CITADEL

August 30, 2010

By Electronic Mail

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

Re: *Proposed Rule Change to Amend the Fee Schedule of the Boston Options Exchange Facility; File No. SR-BX-2010-049*

Dear Ms. Murphy:

Citadel LLC ("**Citadel**")[1] appreciates the opportunity to submit this comment letter in response to the Boston Options Exchange Group, LLC's ("**BOX**") rule filing referenced above (the "**Rule Filing**"), which changed the BOX fee schedule for orders executed in a price improvement period ("**PIP**") auction.[2] Citadel is an active BOX participant and is by far the largest responder to PIP auctions.[3] Thus, our comments reflect our extensive experience as an active market participant and as a particularly active user of the PIP mechanism.

The Rule Filing states that it is "designed to incent BOX [p]articipants to submit their [p]ublic [c]ustomer [o]rders into the PIP for the possibility of price improvement."[4] In fact, the Rule Filing renders the PIP mechanism into a vehicle for internalization and reduces opportunities for price improvement. The Rule Filing does so through a new fee structure that is discriminatory and unduly burdens competition, and is therefore inconsistent with the statutory requirements set forth in sections 6(b)(4), 6(b)(5) and 6(b)(8) of the Securities Exchange Act of

[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] Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Amend Fee Schedule of the Boston Options Exchange Facility, Exchange Act Release No. 62632 (Aug. 3, 2010), 75 FR 47869 (Aug. 9, 2010).

[3] According to statistics published by BOX, in July 2010, Citadel Securities LLC ("Citadel Securities") accounted for 68% of the contracts executed by PIP responders, and the next most active responder accounted for 9%.

[4] Rule Filing at 75 FR 47870.

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1934 (the "**Exchange Act**"). For these reasons, Citadel respectfully submits that the Securities and Exchange Commission (the "**Commission**") should suspend the operation of the Rule Filing and disapprove it.

I. The Rule Filing

The Rule Filing changes BOX's fee schedule for PIP auctions as follows.[5] The standard transaction fee for PIP executions is $0.25 for both broker-dealers and BOX market makers. Initiators of a PIP auction ("**initiators**") must pay a tiered fee between $.10 and $.25 per contract, with tiers based on the participant's average daily volume.[6] In addition, orders that respond to a PIP auction and execute against a customer order (which BOX refers to as "**providing liquidity**") pay a fee of $.25, and customer orders executed in a PIP auction (which BOX refers to as "**removing liquidity**") receive a credit of $.25.

II. Discussion

Under the new fee schedule, most of the time, it will no longer be economically viable for BOX participants to respond to PIP auctions if they are not submitting customer orders to the auction as the PIP initiator. As a result, fewer firms will pursue responding to PIP auctions at all, and those that do ("**responders**") will respond less often and less aggressively. Reducing PIP responders and responses will result in less price improvement for customers.

The new fee structure is blatantly discriminatory against PIP auction responders in favor of PIP auction initiators. The net cost to a responder is much more than the net cost to a PIP initiator because initiators may receive a credit for removing liquidity when a customer order is executed, but no such credit is available to responders.

The discriminatory impact of the Rule Filing is illustrated by the following example that compares (1) the net fees for a PIP initiator franchise that internalizes a customer order in a PIP auction with no competitive responders, and (2) the net fees that a competitive responder franchise would pay if it responds to the PIP auction and executes the same customer order.[7] A

[5] In a PIP auction, customer orders are flashed to BOX participants who have 1 second to respond and compete to execute the order.

[6] The new tiers under Section 7 of BOX's fee schedule are as follows: 150,001 contracts or greater, $0.10 per contract; 100,001 contracts to 150,000 contracts, $0.12 per contract; 50,001 contracts to 100,000 contracts, $0.15 per contract; 20,001 contracts to 50,000 contracts, $0.17 per contract; 0 contracts to 20,000 contracts, $0.25 per contract.

[7] As shown in Exhibit A, the discriminatory impact is even larger when a competitive responder competes for the order and matches the initiator at the final auction price.

