CITADEL

December 21, 2006

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

Re: Chicago Board Options Exchange Hybrid Electronic Quoting Fee (SR-CBOE-2006-98; Release No. 34-54804)

Dear Ms. Morris:

Citadel Investment Group, L.L.C. ("Citadel")[1] appreciates the opportunity to comment on the Chicago Board Options Exchange, Inc. ("CBOE") "Hybrid Electronic Quoting Fee" (the "Fee"). We believe that the Fee is too blunt an instrument to achieve the CBOE's objective of "promot[ing] and encourage[ing] more efficient quoting"[2] and could be readily improved.

Citadel appreciates that the CBOE may not have had the time or resources to design and implement a more precise and effective quote fee structure, given the enormity of the task facing the CBOE before the January 26 launch of the "Penny Pilot" program.[3] Nonetheless, Citadel urges the CBOE and Commission to work together without delay to develop and implement improvements to the CBOE's quote mitigation fee. We believe that there are several straightforward and feasible changes that could substantially improve the effectiveness of the CBOE's mitigation strategy. In particular, we urge the CBOE to modify the Fee so that it takes into account the:

1. number of markets made by each member;
2. quality of markets quoted by each member;
3. volume traded by each member; and
4. quoting obligations of each member.

In addition—and most importantly—the CBOE should eliminate the allotment of 1,000,000 quotes per member before quotation traffic charges accrue.

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[1] Citadel and its affiliates operate one of the world's largest alternative investment firms. Citadel Derivatives Group LLC is one of the most active listed options market makers in the United States and on the CBOE. Citadel Derivatives Group LLC is a CBOE Market Maker, Remote Market Maker ("RMM"), and electronic-Designated Primary Market Maker ("e-DPM").

[2] *See* SR-CBOE-2006-98 at 2.

[3] *See* SR-CBOE-2006-92; Release No. 34-54805 (November 21, 2006).

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I. The Fee

The CBOE proposes to assess a $450 monthly fee on all Market Makers, RMMs, Designated Primary Markets Makers ("DPMs"), e-DPMs and Lead Market Makers ("LMMs") (collectively "Market Makers") who are submitting electronic quotations to the Exchange. Each month, each Market Maker will receive an allocation of 1,000,000 quotes. If a Market Maker submits to CBOE more than 1,000,000 quotes during a month, the Market Maker will be assessed an additional fee of $.03 per 1,000 quotes in excess of 1,000,000. If a Market Maker is assessed the Fee, the Market Maker does not pay a member dues fee.

The Fee is one of several quote mitigation strategies that CBOE plans to implement in connection with the Penny Pilot. Specifically, CBOE's plan also includes amendments to Market Maker quoting obligations, a delisting policy, and a limitation on messages.[4]

II. Problems with the Fee Methodology

As indicated above, Citadel appreciates that the CBOE needed a quick and straightforward plan to address the anticipated demands on CBOE systems capacity. The Fee, however, should be better designed in several important respects.

First, the Fee does not differentiate among Market Makers based on the number of options in which they make markets. Each Market Maker receives the same number of "free" quotes for the basic $450 monthly assessment. This fee structure fails to give smaller Market Makers an incentive to quote more efficiently because they can easily stay within their allotted 1,000,000 quotes per month without incurring any additional expenses. A flat per-message charge across all market participants that does not allow 1,000,000 "free" messages per month would more fairly and effectively promote efficient quoting on CBOE.

Second, the Fee may encourage larger Market Makers to stop making markets in options that are only marginally profitable today. This is likely to discourage competition, and result in disseminated markets that are wider and less deep.

Third, the failure to consider the quality of quoting in calculating the Fee undermines the incentive to quote high quality markets. It also detracts from the policies enunciated in the Commission's Regulation NMS. Specifically, as part of that rulemaking, the SEC modified the market data revenue allocation formulas in effect for the equities markets in aid of a public policy to

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[4] *See* SR-CBOE-2006-92; Release No. 34-54805 (November 21, 2006) (proposing that Market Makers and RMMs provide continuous electronic quotes in 60% of the series of each appointed class with a time to expiration of less than nine months). *See* CBOE Regulatory Circular RG06-124 at: http://www.cboe.org/publish/RegCir/RG06-125.pdf (adopting a new delisting policy whereby equity options classes with a national average daily volume of less than 20 contracts will be delisted). *See also* CBOE Rule 6.23A (the CBOE currently limits the number of messages sent by members accessing CBOE electronically).

reward aggressive quoting to improve the public data stream, and not merely revenues based upon raw quote or trade volume.[5] As noted above, the Fee may actually provide opposite incentives.

