



December 18, 2013

**By Electronic Mail**

Elizabeth Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090  
rule-comments@sec.gov

Re: *NASDAQ OMX PHLX LLC; Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Offer a Customer Rebate; Suspension of and Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change to Offer a Customer Rebate*  
*File No. SR-Phlx-2013-113*

Dear Ms. Murphy:

Citadel LLC (“**Citadel**”)<sup>1</sup> appreciates the opportunity to submit this comment letter to the Securities and Exchange Commission (the “**Commission**”) in response to the NASDAQ OMX PHLX LLC (“**Phlx**”) rule filing referenced above (the “**Rule Filing**”)<sup>2</sup> and the Commission’s proceedings to determine whether to approve or disapprove the Rule Filing.<sup>3</sup>

The Rule Filing amended Phlx’s rebate program to increase rebates available to market participants that transact in Customer-denominated orders on Phlx (the “**Proposal**”). Specifically, under the Proposal, Phlx would offer an additional \$0.02 per contract rebate to members on certain customer orders executed on Phlx where the aggregate volume of customer orders transacted by the Phlx member and its affiliates on Phlx and Phlx’s affiliated options exchanges, the NASDAQ Options Market LLC (“**NOM**”) and NASDAQ OMX BX, Inc. (“**BX**”), equals or exceeds 2.5% of national customer volume in certain options during the month (the “**Eligibility Threshold**”).

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<sup>1</sup> Established in 1990, Citadel is a leading global financial institution that provides asset management and capital markets services. With over 1,100 employees globally, 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 and Boston. Citadel Securities operates an industry leading market making franchise and an institutional markets platform. On an average day, Citadel accounts for approximately 13 percent of U.S. listed equity volume and 20 percent of U.S. listed equity option volume.

<sup>2</sup> Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Offer a Customer Rebate, Exchange Act Release No. 70866 (Nov. 13, 2013) (File No. SR-Phlx-2013-113).

<sup>3</sup> Suspension of and Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change to Offer a Customer Rebate, Exchange Act Release No. 70940 (Nov. 25, 2013) (File No. SR-Phlx-2013-113).

Citadel supports the Proposal and believes that it is consistent with Section 6(b) of the Securities Exchange Act of 1934 (the “**Exchange Act**”), and will help attract order flow to Phlx to the benefit of all Phlx members, while lowering costs for members and potentially, their customers.

The Proposal recognizes and reflects the changed economics of the exchange business structure, where one company may own several affiliated exchanges, each of which is not intended to compete with its sister exchanges, but to offer different features and programs. Citadel believes that the Proposal represents an equitable allocation of fees among members, and is not designed to permit unfair discrimination between members, does not impose any unnecessary or inappropriate burden on competition and does not, in fact, raise novel legal or regulatory issues. Moreover, as the Rule Filing directly relates to the “fees, dues, or other charges” imposed by the exchange, filing for immediate effectiveness was appropriate under Section 19(b)(3)(A).

Because the Proposal is consistent with the standards applicable to exchange rules under the Exchange Act and the applicable requirements for rule filings, while benefiting investors and the public interest, Citadel requests that the Commission reinstate and approve the Rule Filing, and resist calls from other commenters (who also happen to be competitor exchanges) to disapprove it.<sup>4</sup>

### **I. The Proposal Addresses a Critical Issue for Member Firms**

On receipt of every customer order, a broker-dealer that is a member of several options exchanges must decide where to route that order. This decision is generally based on a large number of factors, including best execution considerations specific to the order, as well as each exchange’s functionality, technology, speed of execution, order types, price improvement opportunities, and transaction fees or rebates. Exchange operators, including NASDAQ OMX Group, seek to offer, in many cases through multiple exchange platforms, a range of execution alternatives that allow their member/users broad flexibility to achieve their business objectives and to discharge their regulatory responsibilities in regard to order routing and execution.

Transaction fees and rebates based on volume tiers present a difficult issue for firms to consider when making these routing decisions. In addition to the particulars of the order, a firm must consider whether or not a particular order would move the firm closer to reaching a volume tier. If so, the firm must consider whether that possibility, and the potential benefits to the firm and its customers from reaching the tier, outweigh other factors that might cause the firm to otherwise route the order to a different exchange. In effect, routing to an exchange in order to seek to reach a volume tier may involve a trade-off, where a benefit or preferred functionality on

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<sup>4</sup> See, e.g., Michael J. Simon, Secretary, International Securities Exchange, LLC (“**ISE**”) (Nov. 11, 2013); William O’Brien, Chief Executive Officer, Direct Edge Holdings LLC (Nov. 13, 2013).

one exchange is given up in return for the financial incentive that comes from reaching the volume tier, subject, of course, to the firm's duty of best execution.

