

July 6, 2016

**By Electronic Mail**

Brent J. Fields  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

Re: *Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change to Modify the NYSE Amex Options Fee Schedule with Respect to Fees, Rebates, and Credits for Transactions in the Customer Best Execution Auction; File No. SR-NYSE MKT-2016-45*

Dear Mr. Fields:

Citadel LLC (“**Citadel**”) appreciates the opportunity to comment on the Securities and Exchange Commission (the “**Commission**”) proceedings to determine whether to approve or disapprove the above referenced NYSE MKT LLC (the “**Exchange**” or “**NYSE MKT**”) rule filing.<sup>1</sup> As one of the most active listed options liquidity providers, Citadel is greatly interested in the options market’s continued growth and high level of execution quality for investors.<sup>2</sup>

We commend the Commission for temporarily suspending the Rule Filing and instituting proceedings to determine whether to approve or disapprove the Rule Filing. We urge the Commission to disapprove the Rule Filing, because it is 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 1934 (the “**Exchange Act**”). In summary, and as described below, the proposal would render the Exchange’s fee schedule unfairly discriminatory and would unduly burden competition. The Rule Filing would also turn the Exchange’s Customer Best Execution Auction (“**CUBE Auction**”) into a vehicle for non-competitive internalization and would reduce opportunities for

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<sup>1</sup> Suspension of and Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change to Modify the NYSE Amex Options Fee Schedule with Respect to Fees, Rebates, and Credits for Transactions in the Customer Best Execution Auction, Exchange Act Release No. 78029 (June 9, 2016), 81 FR 39089 (June 15, 2016) (“**Order Instituting Proceedings**”); Notice of Filing and Immediate Effectiveness of Proposed Rule Change Modifying the NYSE Amex Options Fee Schedule, Exchange Act Release No. 77658 (Apr. 20, 2016), 87 FR 24674 (Apr. 26, 2016) (“**Rule Filing**”).

<sup>2</sup> Established in 1990, Citadel is a leading global alternative asset manager and market maker. With over 1,500 employees, Citadel serves a diversified client base through its offices in the world’s major financial centers, including Chicago, New York, London, Hong Kong, San Francisco, Dallas and Boston. On an average day, Citadel accounts for over 15 percent of U.S. listed equity volume, approximately 20 percent of U.S. listed equity option volume, and comparable market share in many of the world’s leading financial markets. Citadel is also one of the most active responders to CUBE Auctions and is one of the most active NYSE MKT participants.

price improvement; if this fee structure is adopted by other markets, it would have the potential to substantially degrade and impair price competition in the options markets as a whole.

## I. The Rule Filing

The proposed rule changes would modify the Exchange's fee schedule relating to the Exchange's CUBE Auction as follows. First, the proposal would increase the fees charged by the Exchange for RFR Responses (orders and quotes submitted during a CUBE Auction that are executed against an agency order submitted by an Initiating Participant). For Non-Customers the increase would be to \$0.70 (from \$0.12) for Penny classes and to \$1.05 (from \$0.12) for Non-Penny classes. Second, the proposal would also increase the rebate paid to those Initiating Participants in CUBE Auctions that meet certain tiers of the Exchange's ACE Program to \$0.18 (from \$0.05) for each of the first 5,000 customer contracts of an agency order executed in a CUBE Auction. Third, the proposal would increase the "break-up" credit paid by the Exchange to Initiating Participants to \$0.35 (from \$0.05) for Penny classes and \$0.70 (from \$0.05) for Non-Penny classes. The "break-up" credit is a payment for each contract in the Initiating Participant's contra-side order paired with the agency order that does not trade with the agency order because it is replaced in the auction.

## II. Discussion

### A. The Proposed Fee Structure Is Unfairly Discriminatory

The Exchange's proposed CUBE Auction fee structure is starkly discriminatory against auction responders—particularly market makers and other Non-Customers—in favor of Initiating Participants. Currently, the net cost to Non-Customer auction responders is already much more than the net cost to Initiating Participants. The Exchange's proposal would increase this difference significantly. The proposal would increase the fees charged by the Exchange to auction responders for Non-Customers for Penny classes by a *multiple of over five*, and by a *multiple of over eight* for Non-Penny classes. By contrast, the proposal would not increase the fee charged to Initiating Participants. As a result, the proposed fee for Non-Customer auction responders in Penny classes (\$0.70/contract) and Non-Penny classes (\$1.05/contract) would be *fourteen* and *twenty-one times higher*, respectively, than the fee charged to Initiating Participants (\$0.05/contract).