Fourth, the Fee is unfair because it does not distinguish among the different classes of Market Makers (*e.g.*, RMMs, DPMs, e-DPMs and LMMs), even though they have very different quoting obligations under CBOE rules. Market Makers quoting on the Hybrid Trading System are subject to requirements relating to quote widths, continuous electronic quoting, and continuous open outcry quoting (among other things).[6] The general CBOE Market Maker requirements are typically applicable on a per class basis depending upon the percentage of volume a Market Maker transacts electronically versus open outcry. For instance, a Market Maker on the CBOE Hybrid Trading System that transacts less than 20% of his contract volume electronically in an appointed class during any calendar quarter will have different quoting obligations than a Market Maker that transacts more than 20%.[7] Likewise, the obligations of a Market Maker, RMM, DPM, e-DPM and LMM vary in terms of the percentage of options classes for which they are required to provide continuous electronic quotes.[8]

By establishing a Fee that treats all Market Makers the same, the CBOE is ignoring its established regulatory framework, which treats certain Market Makers differently based upon their status. The CBOE has recognized this framework for other fee structures, such as transaction fees which vary depending on the type of Market Maker (or other market participant) sending the quote to the Hybrid Trading Facility.[9]

III. Specific Recommendations

To the extent that the CBOE believes that the Fee will be effective in promoting efficient quoting, the CBOE should reformulate the Fee so that it represents an equitable allocation among Market Makers of the Hybrid Trading System and encourages quoting that is healthy for the market. First, the Fee should take into account the different types of Market Maker obligations. It is anomalous to require certain types of Market Makers to have more stringent quoting obligations and then penalize them when they honor those obligations.

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[5] *See* Regulation NMS Final Rule Release No. 34-51808 (June 9, 2005) at 29-34 and 253-259; 70 FR 37496 (June 29, 2005) at 37503-37504 and 37562-37564.

[6] *See* CBOE Rules 8.15A, 8.7(d) and (e), 8.85, and 8.93.

[7] *See* CBOE Rule 8.7(d).

[8] Compare the 60% continuous electronic quoting obligation of a Market Maker and RMM under CBOE Rules 8.7(d)(i), (ii) and (e)(i), with the 90% electronic quoting obligation of a LMM under Rule 8.15A(b)(i) and e-DPM under Rule 8.93(i), and a DPM which is required to provide continuous electronic quotes for <u>each</u> class and series allocated to it under Rule 8.85(a)(i).

[9] *See* CBOE Fee Schedule at: http://www.cboe.com/publish/feeschedule/CBOEFeeSchedule.pdf. (specifying equity options transaction fees as follows: DPM ($.16), e-DPM ($.25), and RMM ($.26)).

Second, the Fee should account for the amount of markets made by each Market Maker. The CBOE and the market as a whole benefit greatly from the broad-based capital commitments that are made by Market Makers. The Fee should not discourage small Market Makers from making additional markets or encourage larger market makers Market Makers to make markets in fewer classes.

Third, the Fee should be modified to provide incentives for those Market Makers providing greater liquidity to the CBOE with aggressive, quality quoting. One significant measure of quoting "efficiency" is the relationship between the volume of quotations and executed trades. Quoting that does not result in an increase in CBOE trading activity should be discouraged since it is likely the result of more passive quoting. Other measures of quoting quality include quote size, quote width, and percentage of time on the NBBO—all of which are already measured by the CBOE. The Fee should reward Market Makers with better statistics.

III. Conclusion

For the reasons provided above, the CBOE and the Commission should work together to implement quote mitigation strategies that are more fair and better designed to improve the quality of the options markets.

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If you have any questions concerning these comments or would like to discuss these matters further, please feel free to contact me at 312-395-3115.

Sincerely,

/s/

John C. Nagel
Director and Associate General Counsel

cc: Chairman Christopher Cox
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Kathleen L. Casey
Commissioner Annette L. Nazareth