



June 21, 2010

**By Electronic Mail**

Elizabeth Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

Re: *Proposed Amendments to Rule 610 of Regulation NMS; File No. S7-09-10*

Dear Ms. Murphy:

Citadel LLC (“**Citadel**”)<sup>1</sup> appreciates the opportunity to comment on the Securities and Exchange Commission’s (the “**Commission**”) proposal to amend Rule 610 of Regulation NMS.<sup>2</sup> Citadel supports the Commission’s proposal to limit the amount of fees that an options exchange may impose (or permit to be imposed) for the execution of an order against the exchange’s best bid and offer, although we believe the cap should be set at a lower level than currently proposed. For the reasons provided in our 2008 rulemaking petition (the “**Rulemaking Petition**”), we believe that an options market access fee cap set at \$0.20 or less is needed to address market distortions caused by excessive options market access fees.<sup>3</sup>

The options market distortions caused by access fees will become much greater if the Commission acts to ban “flash” orders in the options market, as the Commission recently proposed.<sup>4</sup> As we explained in our comment letter on the Flash Ban Proposal, “step-up” mechanisms are a direct response, and serve as the primary counterbalance, to excessive options

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<sup>1</sup> On an average day, Citadel accounts for more than 9% of U.S. listed equity volume and 29% of U.S. listed equity option volume. Founded in 1990, the Citadel group of companies includes an asset management division that principally executes alternative investment strategies across multiple asset classes, Citadel Securities, which includes investment banking and sales and trading platforms and an industry leading market making franchise, and Omnium, a recognized administrator serving financial institutions. With more than 1,200 team members, Citadel operates in the world’s major financial centers, including Chicago, New York, London, Hong Kong and San Francisco. Please note that Citadel Investment Group, L.L.C. recently changed its name to Citadel LLC.

<sup>2</sup> See Proposed Amendments to Rule 610 of Regulation NMS, Exchange Act Release No. 61902 (April 14, 2010), 75 FR 20738 (April 20, 2010) (the “**Proposing Release**”).

<sup>3</sup> See Letter from John C. Nagel, Managing Director & Deputy General Counsel, Citadel, to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, dated July 15, 2008, available at <http://www.sec.gov/rules/petitions/2008/petn4-562.pdf>.

<sup>4</sup> See Elimination of Flash Order Exception from Rule 602 of Regulation NMS, Exchange Act Release No. 60684 (September 18, 2009), 75 FR 48632 (September 23, 2009) (the “**Flash Ban Proposal**”).

market access fees.<sup>5</sup> The Flash Ban Proposal would eliminate the use of step-up mechanisms in the options market and remove the most important counterbalance to excessive market access fees. As a result, if the Commission implements the Flash Ban Proposal in the options markets, the Commission should cap access fees in the options market at a *de minimis* level or prohibit them altogether.

## **I. Discussion**

### **A. *Options Market Access Fees Are Distorting Quotations***

In the Proposing Release and in other previous releases, the Commission noted its authority to adopt rules assuring the fairness and usefulness of quotation information.<sup>6</sup> As we said in our Rulemaking Petition, if market participants are required to rely on the published quotations of options exchanges when routing orders because of trade-through protections and best execution obligations, options market quotations must accurately reflect the true price at which options can be purchased or sold. Because displayed quotations do not reflect exchange access fees and those fees vary widely, an exchange's published quotation does not represent the true cost of execution. Thus, we agree with the Commission's statement in the Proposing Release that a wide disparity in the level of fees charged by different exchanges make the displayed quotations less accurate and useful.<sup>7</sup> If the published quotations of any exchange do not reliably indicate the true cost of trading with a particular quotation, brokers may not provide best execution to their customer orders, and customers may not be able to accurately assess the quality of their executions.

### **B. *Trade Through Protections Necessitate an Access Fee Cap***

The NMS options linkage plan requires each participating exchange to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent trading through better priced quotations disseminated by other options exchanges. This structure is similar to Rule 611 of Regulation NMS, which applies to exchange listed stocks. Regulation NMS couples the trade-through prohibition on equities with an access fee cap. At present, the

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<sup>5</sup> See Letter from John C. Nagel, Managing Director & Deputy General Counsel, Citadel, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, dated November 20, 2009, available at <http://www.sec.gov/comments/s7-21-09/s72109-80.pdf>.

<sup>6</sup> See Proposing Release at 20739; Regulation NMS Adopting Release, Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496 at 37545 (June 20, 2005); Section 11A(c)(1)(B) of the Exchange Act.

<sup>7</sup> Proposing Release at 20755.

options market is operating with a trade through prohibition, but without an accompanying access fee cap.

An options market access fee cap would simply apply to the options market the same protections that benefit investors in the equities market. The same underlying policy goals of the equity access fee cap of Regulation NMS apply to the listed options market – specifically, assuring the practicability of brokers executing investors’ orders in the best market and assuring the efficient execution of securities transactions. These public policy goals are statutory objectives set out in Section 11A of the Securities Exchange Act of 1934, and neither can be achieved if brokers must pay exorbitant fees simply to access the quote that appears to be, but in reality is not, the best displayed quote. Without a fee cap, any exchange can force all other market participants to pay the exchange’s outsized fees in order to fulfill their trade-through and best execution obligations.