Furthermore, the Exchange's proposal would increase—*by a multiple of over three*—the rebate paid to Initiating Participants for each of the first 5,000 Customer contracts of a CUBE Order executed in a CUBE Auction. No such rebate currently is, or would be, available to auction responders. The discriminatory impact of the Rule Filing is perhaps best illustrated by example. As the Commission noted in the Order Instituting Proceedings:

[U]nder the proposal, an Initiating Participant that executes 100% of the agency order in a Penny class is charged a \$0.05 per contract transaction fee and, if applicable, receives a \$0.18 per contract rebate (subject to a 5,000 contract cap). This results potentially in a net

fee that awards a \$0.13 per contract rebate to an Initiating Participant that executes 100% of its customer's order. In contrast, an auction responder in a Penny class is charged a \$0.70 per contract transaction fee, also its net fee. Comparing the net fees charged to the Initiating Participant and Non-Customer auction responders, **the potential disparity in Penny classes is \$0.83 per contract.**<sup>3</sup>

For Non-Penny classes, the fee differential between Non-Customer auction responders and Initiating Participants can be **even higher, \$1.18 per contract.**

This proposed differential in fees is unreasonable and unjustified and is inconsistent with Section 6(b)(4) of the Exchange Act, which requires that the rules of a national securities exchange “provide for the equitable allocation of reasonable dues, fees, and other charges *among* its members and issuers and other persons using its facilities” (emphasis added). In addition, since the proposed fee structure would so blatantly discriminate against Non-Customer responders, it would be inconsistent with Section 6(b)(5) of the Exchange Act, which requires, among other things, that the rules of a national securities exchange be “designed to perfect the operation of a free and open market and a national market system” and not be “designed to permit unfair discrimination *between* customers, issuers, brokers, or dealers” (emphasis added).

**B. This Discriminatory Fee Structure Will Turn the CUBE Auction into a Vehicle for Non-Competitive Internalization and Will Eviscerate the Opportunities for Price Improvement in the CUBE**

The proposed changes to the Exchange's fee structure would turn CUBE Auctions into a mechanism predominantly used to internalize customer orders without significant competition, which will reduce opportunities for price improvement.<sup>4</sup> Under the proposal, internalizing participants would be able to execute transactions at dramatically lower costs than Non-Customer auction responders. When the proposed RFR Response fee for Non-Customers of \$0.70 per contract for Penny classes, or \$1.05 for Non-Penny classes, is added to the \$0.25 trading fee, the total fee responders would be required to pay to the Exchange would be \$0.95 per contract for Penny classes and \$1.30 per contract for Non-Penny classes, an economically prohibitive amount given spreads. Most of the time, it will no longer be economically viable for ATP Holders to submit responses in CUBE Auctions if they are not submitting customer orders. Therefore, if the Exchange's proposal is approved, fewer firms will pursue responding to CUBE Auctions, and those that do will respond far less often and far less aggressively.

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<sup>3</sup> Order Instituting Proceedings at n.20 (emphasis added).

<sup>4</sup> The Commission has long recognized that unrestrained internalization will likely reduce price competition and result in sluggish and inferior market quality. *See, e.g.,* Competitive Developments in the Options Market, Exchange Act Release No. 49175 (Feb. 3, 2004), 69 FR 6124, 6130 (Feb. 9, 2004) (noting, among other things, that “[r]ules or practices that permit or encourage internalization may also reduce intramarket price competition and therefore, cause spreads to widen”).

The Exchange's Rule Filing states that the changes are "designed to attract more volume and liquidity to the Exchange generally, and to CUBE Auctions specifically," which according to the Exchange, "would benefit all market participants . . . through increased opportunities to trade at potentially improved prices as well as enhancing price discovery."<sup>5</sup> On the contrary, the changes would, in reality, *decrease* opportunities for customer orders to trade at improved prices. In many cases, a responder would otherwise be willing to submit competitive, price-improving orders in the CUBE Auction, but when the proposed responder fees are taken into account, the cost to provide price improvement would become uneconomical.

Further, we note that the Exchange's proposed fees for RFR Responses are in many ways analogous to access fees charged by exchanges because, like access fees, RFR Response fees are applied when an order or quotation executes against an order on the Exchange. The Commission has recognized that market forces are not always sufficient to prevent pricing structures that distort the market, and some fees should be limited. The Commission in 2010 proposed that options exchanges be limited to charging a maximum of \$0.30 per contract to access a quote.<sup>6</sup> If the Commission believes that an access fee greater than \$0.30 is potentially problematic, then RFR Response fees for Non-Customers of \$0.70 for Penny classes and \$1.05 for Non-Penny classes should not be permitted.

For these reasons, the Exchange's proposal is inconsistent with Section 6(b)(8) of the Exchange Act, which requires that the rules of a national securities exchange "not impose any burden on competition not necessary or appropriate in furtherance of the purposes of [the Exchange Act]", and it should be disapproved.

