



June 11, 2007

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

**Re: The NASDAQ Stock Market LLC – Proposal to Establish Rules Governing the Trading of Options on the NASDAQ Options Market (SR-NASDAQ-2007-004)<sup>1</sup>**

Dear Ms. Morris:

Citadel Investment Group, L.L.C. (“Citadel”) appreciates the opportunity to comment on the above-referenced filing (the “Proposal”).<sup>2</sup> The NASDAQ Stock Market LLC (“Nasdaq”) proposes to adopt rules governing participation in the NASDAQ Options Market, LLC (“NOM”), a new facility of Nasdaq. Nasdaq understandably has attempted to minimize the technical challenges associated with establishing a new options market by designing the NOM based on the core functionality of Nasdaq’s equities platform. The wholesale importation of Nasdaq’s equities platform to the NOM, however, will undermine the health of the U.S. options markets.

Because of significant differences between U.S. equities and options markets, the Proposal would harm the options markets in several ways. Most importantly, the Proposal would create a hidden market for trading options that would impede transparency and liquidity, discourage market participants from placing displayable limit orders or quotes, and facilitate gaming and non-competitive trading. For these reasons, the Proposal is inconsistent with Section 6(b)(5) of the Securities Exchange Act of 1934 (“Exchange Act”) and should not be approved by the Commission.

**I. The Proposal Would Undermine Transparency, Price Competition, and the Intermarket Linkage**

The Commission has consistently expressed its view that displayed limit orders are a valuable component of price discovery. Rule 602 of Regulation NMS and various exchange rules specifically provide that exchanges will collect, process, and make available to the marketplace the best bid, the best offer, and aggregate quotation sizes for each subject security (the “BBO”).

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<sup>1</sup> Securities and Exchange Commission (“SEC”) Release No. 34-55667 (April 25, 2007); 72 FR 83 (May 1, 2007).

<sup>2</sup> 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.

Under the Proposal, however, Nasdaq will permit “Options Participants”<sup>3</sup> to enter priced limit orders to buy and sell NOM-listed options as “Displayed Orders” or “Non-Displayed Orders.” The Non-Displayed Orders (including the non-displayed portion of Reserve Orders) will not be displayed in NOM, but nevertheless remain available for potential execution against all incoming orders until executed in full or cancelled. Nasdaq also is proposing a Price Improving Order type that allows Options Participants to buy and sell options on NOM in penny increments. Price Improving Orders will be disseminated along with any other displayable interest at the next “legal” minimum price variation (*i.e.*, rounded up or down depending on whether the order is on the bid or offer side), without any information about the true price or size of these orders.

Non-Displayed Orders, Reserve Orders, and Price Improving Orders (we will refer to these order types as “Hidden Orders”) are not current features of the U.S. listed options market and will result in a NOM limit order book that consists of hidden trading interest of unknown depth and size. Because Hidden Orders cannot be disseminated, it will be impossible for market participants to know the true price or size of the best trading interest on the NOM at any given time. The availability of Hidden Orders undermines the notion of having a BBO (or a NBBO) or required dissemination of quotes with size.

In its May 2000 Special Study relating to the display of customer limit orders in the equities and options markets, the Commission emphasized that “[l]imit order display has been found to be a key element in promoting competition, providing liquidity, and increasing transparency.”<sup>4</sup> Later that year, in its July 2000 release proposing the extension of the “quote rule” to listed options, the Commission stated that “[t]he 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.”<sup>5</sup>

Because Hidden Orders are novel to the options market, we urge the Commission to examine carefully whether the Proposal impedes these objectives. Most importantly, the Commission should determine whether or not the Proposal in fact “promote[s] just and equitable principles of trade” and “facilitate[s] transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system,” as required under Section 6(b)(5) of the Exchange Act. We submit that Hidden Orders contradict the policies underlying firm quote obligations under Regulation NMS and the limit order display obligations required by all other options exchanges.

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<sup>3</sup> The term “Options Participant” is defined in Chapter I, Section 1(a)(40) of Nasdaq’s Proposal as “...a firm, or organization that is registered with [Nasdaq] pursuant to Chapter II of [the] Rules for purposes of participating in options trading on NOM as a “Nasdaq Options Order Entry Firm” or “Nasdaq Options Market Maker”.”

