CITADEL

June 4, 2007

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

Re: Chicago Board Options Exchange – Penny Price Improvement (SR-CBOE-2007-39; Release No. 34-55724)

Dear Ms. Morris:

Citadel Investment Group, L.L.C. ("Citadel") appreciates the opportunity to comment on the above-referenced filing (the "Proposal").[1] The Chicago Board Options Exchange, Inc. ("CBOE") proposes to amend its rules for "penny price improvement for options not currently quoted in one-cent increments." The CBOE would like to create a hidden market for options. This hidden market would make a mockery of transparency and order display rules. In addition, the Proposal would undermine the Commission's efforts to conduct an orderly, incremental, and careful analysis of quoting increments through the "Penny Pilot." For these reasons, the Proposal does not meet the requirements of Section 6(b)(5) of the Exchange Act and should not be approved by the Commission.

I. The Proposal Would Damage Transparency, Price Competition, and Quoting Incentives

Rule 602 of Regulation NMS and various exchange rules provide that exchanges will collect and disseminate the price and size of their best-priced bids and offers (the "BBO"). On the CBOE and other options exchanges, quotes are generally submitted and disseminated in 5 and 10 cent increments. Exceptions to nickel and dime quoting include the Penny Pilot classes and certain limited price improvement auctions.

Under the Proposal, CBOE would allow market participants to submit orders in penny increments in classes selected by the CBOE that are not currently quoted in penny increments—that is non-Penny Pilot classes and classes that are not selected for CBOE's Simple Liaison System ("SAL"). Although this new type of penny increment orders would interact with contra-side marketable orders if the CBOE is at national best bid or offer (the "NBBO"), the price and size of these orders would not be disseminated, ***even though they are better than the CBOE's disseminated BBO.*** Instead, the CBOE would be permitted (but not required) to append an indicator (the "Indicator") showing when there is trading interest at a price that is better than the CBOE BBO. The Indicator would not show any prices or sizes.

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[1] Citadel and its affiliates operate one of the world's largest alternative investment firms. On an average day, Citadel and its affiliates account for nearly one fifth of U.S. listed options market volume.

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The Proposal would thus change the CBOE from a transparent market to a dark pool. The CBOE's limit order book would be dominated by opaque trading interest of unknown price and size. Most trading interest would not be disseminated to the market because market participants would be reluctant to quote in nickel and dime increments for fear of getting "pennied" by small hidden orders. All the market would know about these hidden penny orders (if the CBOE decides to use the Indicator) is that there are orders and indications on the limit order book, that might be as insignificant as a single order for 1 contract that is 1 penny better than the CBOE BBO. As a result, it would become impossible to know the true price or size of the CBOE's market.

In its 2000 release proposing the extension of the "quote rule" to listed options, the Commission stated:

> The reliability and availability of quotation information are basic components of a national market system and are needed so that broker-dealers are able to make best execution decisions for their customers' orders, and customers are able to make order entry decisions. Quotation information has significant value to the marketplace as a whole because a quotation reflects the considered judgment of a market professional as to the various factors affecting the market, including current levels of buying and selling interest. Both retail and institutional investors rely on quotation information to understand the market forces at work at any given time and to assist in the formulation of investment strategies.[2]

Citadel believes that these considerations are just as important today and would be completely undermined by the Proposal.

In addition, because the existence of hidden penny orders would not be disseminated to the market, they would not trigger the obligations of other market centers to ship linkage orders to the CBOE. Thus, away-market orders would not be able to benefit from the better prices available on the CBOE, and undisplayed orders resting on the CBOE book would not be protected from trade-throughs by away markets. The Proposal also would destroy the incentive to join a quote at the BBO or to establish a new BBO, by quoting at the next 5 or 10 cent price increment, because it would be too easy for hidden penny orders to jump ahead of displayed orders by a penny at opportune moments.

Hidden trading interest is not a novel concept in the listed options markets. Several options exchanges have introduced opaque "mini-auction" facilities, such as the Boston Option Exchange's PIP and proposed UPIP, the International Securities Exchange's PIM, and the CBOE's SAL. To one degree or other, those facilities have flaws that are similar to the flaws of the Proposal. All of them create market structures that are not transparent and undermine

[2] Exchange Act Release 34-43085 (July 28, 2000); 65 FR 47918, 47925 (August 4, 2000). *See also* Special Study: Report Concerning Display of Customer Limit Orders, Office of Compliance Inspections and Examinations and Office of Economic Analysis (May 4, 2000), text accompanying footnotes 1-3, for a discussion of the importance of *displayed* limit orders in price discovery, the establishment of tight markets and best execution generally.

quoting incentives. The Proposal, however, would be a more dramatic change than the PIP and the PIM. The PIP and PIM operate as separate auction facilities in parallel with the "regular" market. The Proposal would create a new market structure that ***would be*** the regular CBOE market for classes designated by the CBOE.

In sum, the Proposal would undo much of the Commission's good work in fostering transparency and quote competition in listed options markets.

II. The Proposed "Indicator" Would Mislead the Market

The Indicator would function as a bait-and-switch. Broker-dealers and investment advisers routing orders would feel inappropriately compelled to route to CBOE whenever the Indicator shows that a better price is available. Ignoring the Indicator on any given trade would be perilous because it could result in knee-jerk criticisms and complaints, even if the better priced order or indication was only for 1 contract at a penny better. One would not know the sizes and prices of hidden penny orders until after the fact, if ever. As a result, market participants might feel compelled to forego routing to other markets where greater size, a faster and more certain execution, or even better price improvement, might be available.

III. The Proposal Would Be an End-Run Around the Penny Pilot

The Commission and options market participants are proceeding with a carefully designed pilot to study the benefits, costs, and challenges of reducing quoting increments in the options markets. The Proposal would circumvent these efforts by moving to hidden penny quoting without the benefit of the careful study of the data yielded by the Penny Pilot.

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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 & Associate General Counsel