**C. The Exchange Has Failed to Satisfy Its Burden of Demonstrating That the Proposed Fees Are Consistent with the Exchange Act**

Under Section 19(b)(2)(C)(i) of the Exchange Act, the Commission shall approve a proposed rule change of an exchange if it finds that such proposed rule change is consistent with the requirements of the Exchange Act and SEC rules thereunder. Section 19(b)(2)(C)(i) of the Exchange Act states that the Commission shall disapprove a proposed rule change if it does not make such a finding. The Commission's Rules of Practice, under Rule 700(b)(3), state that the "burden to demonstrate that a proposed rule change is consistent with the Exchange Act and the rules and regulations issued thereunder . . . is on the [exchange] that proposed the rule change" and that a "mere assertion that the proposed rule change is consistent with those requirements . . . is not sufficient."

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<sup>5</sup> Rule Filing at 24676.

<sup>6</sup> Proposed Amendments to Rule 610 of Regulation NMS, Exchange Act Release No. 61902 (Apr. 14, 2010), 75 FR 20738 (Apr. 20, 2010).

The Exchange has failed to meet this burden, and therefore the Commission should disapprove the Rule Filing. In the Order Instituting Proceedings, the Commission correctly noted that the Exchange’s justifications for the proposed changes are deficient in several respects. For example, the Commission noted that, with respect to satisfying the standard of Exchange Act Section 6(b)(5), the Exchange’s justification “does not address a key aspect of its proposal, namely the fact that it would substantially exacerbate the differences in the fees assessed by the Exchange on Initiating Participants and non-Initiating Participants . . . .”<sup>7</sup> The Commission also correctly observed that the Exchange failed to explain, among other things, “why the proposed increases in the break-up credit payable to Initiating participants for *not* executing transactions on the Exchange . . . is reasonable, equitable, and not unfairly discriminatory.”<sup>8</sup>

We note that the Exchange just recently—in February 2016—*reduced* the (i) RFR Response fees for Non-Customers to \$0.12 for Penny classes (from \$0.60) and Non-Penny classes (from \$0.95); (ii) rebates available to Initiating Participants in CUBE Auctions under the ACE Program to \$0.05 (from \$0.12) and (iii) break-up credits paid to Initiating Participants to \$0.05 (from \$0.35 for Penny classes and \$0.70 for Non-Penny classes).<sup>9</sup> In the February 2016 Filing, the Exchange explained that these reductions were “designed to address concerns expressed to the Exchange by Market Makers about ‘imposing oversized transaction fees on market makers . . . when they compete with the facilitation side to pre-matched auction crosses’ including the CUBE Auction.”<sup>10</sup> The Exchange also stated that the changes, particularly the reduction in the RFR Response fee, “[address] the concerns raised and, as a result, may attract greater volume and liquidity to the Exchange, which would improve its overall competitive and strengthen its market quality for all market participants.”<sup>11</sup>

The Exchange has failed to explain in the current Rule Filing why the concerns and justifications that it cited in February 2016 as the basis for reducing the same fees, rebates and credits are no longer germane. Furthermore, the Exchange has also not explained why, given the aforementioned statements in the February 2016 Filing, it would now be appropriate and consistent with the Exchange Act to *increase* the fees *above* the pre-February 2016 levels.

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<sup>7</sup> Order Instituting Proceedings at 39091.

<sup>8</sup> *Id.* (emphasis in original).

<sup>9</sup> Notice of Filing and Immediate Effectiveness of Proposed Changes Modifying the NYSE Amex Options Fee Schedule, Exchange Act Release No. 77106 (Feb. 10, 2016), 81 FR 8107 (“**February 2016 Filing**”).

<sup>10</sup> *Id.* at 8108.

<sup>11</sup> *Id.* The Exchange also stated in the February 2016 Filing that the changes are “pro-competitive as the fees and credits are designed to incentivize increases in volume and liquidity to the Exchange . . . . *Id.*”

**D. The Proposed Fees, If Adopted Broadly by the Options Markets, Would Discourage Public Quoting**

Despite the Exchange's assertions in the Rule Filing, the proposed change will not help enhance price discovery. On the contrary, the proposed fee changes would impede it. The CUBE Auction is a source of dark liquidity, where market participants have the opportunity to internalize customer marketable orders at a price that they were not publicly quoting. While dark liquidity has an appropriate and limited place in the options market, NYSE MKT's proposed fee changes will actually discourage public quoting in the lit markets. Many desirable orders that would otherwise have traded against publicly displayed quotes on another exchange will instead be routed to the CUBE Auction and internalized at the NBBO in a dark venue. Over time, this will cause harm to the lit markets by reducing the number, size, and quality of quotes that are visible, which reduces transparency and competition.