<sup>4</sup> See Special Study: Report Concerning Display of Customer Limit Orders, Office of Compliance Inspections and Examinations and Office of Economic Analysis (May 4, 2000).

<sup>5</sup> See Exchange Act Release 34-43085 (July 28, 2000); 65 FR 47918, 47925 (August 4, 2000).

Hidden Orders also will discourage market makers from quoting at their best prices, and discourage other market participants from sending displayable limit orders. A displayed order or quote will become less worthwhile because many contra-side orders will be “pennied” by Hidden Orders at opportune moments. These disincentives ultimately will lead to less price competition in the U.S. options market.

In addition, the Proposal fails to address how Hidden Orders will interact with the Options Inter-Market Linkage Plan for the NOM. Since Hidden Orders will not be disseminated, they presumably will not trigger trade-through rules at other markets or obligations of other markets to ship Linkage orders to the NOM. In particular, Price Improved Orders will not establish a new disseminated BBO or NBBO, even if they in fact improve the NOM’s market. Thus, away-market orders will lose the benefit of the superior prices available on the NOM, and the Non-Displayed Orders and Price Improving Orders resting on the NOM undermine the market-wide system of trade-through protection.

Hidden Orders go beyond the problems created by the so-called “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. They all undermine quoting incentives and transparency, and undermine the Intermarket Linkage. Hidden Orders, however, would be a more dramatic change than the PIP or PIM. The PIP and PIM operate as separate auction facilities in parallel with the “regular” market. Conversely, Hidden Orders would be a fundamental part of the regular NOM market.

## **II. Hidden Orders Would Facilitate Gaming, Non-Competitive Internalization, and Non-Competitive Trading**

Like many options exchanges, Nasdaq has proposed “Order Exposure Requirements.” Section 14 of Chapter VII provides that an Options Participant cannot trade as principal against an order that they have submitted as agent unless (i) the agency order is exposed for 3 seconds, or (ii) the Options Participant has been quoting for 3 seconds prior to receipt of an agency order that is executable against the Options Participant's quote. Commentary .03 to this provision provides that the 3 second requirement is deemed satisfied by a Non-Displayed Order if the order would have been displayed for 3 seconds but for its non-display status. This position is flawed because it will invite rampant internalization and gaming by Options Participants who can trade with their agency orders without the market having a meaningful opportunity to compete for these orders.

Furthermore, Commentary .04 to the same Order Exposure Requirements provides that: “*Prior to submitting an order to NOM, an Options Participant cannot inform another Options Participant or any other third party of any of the terms of the order.*” (Emphasis added.) Because this commentary does not prohibit signaling *after* an order is placed, this commentary will fail to prevent signaling to other Options Participants or third-parties that they have a Hidden Order at the top of the book that is “really” better than the disseminated price. An Options Participant seeking to signal to another person that such a Hidden Order is on the book will be free to do so once the order is entered into the system.

Again, this point seems to open the options market to gaming, since the existence or (as the case may be) the terms of these orders will not be known to the rest of the market. Such signaling also would raise profound issues under Rule 602 of Regulation NMS, which provides, in pertinent part, that: “each national securities exchange shall ... collect, process, and make available to vendors the best bid, the best offer, and aggregate quotation sizes for each subject security ... which is communicated on any national securities exchange by any responsible broker or dealer.” Under Rule 601(b)(8) of Regulation NMS, the term “bid or offer” means: “the bid price or the offer price communicated by a member of a national securities exchange or member of a national securities association to any broker or dealer, or to any customer, at which it is willing to buy or sell one or more round lots of an NMS security, as either principal or agent, but shall not include indications of interest.” As defined in Rule 601(b), “quotation” means a bid or offer. Thus, if a Non-Displayed Order or the reserve portion of an order is sent in to the NOM but is not communicated to anyone, then it is not a bid, offer or quotation and is therefore not required to be disseminated. However, if the existence or terms of such an order is communicated to another member or a customer, even after it is entered into the NOM system, Nasdaq *must disseminate it as a quote* if it represents the NOM’s BBO. Therefore, as a matter of law, Commentary .04 must be revised to prohibit disclosure of Hidden Orders to other market participants.

### **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