CITADEL

June 9, 2006

Nancy Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

**Re: Boston Stock Exchange, Inc. Proposed Amendment to Boston Options Exchange Fee Schedule for Improvement Orders Submitted Into a Price Improvement Period by a Public Customer That are not Submitted as Customer PIP Orders (SR-BSE-2006-10).[1]**

Dear Ms. Morris:

Citadel Investment Group, L.L.C. ("Citadel") appreciates the opportunity to comment on the proposed Boston Options Exchange ("BOX") amendment to its Fee Schedule (the "Proposed Fees").[2] The BOX proposes to increase the fees charged for a particular order type for the express purpose of discriminating against certain kinds of public customers likely to use that order type.

The Commission should reject the Proposed Fees because they fail to allocate fees equitably among BOX members and other users as required under Section 6(b)(4) of the Securities Exchange Act of 1934 ("Exchange Act"). The Proposed Fees also are designed to operate in an unfairly discriminatory manner that is inconsistent with the requirements of Exchange Act Section 6(b)(5). Lastly, the Proposed Fees would hinder competition among those seeking to price improve orders, thereby making it easier for BOX Market Makers to step ahead of customer limit orders by a penny. This anti-competitive design is inconsistent with the requirements of Exchange Act Section 6(b)(8).

---

[1] *See* Release. 34-53774 (May 9, 2006), 71 Fed. Reg. 28058 (May 15, 2006), SR-BSE-2006-10 (the "Proposal").

[2] Citadel and its affiliates operate one of the world's largest alternative investment firms. On an average day, Citadel affiliates account for approximately 3% of the daily volume on the New York Stock Exchange and Nasdaq, and well over 10% of U.S. listed options market volume. Citadel Derivatives Group LLC is the second most active market maker on the BOX and an equity investor in the BOX.

131 South Dearborn Street 312-395-2100 Telephone
Chicago, Illinois 60603 312-977-0270 Facsimile

CITADEL

We are also very concerned that the Proposed Fees, if approved, would be a dangerous precedent for the creation of special classes of investors to target for special or unfavorable treatment. This type of distinction is reminiscent of the failed efforts of the Nasdaq to defend its market makers against "SOES bandits."[3] As such, the Commission should not rely on the BOX's conclusory and unsupported assertions when determining whether the Proposed Fees are appropriate, but should instead require clear and compelling empirical evidence to support this proposed discrimination.[4]

The risk of establishing a dangerous precedent here is all the more significant because the Proposed Fees are part of the BOX's recent concerted efforts to facilitate and encourage market discrimination to protect BOX Market Makers from competition. Recently, the BOX proposed to allow its Market Makers to discriminate against particular order senders.[5] If approved, these types of discriminatory market structures would quickly spread to the other options exchanges, degrading transparency, liquidity, and competition, to the detriment of all investors.

## I. Background

The BOX operates an auction facility known as the PIP.[6] The PIP is a three second auction in penny increments that allows orders to be executed at prices inside the National Best Bid or Offer ("NBBO"), which is currently disseminated in nickel or dime increments. Most commonly, a PIP auction begins when an Order Flow Provider ("OFP") sends a Directed Order to a particular Market Maker and the Market Maker agrees to trade with the order at a penny better than the NBBO.

The rules governing the PIP permit Public Customers (that is, anyone other than a broker-dealer)[7] to participate as bidders in the three second PIP auctions and thereby potentially trade with and price improve orders that are submitted to the PIP. Public Customers may do so in one

---

[3] *See* Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market, Release 34-37542 (Aug. 8, 1996).

[4] *See, e.g., William Timpinaro, et al v. Securities and Exchange Commission*, 303 U.S. App. D.C. 184, 2 F.3d 453 (1993) and *Clement v. Securities and Exchange Commission,* 674 F.2d 641, 644 (7th Cir. 1982).

[5] *See* Releases No. 34-53357 (Feb. 23, 2006), 71 Fed. Reg. 10730 (March 2, 2006), and 34-53015 (Dec. 22,2005), 70 Fed. Reg. 77207 (December 29, 2005), SR-BSE-2005-52, and our comment letters regarding those BOX proposals: Letters to Nancy Morris, Secretary, Securities and Exchange Commission, from Adam C. Cooper, Senior Managing Director & General Counsel, Citadel dated: Jan. 11,2006; Jan. 12, 2006; March 17, 2006; and May 30,2006 (currently available at http://www.sec.gov/rules/sro/bse/bse200552.shtml).

[6] *See generally*, Chapter V., Section 18 of the BOX Rules.

