CITADEL

August 6, 2010

By Electronic Mail

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

Re: *Elimination of Flash Order Exception from Rule 602 of Regulation NMS; File No. S7-21-09*

Dear Ms. Murphy:

Citadel LLC ("**Citadel**")[1] appreciates the opportunity to submit this comment letter in response to the Securities and Exchange Commission's (the "**Commission**") reopening of the comment period on its proposal to eliminate the flash order exception from Rule 602 of Regulation NMS with respect to listed options ("**Reopening Release**").[2]

In the Commission's original proposal to ban the use of flash orders ("**Flash Ban Proposal**"),[3] the Commission asked whether it should adopt a different approach for flash orders in listed options than for flash orders in listed equities.[4] In our letter commenting on the Flash Ban Proposal, we explained how the elimination of flash orders and "step-up" mechanisms on options exchanges would inflict substantial unintended damage on price transparency, liquidity, and execution quality currently enjoyed by retail customers.[5]

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[1] On an average day, Citadel accounts for approximately 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, and Citadel Securities that includes investment banking, a sales and trading platform, 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.

[2] Elimination of Flash Order Exception from Rule 602 of Regulation NMS, Exchange Act Release No. 62445 (July 2, 2010), 75 FR 39626 (July 9, 2010).

[3] Elimination of Flash Order Exception from Rule 602 of Regulation NMS, Exchange Act Release No. 60684 (Sept. 28, 2009), 74 FR 48632 (Sept. 23, 2009).

[4] *Id.* at 48640.

[5] Letter from John C. Nagel, Citadel, to Elizabeth M. Murphy, Securities and Exchange Commission (Nov. 20, 2009), *available at* http://www.sec.gov/comments/s7-21-09/s72109-80.pdf.

131 South Dearborn Street
Chicago, Illinois 60603

For the following reasons, we continue to believe that the listed options market and retail customers would be harmed by the elimination of step-up orders.

- Flash orders and related step-up mechanisms are necessary to avoid excessive access fees and to provide price and size improvement for retail orders in the options market, given the combination of access fees and a prohibition on over-the-counter trading that prevents internalization in listed options.

- Even if the Commission's pending proposal to cap access fees in listed options is ultimately adopted,[6] the absence of step-up mechanisms would inhibit meaningful access fee competition among exchanges. Step-up mechanisms serve as a critical counterbalance to excessive access fees, because they often avoid the need to route orders to markets with much higher access fees. Without such mechanisms, the incentive for markets to compete for order flow by lowering their fees would be reduced. This competition would still be important with the proposed $.30 fee cap because there is an enormous difference between $.30 and the free executions that are frequently available on traditional exchanges for executing customer orders.[7] In our experience, step-up mechanisms are most often used when the NBBO is a penny wide. Access fees capped at $.30 would thus remain a substantial portion of the quoted spread.

- Although the Reopening Release raises the theoretical possibility that customer orders that are displayed but not executed in a step-up mechanism might "miss the market," our experience indicates that step-up mechanisms do not cause orders to miss the market. On the contrary, we believe that customer orders often receive effective price improvement through a step-up mechanism because they are executed at the national best bid or offer (the "**NBBO**") or better in larger size than if they been routed to a high access fee exchange, and pay little or no access fee.[8] In effect, step-up mechanisms can provide valuable execution quality

[6] Proposed Amendments to Rule 610 of Regulation NMS, Exchange Act Release No. 61902 (Apr. 14, 2010), 75 FR 20738 (Apr. 20, 2010).

[7] Traditional exchanges generally have customer priority, affirmative quoting obligations, pro-rata allocation rules, and no or low access fees for customers. Payment for order flow is no longer a defining characteristic of traditional exchanges. For example, the PHLX and ISE have eliminated their payment for order flow programs in many of the most actively traded classes.

[8] High access fee exchanges generally have strict price time allocation rules with no customer priority, no quoting obligations, and high access fees that subsidize large rebates.

improvement, as the overall order gets a better price by executing at the NBBO without paying an access fee. In addition, the supplemental liquidity offered in a step-up mechanism avoids the substantial risk of missing the often fleeting and small-sized NBBO quotes on high access fee exchanges.