The Proposal would significantly reduce this problem. By allowing Phlx members to obtain credit toward the Eligibility Threshold even for orders executed on Phlx's affiliated options exchanges, the Proposal would recognize that members cannot route every order to Phlx, and in some cases will have compelling reasons to send orders to its sister exchanges. In effect, the Proposal provides members with greater flexibility in making routing decisions, while at the same time providing significant incentives to route significant order flow to the Phlx. The Commission should support the Proposal as it allows members to better fulfill their duties to customers and manage their businesses while encouraging competition among exchanges. In fact, prohibiting this type of Proposal could cause a firm to be incentivized to send an order to Phlx in order to reach the volume tier, even though, for other reasons, it would be more advantageous to the firm or its customer to send the order to NOM or BX.

## **II. Equitable Allocation of Reasonable Fees**

The Proposal meets the requirement under Section 6(b)(4) of the Exchange Act that the rules of an exchange provide for the equitable allocation of reasonable dues, fees, and other charges among members and others.

### **A. The Proposal is Presumed to Reasonably Allocate Fees**

Under the Commission's historical guidance, and approving federal court precedent, the Proposal should be presumed to reflect an equitable allocation of reasonable fees, absent countervailing factors not present here. Specifically, the Commission has explained that where an exchange is subject to significant competitive forces in setting the terms of its proposed fees, the exchange's fees are presumed to be equitable, fair, reasonable and not unreasonably or unfairly discriminatory.<sup>5</sup>

Based on the data provided by Phlx in the Rule Filing, it is clear that Phlx and all options exchanges are subject to significant competitive forces in setting their fees. In fact, the Commission recently found that there is significant competition for order flow in the options markets.<sup>6</sup> As such, absent a "substantial countervailing basis" to find otherwise,<sup>7</sup> which as we discuss below is not present here, the Proposal is presumed to comply with the Exchange Act.<sup>8</sup>

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<sup>5</sup> See Exchange Act Release 59039 (Dec. 2, 2008) at 48-50 ("ArcaBook Order"); *NetCoalition v. SEC*, 615 F.3d 525 (D.C. Cir. 2010) (approving the Commission's test set forth in the ArcaBook Order, in general, but disagreeing on whether this test was met in the context of proprietary market data at issue in that context).

<sup>6</sup> See, e.g., Exchange Act Release No. 68202 (Nov. 9, 2012) (File No. SR-PHLX-2012-27) at note 40 and accompanying text (approving Phlx proposed rule change relating to fees and rebates for complex orders).

**B. The Proposal is Similar to Other Rebate Programs Considered Equitably Allocated**

Changes to fees charged or rebates offered by exchanges have consistently and for many years been supported as equitable, fair, reasonable and not unreasonably or unfairly discriminatory under Section 6(b)(4), on a variety of grounds. In practice, “equitably allocated” has come to mean that the fee does not unfairly place the burden on funding the exchange on one type of user or class of member, and that there should be some connection between the service and the fee or rebate.

Reduced fees or rebates based on volume, in general, have been approved or accepted by the Commission and not been considered inequitable, even if they benefit one class of member (such as more heavy users of the exchange) over others. The theory has been that, while these direct benefits flow to only some members, the reduced fees or rebate tiers will attract greater usage of the exchange, and all members and customer orders will benefit from both the greater liquidity on the exchange and the spreading of other fees across a larger number of transactions and members. Greater usage of an exchange would also provide the exchange with more funding to support its regulatory functions.

For example, the ISE adopted a change to a rebate program, based on, among other things, its view that “it is reasonable and equitable to provide rebates for [an order type] ... because paying a rebate would continue to attract additional order flow to the [ISE] and create liquidity in the symbols that are subject to the rebate, which ... ultimately will benefit all market participants who trade on ISE.”<sup>9</sup> Similarly, EDGX Exchange, Inc. (“EDGX”) recently amended a fee and rebate tier, noting that the change complied with Section 6(b)(4) because “the increased liquidity that may result from [m]embers attempting to achieve the tier would benefit all investors by deepening EDGX’s liquidity pool and improving investor protection.”<sup>10</sup>

The Proposal meets these same standards, in that it is designed to attract additional order flow to Phlx by offering members able to achieve the Eligibility Threshold an additional rebate.

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(continued...)

<sup>7</sup> ArcaBook Order at 48.

<sup>8</sup> While the ArcaBook Order was vacated by the U.S. Court of Appeals for the District of Columbia, that decision was based on the court’s disagreeing with the Commission as to whether, in fact, that exchange was subject to significant competitive pressure in setting prices for its proprietary market data—a product which that exchange is the exclusive provider. In contrast, the Proposal relates to a transaction *rebate* that is aimed at attracting order flow to Phlx. A rebate, as a negative fee, is clearly the product of intense competition among exchanges to attract order flow and provide transaction execution services, a product over which no exchange has a monopoly.

<sup>9</sup> Exchange Act Release No. 69395 (Apr. 18, 2013) (File No. SR-ISE-2013-31).

<sup>10</sup> Exchange Act Release No. 70601 (Oct. 2, 2013) (File No. SR-EDGX-2013-37).