[7] *See* Chapter I, Section 1(a)(50) of the BOX Rules.

CITADEL

of two ways. First, they may do so passively by submitting through a BOX OFP a type of resting limit order in penny increments, known as a "Customer PIP Order" or "CPO." A CPO indicates that the Public Customer wishes to trade in a PIP up or down to a certain price, should a PIP auction happen to occur at any time while the CPO is resting on the BOX book and regardless of market conditions at the time of any PIP auction. Second, a Public Customer may participate in a PIP auction dynamically by sending an order through a BOX OFP in reaction to a broadcast message that a PIP has been initiated and based on market conditions at the time of the auction. In BOX terminology, both of these types of orders are referred to as "Improvement Orders."

Currently, Public Customer Improvement Orders that are executed in PIP auctions are not charged a fee because all Public Customer orders are free. The BOX is proposing to amend its Fee Schedule to charge Public Customers a $.20 per contract fee for executed Improvement Orders that are not CPO's ("non-CPO Orders"). This fee is equivalent to the standard fee that BOX charges to its Market Makers for all order types. Market Makers, however, may pay a lower fee if they qualify for the volume discount that is based on total volume traded across all assigned classes. CPOs and all other Public Customer orders traded on BOX will continue to be free.

## II. The Proposal Fails to Meet Statutory Requirements

The BOX's justification for the Proposed Fees makes clear that the BOX overtly intends to discriminate between and among "Public Customers" based upon their supposed level of sophistication and access to technology:

> A Public Customer receiving and reacting to the PIP broadcast needs highly developed technology similar to the technology used by BOX OFPs and Market Makers, which is not readily available to the average investor. This technology is necessary for the Public Customer to receive significant amounts of data at an extremely high rate of speed and to react to the PIP broadcast, within the time frame of the three-second PIP auction. Typically, a Public Customer who can receive a PIP broadcast and react to it by submitting an Improvement Order would be a sophisticated investor possessing the aforementioned technology. The sophisticated Public Customer investor's possession of the technology, similar to BOX OFPs and Market Makers, allows this Public Customer to compete in PIPs on the same level playing field as OFPs and Market Makers.[8]

This rationale is defective and inconsistent with the statutory requirements of the Exchange Act. Rather than creating a level playing field, the Proposed Fees would unfairly discriminate against certain Public Customers—and treat them not only worse than other Public Customers, but worse than Market Makers that have a number of inherent advantages and privileges not available to

[8] *See* the Proposal at page 4.

CITADEL

Public Customers. The Proposed Fees also would reduce competition and thereby make it easier for Market Makers to trade ahead of Public Customers.

### A. The Proposal Fails to Allocate Fees Equitably

The Proposal fails to articulate a proper basis or provide sufficient evidence for the Commission to determine that the Proposed Fees provide for the equitable allocation of reasonable fees among members and persons using BOX facilities as required under Section 6(b)(4) of the Exchange Act. Instead of a proper basis, the BOX simply states that the fees are reasonable because "[non-CPO Orders] are submitted into a PIP auction, which is a special trading mechanism within the BOX Trading Host that utilizes the PIP broadcast to create these orders."[9]

The BOX does not explain how the Proposed Fees are equitably allocated among members and persons using the facilities of the exchange. These fees have not been and cannot be justified by the extent to which non-CPO Public Customer Improvement Orders burden the BOX system, require incremental technology, operational or regulatory costs for the BOX, or otherwise defray costs or raise revenues for BOX and therefore need to be allocated among members and other users. These Fees have a single motivation: to discourage sophisticated Public Customers, who are not BOX members or broker-dealers, from competing with BOX Market Makers.

The Proposed Fees also are inequitable in another important respect. Public Customers do not receive a volume discount similar to the one provided to BOX Market Makers.[10] The BOX fails to justify why certain Public Customers should pay more than Market Makers to access the PIP.

Although the rationale of the Proposed Fees is fatally defective regardless of the differences between Market Makers and Public Customers, it is important to note that Market Makers are fundamentally different than Public Customers. Among other things, Market Makers have elected to become broker-dealers, BOX Participants, and Market Makers, enjoying in each of these capacities a variety of benefits and privileges that Public Customers do not enjoy, and serving different economic functions on the BOX and in the marketplace at large.[11] Indeed, it is

---

[9] *See* Proposal at page 4.

[10] BOX Fee Schedule at http://www.bostonoptions.com/pdf/SECFEE%205-30-06.pdf.