- Step-up orders support the model of the traditional exchanges. These exchanges provide deep liquidity for a diverse range of options, reward quoting in size and have market makers with affirmative quoting obligations across the full range of options in assigned symbols. In contrast, high access fee exchanges primarily quote only the most liquid contracts and their liquidity providers are mostly "fair weather" proprietary traders without any quoting obligations and who trade to collect rebates. We believe that eliminating step-up orders would force traditional exchanges to move towards the high access fee exchange model. This would effectively transfer to professional traders the economic benefits experienced today by retail customers on traditional exchanges. In addition, fewer liquidity providers would be willing to take on affirmative quoting obligations, decreasing liquidity in options other than the most actively traded series and widening spreads in such options. We believe this would harm retail investors and other market participants.

- Eliminating step-up mechanisms would not increase the amount of price improvement. The majority of step-up order executions occur when the NBBO for an option is one penny wide, leaving no room for further price improvement. Step-up mechanisms are often used in option series with penny-wide markets because access fees and rebates are largest relative to the spread in these series and these series are the most actively traded liquid series, which is where the rebate driven traders prefer to trade.

Beyond these important reasons for not eliminating flash orders in options, we are concerned that the Commission's premises and preconceptions regarding the effects of flash orders in the options market, and the potential impact of banning flash orders (and therefore step-up mechanisms), are not well supported by any data regarding these fundamental points. For example, the Commission has cited no data regarding the incidence of latencies due to step-up mechanisms and rerouting of orders resulting in customer harm; the market conditions in which step-up mechanisms are most actively used; the impact of a ban on flash orders on liquidity and execution costs for retail customer orders; the supposed potential of flash orders to discourage aggressive quoting;[9] or the impact of adopting a flash order ban with or without simultaneously capping access fees.

In addition, the Commission asks in the Reopening Release several fundamental questions about the execution quality received by investor orders that are placed in a step-up mechanism. For example, the Commission requests information on what proportion of flashed orders receive an execution at a price better than, equal to, or worse than the NBBO, what proportion of flashed orders are routed to other exchanges, the proportion of such routed orders that receive an execution, the percentage of orders executed in a step-up mechanism, and the percentage of orders that participate in price improvement mechanisms offered by exchanges. These are questions that should be answered through thorough and methodical fact gathering and analysis before the Commission takes action, rather than through unverified and potentially incomplete data collected through the public comment process.

The Commission carefully studied the impact of decimalization and of penny quoting in options before introducing these fundamental market changes. There is no such record to support a flash order ban in options. We believe the Commission asks many important questions in the Reopening Release, and that it should gather the data necessary to answer them confidently before acting.[10]

* * *

[9] We believe that some market observers have an unjustified and unfounded belief that step-up orders discourage price discovery in options, and that high access fee exchanges encourage it with high rebates. In fact, the situation is generally the reverse. Traditional exchanges are the primary source of options price discovery because these markets (i) are populated with market makers with quoting obligations and (ii) represent a majority of market share. Step-up orders support these exchanges, which in turn allows these exchanges to continue to play a leading role in options price discovery. In contrast, high access fee exchanges primarily "match" the quotes on traditional exchanges and opportunistically (and occasionally) tighten one or both sides of the market by one pricing increment, enabled in large part by the rebates they offer to liquidity providers. Such rebates are, in turn, largely funded by access fees. Because high access fee exchanges improve the NBBO only a small percentage of the time, these access fees result in unfavorable all-in execution prices most of the time and on average. Therefore, in most cases, any perceived quoting superiority is illusory. Moreover, eliminating step-up mechanisms would not cause market makers on traditional exchanges to quote more aggressively. Rather, they would simply migrate to the less retail customer friendly high access fee exchanges.

[10] In this regard, we would support the Commission requiring standardized disclosure of execution quality statistics for price and speed measured at the time of order receipt by a broker-dealer, exchange access fees, and step-up orders.

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In summary, we continue to believe that flash orders and step-up mechanisms serve an important economic function in the options marketplace and benefit retail and other investors. The Commission has not demonstrated a concrete empirical and analytical basis for concluding that the flash orders detract from market quality, and we do not believe it can do so.

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

Sincerely yours,

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
David Shillman, Associate Director, Division of Trading and Markets
Heather A. Seidel, Assistant Director, Division of Trading and Markets