executing broker	In the current OTC derivatives markets, there is a dealer on one side of every trade and, in view of the potentially long durations of derivatives trades, buyside participants are highly concerned to transact only with the largest dealers who are perceived as having the lowest potential risk of default; if instead with an STP CCP model, a buyside transactor is assured instantaneously or within no later than the same day that its contract is accepted for clearing, it need not be concerned with counterparty risk to the dealer with which it executes the trade; this eliminates any “balance sheet” advantage of large dealers that are perceived to be “too big to fail”	Replacement of bi-lateral exposure with real-time clearing to a CCP allows new market making entrants to compete on price and risk management rather than balance sheet; greater competition leads to an increase in liquidity available to investors and greater price discovery opportunities and consequent improved risk management and reduction in bid-offer spreads Greater competition and price discovery efficiency reduces bid-offer spreads thus reducing per transaction revenues for dealers, potentially offset through an overall expansion in market volumes – as liquidity increases and transaction costs and counterparty and operational risks are reduced, new investors enter the market and existing investors trade more, thereby increasing market making volumes altogether

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<p>No barriers to competition – new liquidity providers</p>	<p>The preceding conditions create the potential for a wide range of liquidity providers to provide enhanced competition in making markets in the cleared derivatives, provided there are no other barriers to their offering liquidity; it is crucial that anonymity be preserved throughout the clearing process, otherwise CMs might reject or differentially price clearing of trades their customers execute with competing liquidity providers; similarly, direct clearing access to CCPs must be non-discriminatory, solely on objective, risk-based criteria</p>	<p>The elimination of bi-lateral risk noted above permits new competitors to provide liquidity as executing brokers in cleared contracts, resulting in many new sources of liquidity and, through competition, further reduction in bid-offer spread; note that some CCP models, even if they have STP, or STP with direct CCP clearing members, may not permit transactions done with executing brokers who are not CCP CMs to be cleared in real time, or may not preserve anonymity through the clearing process, even though there is no risk management basis for disclosure, thus in each case deterring or preventing buyside participants from transaction with non-CCP CMs</p>	<p>Same benefits and costs as with eliminating the balance sheet advantages of the largest dealer banks, with the added factor of ensuring that there are no structural impediments to new competitors trading in a given CCP's products with anonymous real-time or at least same-day acceptance for clearing</p>
<p>Electronic trading – ultimately in the form of a central limit order book whereby anonymous bids and offers are continuously posted</p>	<p>Efficient clearing models enable electronic trading with STP to the CCP for products with sufficient liquidity, provided there are no barriers to electronic trading such as requirements for bi-lateral contract execution or trade processing delays; electronic trading, especially full exchange trading, provides open competition with anonymous, binding bids and offers; this continuous price transparency allows real-time risk management and an exchange's depth of market allows rapid adjustment of risk positions, including providing a pool of liquidity for risk management in times of market stress, where bi-lateral markets may become much more challenged</p>	<p>In the current OTC bi-lateral markets, there is highly limited pre-trade transparency – instead, dealers signal non-binding, indicative prices for small lots as an inducement to individual bi-lateral negotiation; this inefficiency in price discovery leads to wider bid-offer spreads, reduced liquidity, and challenges in risk management; electronic trading can dramatically increase efficiency of price discovery, enabling much more competition, leading in turn to both greater liquidity and tighter bid-offer spreads</p>	<p>Electronic trading greatly increases price discovery and competition versus bi-lateral negotiation, thus providing buyside investors, especially in a full exchange context, continuous access to the tightest bid-offer spreads</p> <p>The tighter bid-offer spreads resulting from full electronic price discovery and competition further reduce dealers' individual transaction revenues; however, historically electrification of markets has led to significant further increases in overall demand, thus allowing competitive dealer market makers to offset bid-offer compression through larger volumes; furthermore, trading platforms provide incentives for dealers that are most effective in providing competitive and continuous liquidity, thus providing opportunities to capture market share and improved economics through active market making</p>