Because the CUBE Auction would facilitate an even greater level of this non-competitive internalization under the proposed fee structure, many market participants interested in internalizing customer order flow will direct that flow to the CUBE Auction. Many of these customer orders would be successfully internalized at prices that are inferior to what would be achievable in a vigorous auction or a more competitive price improvement environment, depriving these customers of a better opportunity to receive price improvement on another exchange that does not have a similarly lop-sided price improvement auction fee structure. Furthermore, if the Rule Filing is approved, then competitive pressures could force other exchanges to adopt fee structures that similarly discriminate against Non-Customer responders in price improvement auctions, which would have a degrading effect on price competition in the options markets as a whole.

**III. Responses to Specific Commission Requests for Comment**

The following section briefly responds to several of the specific issues upon which the Commission requested comment.

**A. Whether the Commission should undertake a broader review of the fee structures applied by the options exchanges to their price improvement auctions.**

Yes. Citadel previously raised many of the same general concerns discussed in this letter in comments submitted to the Commission in 2010 and 2011 regarding proposed changes to the fee structure for the price improvement mechanism of the Boston Options Exchange ("BOX").<sup>12</sup>

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<sup>12</sup> See Letter from John C. Nagel, Managing Director & General Counsel, Citadel, to Elizabeth M. Murphy, Secretary, Commission, dated Aug. 30, 2010 (urging the Commission to suspend, and ultimately disapprove, File No. SR-BX-2010-049); Letter from John C. Nagel, Managing Director & General Counsel, Citadel, to Elizabeth M. Murphy, Secretary, Commission, dated May 3, 2011 (urging the Commission to suspend, and ultimately disapprove, File No. SR-BX-2011-046); Letter from John C. Nagel, Managing Director & General Counsel, Citadel, to

If the Commission approves NYSE MKT's proposal, competitive pressures may force the other options exchanges to seek to establish fee structures that are similarly unfair and discriminatory to auction responders. Thus, before precedent is established that is difficult to reverse, Citadel urges the Commission to disapprove NYSE MKT's Rule Filing and conduct a holistic review of fee structures applied to the price improvement auctions of all options exchanges.

**B. Whether the Commission should view a specific auction response fee level for Penny classes, such as an amount exceeding half the minimum trading increment, as presumptively unreasonable, unfairly discriminatory, imposing an unnecessary or inappropriate burden on competition, or otherwise inconsistent with the Act.**

Yes. The Commission should view an auction response fee that exceeds half the minimum trading increment as *per se* inconsistent with Exchange Act standards. In the case of price improvement auction related fees, the relevant trading increment is the increment for auction responses—i.e., one penny—and not the trading increment for displayed quotations. Over the past few years, the options exchanges have increasingly escalated fees charged to auction responders, which means that, for the reasons explained above, internalization has, to the detriment of price improvement, increased.

**C. Whether transaction fees that exceed half of the minimum trading increment in Penny classes make participation uneconomical for potential auction responders, given that they may not be able to compete with the Initiating Participant at the same trading increment due to the impact of such fees.**

Yes. Citadel believes that the Commission should not permit any transaction fees above \$0.50 per contract for Penny classes. As discussed elsewhere in this letter, the imposition of excessive fees on auction responders would make it no longer economically viable for ATP Holders to submit responses in CUBE Auctions if they are not submitting customer orders. The imposition of high fees, together with high rebates paid to initiators, provides initiators with a vast economic advantage over responders in executing against customer orders in price improvement auctions. This advantage is inconsistent with Exchange Act standards, as discussed.

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Again, Citadel commends the Commission for temporarily suspending the Rule Filing and instituting proceedings to determine whether to approve or disapprove the Rule Filing. For

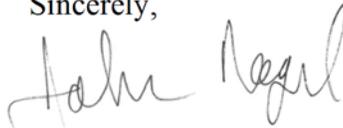
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Elizabeth M. Murphy, Secretary, Commission, dated Aug. 11, 2011 (urging the Commission to suspend, and ultimately disapprove, File No. SR-BX-2011-046); Letter from John C. Nagel, Managing Director & General Counsel, Citadel, to Elizabeth M. Murphy, Secretary, Commission, dated Nov. 17, 2011 (urging the Commission to disapprove File No. SR-BX-2011-046).

the foregoing reasons, Citadel submits that the Rule Filing would harm the quality of the options markets, fail to equitably allocate fees, unfairly discriminate, and unduly burden competition. Citadel thus strongly urges the Commission to disapprove the Rule Filing, as it is inconsistent with the statutory requirements set forth in Sections 6(b)(4), 6(b)(5) and 6(b)(8) of the Exchange Act.

If you have any questions, please do not hesitate to contact me at [REDACTED].

Sincerely,



John C. Nagel  
Managing Director and  
Sr. Deputy General Counsel  
Citadel LLC