BOX participant that sends a customer order to initiate a PIP auction would pay $.10 for initiating the auction (at the lowest tier fee level).[8] When this initiator internalizes the order by having its own market making desk execute against the customer order that was sent to the PIP auction, the initiator's firm would pay an additional $.25 to trade with the customer order in the auction, but this charge would be offset by the $.25 credit the initiator would receive for the customer order that initiated the auction. Thus, in total the internalizing participant would pay a net fee of $.10 for the transaction.

In contrast, a competitive responder to the PIP auction that did not send the customer order to initiate the auction would not receive the $.25 credit for the customer order execution. Instead, a competitive responder would be required to pay a $.25 transaction fee and a $.25 fee for trading with the customer order in the PIP. Thus, the competitive responder would be required to pay a total fee of $.50, five times more than the internalizing participant and 50% of the minimum quoting increment.[9]

This example is summarized in the following table:

Case 1: Comparing Initiator Execution Fees With Responder Fees (One Auction Winner)	
Case 1A: Initiator executes 100% of the order	
	(Fee) / Rebate
Initiator pays transaction fee	$(.10)
Initiator pays 'provide liquidity fee'	$(.25)
Customer PIP order receives 'remove liquidity credit'	$.25
Total initiator franchise economics per contract traded	$(.10)

[8] In this example, we assume that the initiator qualifies for the lowest fee because the vast majority of customer order flow is routed by firms that can readily meet the volume requirements for the lowest fee.

[9] This total fee of $.50 also exceeds the $.30 maximum access fee cap recently proposed by the Commission. *See* Proposed Amendments to Rule 610 of Regulation NMS, Exchange Act Release No. Release No. 34–61902, 17 CFR 20738 (Apr. 14, 2010).

Case 1B: Competitive responder executes 100% of the order	
	(Fee) / Rebate
Competitive responder pays transaction fee	\$(.25)
Competitive responder pays 'provide liquidity fee'	\$(.25)
Total responder franchise economics per contract traded	\$(.50)
Net advantage of initiator over competitive responder	***\$.40***

As a result of the highly discriminatory fee schedule, non-internalizing participants have far less economic incentive to participate in PIP auctions as responders because internalizing participants are able to execute transactions for fees that are dramatically lower and often a substantial portion of the quoted spread. The new fee structure will thus reduce the likelihood and size of price improvement in the PIP because competitive responders will be less likely to participate in PIP and will participate less aggressively when they do participate. For these reasons, the new fee schedule burdens competition and is unreasonably discriminatory.

Moreover, this discriminatory impact was carefully crafted to drastically increase the internalization capabilities of PIP. Rather than focusing on price improvement, BOX is now actively marketing the PIP and its new fee schedule as an enhanced internalization vehicle. Our own experience confirms that that the new fee schedule significantly increases the ability to use PIP as a vehicle for internalization. Since the new PIP fee schedule went into effect, Citadel Securities tested new functionality for routing orders to PIP as the initiator. This test resulted in almost full internalization in the most liquid option contracts. In options with a quoted spread of \$.01 at the time of receipt, Citadel Securities internalized approximately 92% of the contracts at the national best bid or offer ("**NBBO**"). In options with a quoted spread of \$.02 at the time of receipt, Citadel Securities internalized approximately 68% of contracts at the NBBO. While the ability to internalize at these rates will offer substantial short-term benefits to Citadel Securities, we are concerned about the long-term damage to options market quality that will result from higher levels of internalization.[10]

[10] After May 6, 2010, the Commission has shown renewed interest in the importance of quoting in the equity markets. Quoting is far more important to the options markets than it is in the equity markets. Our analysis shows that on an average day, a staggering 85% of listed option series do not trade at all, and 93% of listed option series trade three or fewer times. Despite this low turnover, there are continuous two-sided quotes available in all option series.