[11] For example, broker-dealers may post continuous two-sided quotes or accept customer orders in securities as principal or agent, BOX Participants enjoy direct access to BOX and its facilities, and Market Makers enjoy margin benefits under Section 220.7(g)(5) of Regulation T of the Federal Reserve System. None of these benefits are enjoyed by Public Customers, however sophisticated their technology.

CITADEL

because of these advantages that on U.S. securities exchanges, market fees and other rules generally favor public customers over broker-dealers.

### B. The Proposed Fees Would Unfairly Discriminate

The Proposal also fails to explain why the Proposed Fees are "not designed to permit unfair discrimination between customers, issuers, brokers, or dealers . . ." as required by Section 6(b)(5) of the Exchange Act. In fact, the Proposal is expressly designed to discriminate unfairly among two types of Public Customers: (i) those who have access to sophisticated technology and trading techniques (referred to by the BOX as "professionals"), and (ii) all others (referred to by the BOX as "investors").

The BOX claims that it is appropriate to discriminate against "professional" Public Customers because "customers behaving as 'options professionals' should be subject to the same trading fees [as Market Makers] in the interests of a level playing field."[12] This justification fails for two reasons. First, as discussed above, Public Customers cannot "behave" like BOX Market Makers because they do not have all of the privileges afforded to Market Makers. Second, the BOX has presented no evidence to show that its proposed distinction between "professional" Public Customers and "investor" Public Customers is fair. The Report of the Special Study of Securities Markets of the Securities and Exchange Commission explained that "unfair discrimination between customers or issuers, or brokers or dealers," occurs when rules discriminate "among participants within any properly recognized category—those making similar uses of, contributions to, and demands upon the market facilities."[13] The BOX has presented no evidence to satisfy this standard.

### C. The Proposed Fees Would Harm Competition

Because the Proposed Fees would discourage Public Customers from sending non-CPO Improvement Orders to the BOX, there would be fewer Improvement Orders competing to price improve orders submitted to the PIP. Less competition would permit Market Makers to internalize Public Customer orders sent to the PIP at prices less favorable to those Public Customers, and correspondingly, would make it easier for Market Makers to step ahead of or "penny" Public Customer limits orders posted on the book. This would, in turn, encourage BOX Participants to internalize more of their order flow, diminishing price discovery and transparency, and increasing costs for all investors trading in the options markets.

To fully appreciate this anti-competitive impact of the Proposed Fees, it is important to understand the fundamental purpose of the PIP. The PIP is a mechanism designed to allow Market Makers to step ahead of resting limit orders selectively and opportunistically. The much-

---

[12] See Proposal at page 4.

[13] H.R. Doc. No. 95, 88th Cong., 1st Sess. 14 (1963).

CITADEL

publicized price improvement available to customer orders in the PIP will occur only at the expense of a resting limit order already on the book and only when a market professional has opportunistically decided that it is advantageous to step ahead of a resting limit order by a penny. PIP auctions will rarely result in two retail Public Customers trading with each other because traditional retail investors are not expected to respond to PIP auctions. As the BOX explains, "A Public Customer receiving and reacting to the PIP broadcast needs highly developed technology similar to the technology used by BOX OFPs and Market Makers, which is not readily available to the average investor."[14]

A simple example—representative of what occurs countless times each day—demonstrates this point. Assume that the national best bid is $5.00 as a result of a resting retail customer limit order to buy for $5.00. Another retail customer sends his broker-dealer a market order to sell. The broker-dealer sends the market order as a Directed Order to the broker-dealer's affiliated Market Maker, rather than routing the order to the BOX book where it would have matched against the resting customer limit order at $5.00. The Market Maker, dynamically and opportunistically judging market conditions, decides to step ahead of the resting limit order and agrees to "PIP" the market order at $5.01. As a result, the retail customer who placed the $5.00 limit order remains unfilled, and the Market Maker has a chance to internalize the retail customer's market order for a penny if others do not compete to further improve the order. The absence of robust competition from Public Customers to further improve such orders would be all but assured if the Proposed Fees are approved.

For these reasons, we urge the Commission to reject the Proposal. We also urge the Commission to analyze the harm to retail investor limit orders inflicted by the PIP and similar mechanisms on other exchanges.

* * *

If you have any questions concerning these comments or would like to discuss these matters further, please feel free to contact me at 312-395-3067.

Sincerely,

Adam C. Cooper
Senior Managing Director &
General Counsel

[14] See Proposal at page 3.

CITADEL

cc: Chairman Christopher Cox
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
Commissioner Annette L. Nazareth
Robert L.D. Colby, Acting Director, Division of Market Regulation
Elizabeth King, Associate Director, Division of Market Regulation