CITADEL

November 18, 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:

In July, the Commission reopened the comment period on its proposal to ban flash orders (the "**Flash Ban Proposal**")[1] and opened a public comment period through August 9 to help the Commission decide whether listed options and listed equities should be treated differently under this proposal.[2] Almost two months after the reopening comment period closed, GETCO submitted a late comment letter to "provide additional data" to support its position that a flash order ban should apply to listed options.[3] Citadel LLC ("**Citadel**") submits this supplemental letter to briefly summarize how the late data in the GETCO letter is incomplete and misleading. For the reasons provided in our earlier comment letters, eliminating flash orders and "step-up" mechanisms on options exchanges would inflict substantial damage on price transparency, liquidity, and the execution quality currently enjoyed by retail customers.[4]

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[1] 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).

[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] Letter from John A. McCarthy, GETCO, to Elizabeth M. Murphy, Securities and Exchange Commission (Sept. 29, 2010), *available at* http://www.sec.gov/comments/s7-21-09/s72109-161.pdf.

[4] *See* 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; Letter from John C. Nagel, Citadel, to Elizabeth M. Murphy, Securities and Exchange Commission (Aug. 6, 2010), *available at* http://www.sec.gov/comments/s7-21-09/s72109-144.pdf (together, the "**Prior Citadel Letters**").

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GETCO argues that the data provided in its letter shows that maker/taker exchanges, which do not use step-up mechanisms, encourage aggressive quoting and thus improve market quality. For the following reasons, the data in the GETCO letter is misleading and incomplete:

- On its face, the GETCO letter does not present data showing that banning flash orders in the listed options market would improve market quality. The GETCO letter and data show that a minority of the time, market participants choose to quote on maker/taker markets at the best net price in a particular option contract, but the majority of the time, traditional exchanges set the best net price because they charge low or no access fees. The GETCO letter does ***not*** show that maker/taker exchanges are so consistently causing improved prices that there is a justification for driving the entire options market to this single model, which is a likely result if step-up mechanisms are banned. If anything, the data shows that the market is well served by a combination of the maker/taker model and the traditional exchange model.[5]

- GETCO states that even after taking access fees into account, maker/taker exchanges provide a better "all in" cost to investors.[6] However, a maker/taker exchange would have to cause a market participant to quote at the best quote a higher percentage of the time than shown in the GETCO letter in order to result in a net better price for investors. For example, with its access fee of forty-five cents per 100 shares, NYSE Arca Options ("Arca") would have to cause a market participant to quote at one price increment (*i.e.*, one penny) better than the prevailing market more than forty-five percent of the time to provide net better

[5] As noted in the Prior Citadel Letters, eliminating step-up mechanisms would result in a migration of trading activity to maker/taker exchanges, effectively forcing other markets to adopt this model. Not only would this erode valuable intermarket competition, it would also undermine the role of the market makers who provide much of the vitality of the listed options market. The traditional exchanges impose quoting obligations on market makers and also provide quoting incentives through participation guarantees when certain quoting obligations are satisfied. If, as we believe, eliminating flash orders in options will result in the demise of the models of the traditional exchanges and their market maker systems, we will have a listed options market in which liquidity is provided primarily by high frequency traders seeking to maximize rebates. Such a system cannot be relied upon to provide steady liquidity for retail investors.

[6] If the Commission ultimately adopts its proposed access fee cap in listed options, it is likely that the generous liquidity rebates that permit marker/taker models to be successful in certain cases will shrivel because they are funded by high access fees.

pricing to the market on average. The GETCO letter states that just over 25% of trades are executed when only maker/taker exchanges are quoting at the best price.[7]

- Moreover, the GETCO letter assumes contrary to fact and common sense that every time a maker/taker exchange is quoting at the best price, the maker/taker exchange provided a net benefit to the market. To make this leap, GETCO assumes, without mentioning, that the best quoted price would not have existed in the market but for the maker/taker exchange. On the contrary, in many instances a market participant would have quoted at that best price regardless of the existence of the maker/taker exchange, and simply directed that best priced quote to a high access fee maker/taker exchange, rather than a low or no fee exchange, to collect the maker/taker rebate. In these instances, the maker/taker exchange actually caused the market participant who accesses this price level to pay a net worse price because the maker/taker exchange charges a higher access fee to access this price level. GETCO has presented no data to show how often maker/taker exchanges actually cause market participants to quote at better prices, rather than simply directing better price quotes away from low or no fee exchanges to a high access fee maker/taker exchange.

- The GETCO letter fails to discuss quote size, which is one of the most important issues for execution of an order. Maker/taker exchanges primarily quote only the most liquid option contracts and do not typically offer deep liquidity. Traditional exchanges, on the other hand, provide deep liquidity for a diverse range of options, due in part to participation guarantees that reward quoting in size. It is not helpful to a customer when a maker/taker exchange displays a better price in a particular option contract if, as is often the case, the size of the displayed quote is not of

[7] Without a step-up mechanism, and using the 25% figure quoted by GETCO, a market participant might pay $.55 less to transact on Arca than on a no access fee exchange 25% of the time (1 penny better quote, minus a $.45 access fee). The other 75% of the time, a market participant would save the $.45 Arca access fee by trading on a no fee exchange rather than on Arca. Rather than saving money for investors on average, Arca's maker/taker fees thus cause investors to pay an average of $.20 per contract more than no fee exchanges ((25%*$.55) – (75%*$.45)). We note that this net harm to investors could drop to $.05 per contract with the proposed $.30 access fee cap ((25%*$.70) – (75%*$.30)) and could become a net benefit of $.05 per contract with a $.20 access fee cap ((25% * $.80) – (75% *$.20)), assuming that Arca charges the highest access fee allowed.

sufficient size to fill the customer's order and is smaller than the size available through a step-up mechanism on a traditional exchange.

- In support of its thesis, GETCO cites various statistics that measure the aggressiveness of quoting on Nasdaq OMX Phlx ("**Phlx**"). GETCO does not mention that Phlx operates on a maker/taker model only with respect to certain option contracts. Thus, GETCO's reference to the Phlx in this regard is misleading. In addition, we note that other factors unrelated to step-up mechanisms and maker-taker fees result in aggressive quoting on Phlx, including preferencing and pro rata allocation rules.

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In summary, we continue to believe that flash orders and step-up mechanisms serve an important function in the options marketplace and benefit retail and other investors. The public record for the Flash Ban Proposal does not provide an empirical and analytical basis for concluding that the flash orders detract from option market quality, and we do not believe any objective analysis could lead to such a conclusion.

If you have any questions, please do not hesitate to contact me at (312) 395-2100.

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
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