The ability to internalize without quoting allows firms with substantial order flow to cherry pick the most desirable order flow from the market. This, in turn, will reduce the incentive to quote in the lit markets. We believe

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The discriminatory impact and design of the Rule Filing is at odds with sections 6(b)(4) and 6(b)(5) of the Exchange Act, which require the rules of a national securities exchange to provide for the equitable allocation of fees among its members and not be designed to permit unfair discrimination between customers or broker-dealers. Furthermore, section 6(b)(8) of the Exchange Act requires that the rules of a national securities exchange not impose any burden on competition not necessary or appropriate in furtherance of the Exchange Act. By clearly promoting internalization and reducing competition to price improve customer orders, the new fee schedule burdens competition and thus does not satisfy section 6(b)(8).

Finally, regardless of whether the Commission ultimately agrees with our analysis, Citadel respectfully submits that the Commission must recognize that this filing is not a mere "uncontroversial" fee filing. Rather, it is a significant change in options market structure that should be subject to robust public comment and full Commission review.

The Commission has long recognized that internalization is a form of economic inducement that exchanges use to attract order flow, and that unrestrained internalization likely would reduce price competition and result in sluggish and inferior market quality.[11] To address these concerns, the Commission has a well-established precedent of approving exchange rules only if the rules limit the percentage of orders that can be internalized.[12] The Rule Filing enables exceptionally high levels of internalization and should not be allowed to circumvent long-

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that if the incentives to quote are decimated by internalization, the screens will go dark in all but the most liquid options and quoted spreads will widen in the most liquid options.

[11] Competitive Developments in the Options Markets, Exchange Act Release No. 49175 ([Date]), 69 FR 6124, 6129 and 61230 (Feb. 9, 2004) ("**2004 Options Markets Concept Release**").

[12] For example, in connection with the International Stock Exchange's ("**ISE**") approval to operate as a national securities exchange, the Commission effectively limited the percentage of certain orders that could be internalized by traders at parity to 40% in most circumstances. *See* In the Matter of the Application of the International Securities Exchange, LLC For Registration as a National Securities Exchange, Release No. 42455 (Feb. 24, 2000), 65 FR 11388 (Mar. 2, 2000). The Commission has generally held the line at this level when approving other exchange order allocation rules. 2004 Options Markets Concept Release 69 FR at 61230.

Another example was the former Philadelphia Stock Exchange (the "**PHLX**") proposal to amend its rules to allow specialists to effectively internalize up to 80% of an order. The Commission expressed "serious concerns as to whether such changes [were] consistent with the [Exchange] Act and the rules and regulations thereunder" and noted that the PHLX proposal broke from precedent by representing a "significant increase in the amount of order flow that would be guaranteed to one market participant." Proposed PHLX Rule Changes, Exchange Act Release No. 43100 (July 31, 2000), 65 FR 48778, 48784 and 48789 (Aug. 9, 2000). Because the PHLX proposal could have resulted "in a significant alteration to the current structure of the options markets," the Commission published a notice of its intent to initiate disapproval proceedings, and the rule proposal was ultimately withdrawn. *Id.*

standing Commission precedents limiting internalization merely because the Rule Filing achieves this end result through an "effective on filing" fee change.

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For the reasons outlined above, the Commission should suspend, and ultimately disapprove the Rule Filing.

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

Exhibit A

Case 2: Comparing Initiator Execution Fees With Responder Fees (Initiator and Responder Match Final Auction Price)	
Case 2A: Initiator gets 40% of the order due to other competitive responses at best price	
	(Fee) / Rebate
Initiator pays transaction fee on 40% of customer order	40%*$(.10) = $(.04)
Initiator pays 'provide liquidity fee' on 40% of customer order	40%*$(.25) = $ (.10)
Initiator receives 'remove liquidity credit' on 100% of customer order (entire order must trade)	100%*$.25 = $.25
Total initiator franchise economics per contract traded	$.11
Case 2B: Competitive responder executes 60% of the order	
	(Fee) / Rebate
Competitive responder pays transaction fee on 100% of their response	100%*$(.25) = $(.25)
Competitive responder pays 'provide liquidity fee' on 100% of their response	100%*$(.25) = $(.25)
Total responder franchise economics per contract traded	$(.50)
Net advantage of initiator over competitive responder	***$.61***