CITADEL

April 25, 2011

By Electronic Mail

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

Re: *Notice of Proposed Rule Change, as Modified by Amendment No. 1, to Create a Directed Order Program on a 6-Month Pilot Basis; File No. SR-BATS-2011-009*

Dear Ms. Murphy:

Citadel LLC ("**Citadel**")[1] appreciates the opportunity to submit this comment letter in response to the BATS Exchange, Inc. rule filing referenced above (the "**Rule Filing**").[2] The Rule Filing proposes to create a directed order mechanism on a pilot basis. Because the Rule Filing would hinder competition and harm the price discovery process, the Commission should not approve the Rule Filing.[3]

The Rule Filing would change BATS Exchange Options Market ("**BATS Options**") rules to create two new order types on a pilot basis: Market Maker Price Improving Orders ("**MMPIOs**") and Directed Orders. MMPIOs are orders sent by Market Makers that have a displayed price and size accessible by any BATS Options Member, and a non-displayed price accessible only by BATS Options Members approved by the Market Maker. A Directed Order is any order sent by a BATS Options Member directed to a particular BATS Options Market Maker.

[1] On an average day, Citadel accounts for approximately 8-9% of U.S. listed equity volume, and 25-30% 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. Citadel operates in the world's major financial centers, including Chicago, New York, London, Hong Kong and San Francisco.

[2] *See* Exchange Act Rel. No. 64132 (May 28, 2011).

[3] BATS originally proposed to create a directed order program that allowed sub-penny pricing. *See* Exchange Act Rel. No. 63403 (December 1, 2010), 75 FR 76059 (December 7, 2010) (SR-BATS-2010-034). Citadel submitted a comment letter arguing that the original rule filing should not be approved. *See* Comment Letter from John C. Nagel, Managing Director and General Counsel, Asset Management and Markets, Citadel LLC, to Elizabeth Murphy, Secretary, Securities and Exchange Commission (Dec. 28, 2010), available at http://www.sec.gov/comments/sr-bats-2010-034/bats2010034-3.pdf. BATS later withdrew the original filing and replaced it with the Rule Filing discussed in this comment letter.

601 Lexington Avenue
New York, New York 10022

A Directed Order may interact with a MMPIO only if (1) the sender of the Directed Order has been approved by the Market Maker, (2) the displayed price of the MMPIO is equal to the National Best Bid or Offer (the "NBBO"), and (3) the Directed Order is marketable against the non-displayed price of the MMPIO.

With these changes, the Rule Filing would prohibit meaningful competition to interact with customer orders in many cases. In options series that trade in penny increments, market participants could only compete with a MMPIO by improving the NBBO with a displayed quote accessible to all market participants. Requiring that competing orders be both displayed and accessible by all market participants gives a drastic and unfair advantage to a MMPIO sender who can improve the NBBO with a hidden order only accessible to approved senders.

This unfair advantage also would hurt price discovery by effectively creating multiple NBBO because each market maker would have a private NBBO for certain approved directed order senders. If the Rule Filing is approved, market participants competing in the open auction available to all market participants would be forced to quote less aggressively to account for adverse selection because MMPIOs would cherry-pick the most desirable order flow from the market with private hidden quotes. This would damage market liquidity and cause average publicly quoted spreads to widen in some option contracts, particularly those that trade with wider than average spreads.

This unfair advantage also would effectively cap price improvement opportunities in many cases. In series that trade in penny increments, MMPIO senders would always know that they only need to improve the NBBO by a penny to fully internalize incoming Directed Orders because other market participants are prohibited from sending non-displayed quotes at the next quoting increment. In contrast, the currently used price improvement auctions on other exchanges do not have a structure that permits a market maker to price improve by a penny with no competition.

In option series that trade in nickel and dime increments, competition with MMPIOs is likewise severely limited. When a MMPIO has a non-displayed price in between standard quoting increments, other market participants can only compete with the MMPIO by sending a non-displayed quote that is available to all market participants. Sending quotes accessible to all market participants is much riskier and less profitable than sending quotes accessible to only approved market participants. Moreover, in options that trade in nickel and dime increments, a Market Maker can submit a non-displayed price for approved participants at a nickel or dime increment better than the NBBO. In contrast, to compete at this price level, other market participants would have to enter a displayed price available to all market participants at the same nickel or dime increment because non-displayed orders are not permitted at standard price increments.[4] Put another way, a Market Maker would always know that they usually can fully

[4] For example, in an option that trades in nickel increments, if the NBB for the option is $.05, and a Market Maker has a non-displayed MMPIO at $.10, other market participants could not match the $.10 MMPIO price with a (...continued)

internalize orders from approved senders at one standard tick better than the NBBO because no one else would be permitted to send non-displayed quotes at that price level.

We note in closing that the requirement in the Rule Filing that a Market Maker must be quoting at the NBBO in order to participate in the execution of a Directed Order is critically important because this requirement rewards active provision of liquidity and quote competition. This quoting requirement does not, however, remediate the generally anti-competitive design of MMPIOs and Directed Orders, and the Commission should thus not approve the Rule Filing or any similar options directed order mechanism without an NBBO quoting requirement.[5]

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

(continued...)

non-displayed order. Rather, they would have to either display an order at $.10 or send a non-displayed order at $.11.

[5] In this regard, it is important to keep in mind that market makers can limit their exposure to an NBBO quoting requirement by taking steps to make sure that their quotes stay further back in the queue by cancelling them and resubmitting them to ensure that other quotes have time priority at that price level.