***C. Implementing the Proposed Ban on Step-Up Orders Would Increase the Need for a Fee Cap, and Warrant a Lower Fee Cap***

If the SEC adopts its Flash Ban Proposal, which would effectively prohibit the use of step-up orders in the options market, it is essential that access fees for options be capped at a *de minimis* level or prohibited altogether. Step-up orders are used when one options exchange receives a marketable order at a time when it is not quoting at the national best bid or offer (“NBBO”). The order cannot be executed on that exchange without violating the prohibition on trade-throughs. However, if the order is routed to a market that is quoting at the NBBO, the order might receive an inferior execution when the destination market’s access fees (such as “take” fees assessed on “takers” of liquidity) are factored in. In such a case, before routing the order to another exchange, the receiving exchange will display (flash) the order to its participants for a short period of time, and exchange participants will be given an opportunity to match or improve the best price displayed on other exchanges. When an exchange participant “steps up,” the customer receives an execution at the best quote without paying an access fee charged by another market. Thus, step-up orders provide a way for investors to avoid paying access fees. The availability of a step-up mechanism is particularly important in today’s options market because unlike the equities market, the options market has unlimited access fees.

Step-up mechanisms are more important in the options market than in the equities market. In the equities market, dealers may internalize orders to avoid access fees charged by another market center. Internalization acts as a counterbalance to trading centers imposing an excessive access fee because a trading center that imposes an excessive fee will lose volume by encouraging internalization. Internalization and other forms of off-exchange trading are generally prohibited in listed options. Therefore, options step-up mechanisms are the only lawful means for a broker-dealer handling an option order to avoid paying high access fees charged by markets displaying the best quotations.

If the Commission were to ban step-up mechanisms in the options market without limiting access fees to a *de minimus* level, the Commission would allow market participants to be “held hostage” by a market that has high access fees. If such a market happens to be displaying the best price in an option at a given time, market participants would, by virtue of trade-through and best execution obligations, be forced to trade on that market, with no step-up mechanism or ability to internalize or trade off exchange. Such a result is not consistent with good public policy and the statutory standards that guide the Commission’s rulemaking.

Thus, if flash orders are prohibited, options market access fees should be capped at a *de minimis* level or prohibited altogether.<sup>8</sup>

**D. *Other Structural Differences Between the Options and Equities Markets Call For a Lower Fee Cap in Options Than in Equities***

The Proposing Release explains that the proposed access fee cap is not higher for options relative to the cap for equities because the caps are set at the same level measured in terms of price per 100 underlying shares. However, when an investor buys a security, whether it is a stock, a bond, or an option on a stock, what is important to the investor is the amount of the fee relative to the price paid for the security, not the amount of the fee relative to the underlying notional exposure that the trade provides.

In this regard, the proposed options fee cap is much higher as a percentage of average option prices compared to the equities fee cap as a percentage of average stock prices. In the equities market, the access fee cap of \$0.003 per share equals approximately 0.0160% of the average stock execution price for retail investors. The proposed options market fee cap would equal approximately 0.193% of the average option execution price for retail investors, which is 12 times greater than the equities fee cap measured as a percentage of average retail execution price.<sup>9</sup> The Commission should carefully consider these relative differences, rather than simply applying the equities fee cap to options.

The pricing model of options exchanges also warrants a significantly lower fee cap than the \$0.30 cap proposed by the Commission. Options exchanges that use a customer priority model provide substantial benefits to public customers, because the orders of public customers

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<sup>8</sup> We note that at the time we advocated for a \$0.20 fee cap in our Rulemaking Petition, it was not anticipated that step-up orders would be prohibited. In light of the Commission’s Flash Ban Proposal, we believe the access fees in the options market should be capped at a *de minimis* level well below \$0.20 or prohibited altogether.

<sup>9</sup> In June 2010, the average listed retail equity execution price was approximately \$18.70, and the average listed option execution price was approximately \$1.55.

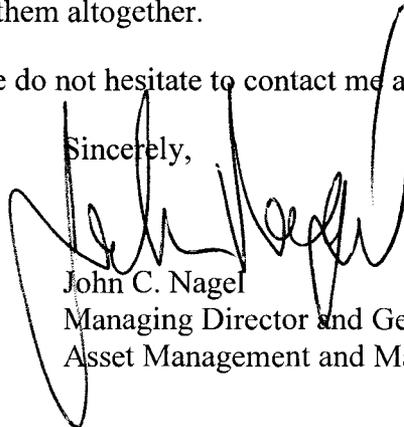
generally receive free executions (or a rebate) and customers receive execution priority ahead of market professionals at a given price. On the other hand, high access fees – particularly on exchanges with maker/taker pricing models – operate to subsidize rebate payments to the electronic trading firms that place the overwhelming majority of executed limit orders on the order books of maker/taker exchanges. Allowing excessive access fees to be charged essentially undercuts the benefits to public customers of trading on customer priority exchanges and disproportionately rewards professional, proprietary trading firms. This is not a result that the Commission should encourage or perpetuate.

## II. Conclusion

We agree with the policy goals that the Commission seeks to achieve with its proposal. For the reasons discussed above, we believe that to reduce the distortions in the market caused by access fees and in light of the differences between the options and equities markets, the Commission should cap options market access fees at \$0.20 or less. If the Commission bans the use of step-up mechanisms in the options market, the Commission should cap options market access fees at a *de minimis* level or ban them altogether.

If you have any questions, please do not hesitate to contact me at (312) 395-3115.

Sincerely,



John C. Nagel  
Managing Director and General Counsel  
Asset Management and Markets

cc: Hon. Mary Schapiro, Chairman  
Hon. Luis A. Aguilar, Commissioner  
Hon. Kathleen L. Casey, Commissioner  
Hon. Troy A. Paredes, Commissioner  
Hon. Elisse B. Walter, Commissioner  
Robert W. Cook, Director, Division of Trading and Markets  
James A. Brigagliano, Deputy Director, Division of Trading and Markets  
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