The Proposal would, at the same time, make it easier for members to reach the Eligibility Threshold by considering volume on affiliated exchanges. That aspect of the Proposal, however, does not change the Proposal's essential nature as a tiered rebate program, the sort of which has long been approved or accepted by the Commission.

### **III. The Proposal is Not Unfairly Discriminatory**

The Proposal would not discriminate among members in a manner that would violate Section 6(b)(5) of the Exchange Act, or present a discriminatory effect. In particular, while the Proposal would include volume a member or its affiliates transacts on NOM and BX for purposes of the Eligibility Threshold, it does not require a member to become a NOM or BX member. Indeed, a Phlx member that is neither a NOM nor BX member may meet the Eligibility Threshold by transacting sufficient volume on Phlx alone. Moreover, the rebate is only paid in connection with transactions executed *on Phlx*, and no Phlx rebate is paid in connection with transactions effected on NOM or BX.

In practice, it is likely that most Phlx members with significant enough customer order flow to potentially reach the Eligibility Threshold are already members of BX and NOM. Even if there are high volume Phlx members that are not members of NOM or BX, becoming a member of these additional exchanges is not an unreasonably discriminatory burden in exchange for the greater ability to meet the Eligibility Threshold. A fee structure is not discriminatory simply because not all members may choose to take advantage of it.<sup>11</sup> For example, the Commission has approved of fees as not unfairly discriminatory where the fee is connected to a service made available to all members on the same terms, even if only some voluntarily elect to use the service and pay the fee.<sup>12</sup>

### **IV. The Proposal Does Not Place Any Undue Burden on Competition**

Consistent with Section 6(b)(8) of the Exchange Act, the Proposal will not place any undue burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. On its face, the Proposal has the effect of *lowering* fees, and should therefore be presumed to be pro-competitive. Indeed, the Proposal will enhance competition, as members benefit from greater rebates and lower prices, and competing exchanges are forced to innovate to maintain customers and market share.

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<sup>11</sup> Of course, because of statutory requirements applicable to NOM and BX, and which are embedded in the membership criteria and rules of those exchanges, Phlx members can easily become members of those sister exchanges with very little cost or delay, on nondiscriminatory terms, should they choose to do so.

<sup>12</sup> See, e.g., Exchange Act Release No. 68735 (Jan. 25, 2013) (File No. SR-NASDAQ-2012-119) (approving NASDAQ Stock Market proposal to charge fees on exchange members electing to receive certain market data via a wireless connectivity system).

Citadel also agrees with Phlx that the Proposal does not constitute anticompetitive tying for the reasons Phlx cites.<sup>13</sup> In particular, tying only exists where the purchase of one product is conditioned on a requirement to purchase a separate product. Here, however, there is no requirement that Phlx members transact on NOM or BX. Further, even where tying exists, it is only anticompetitive where the party allegedly tying has market power. As noted above, the Commission has recently found that there is, in fact, intense competition in the market for options execution services and Phlx is subject to significant competitive forces,<sup>14</sup> rather than a dominant market participant.

Lastly, it is true that not all exchanges have affiliated exchanges through which they could structure a program similar to the Proposal. However, this does not constitute an undue burden on competition, but rather a potential for its enhancement. If an exchange operator believes that it can better compete by forming an additional, affiliated exchange, it may do so, increasing competition and lowering costs to investors.

#### **V. Considering Activity on Affiliated Exchanges is Neither Novel, Nor Inappropriate**

Citadel understands that certain commenters have raised concerns that the Proposal would consider a member's activity on Phlx's affiliated options exchanges in determining the rebate available for transactions on Phlx.<sup>15</sup> While this aspect of the Proposal is uncommon, it is not novel or inappropriate.

It is important to recognize the realities of competition among today's exchanges: in many cases, separate exchanges no longer represent separate competitors. While exchanges were once each separate businesses organized by groups of members, exchange operators now run for-profit businesses, in many cases, with more than one affiliated exchange held under the same holding company. These affiliated exchanges, though active in the same market, tend to offer different functionality or pricing structures than their sister exchanges, rather actually competing with their affiliates. It thus makes economic sense that exchanges differentiate between their sister exchanges and actual third-party competing exchanges, as it is not in the economic interests of their owners to compete with themselves. Recognizing this reality and reflecting it in the way exchanges set their fees fosters competition among the actual competing exchange operators.

Further, as Phlx noted in the Rule Filing, the Commission has previously permitted a market to consider a member's activity both on that market and an affiliated market in qualifying

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<sup>13</sup> See Rule Filing at 27-36.

<sup>14</sup> See *supra* note 6.

<sup>15</sup> See *supra* note 4.

the member for a volume-based rebate.<sup>16</sup> In fact, the Commission has affirmatively approved a proposal quite similar to Phlx's: volume tiers being calculated based on a market participant's aggregate activity on two affiliated markets.<sup>17</sup> While these examples have generally involved two markets operated by the same self-regulatory organization ("SRO"), that has not always been the case.<sup>18</sup> In any event, differentiating between separate affiliated markets operated by the same SRO, on the one hand, and separate affiliated exchange operated by affiliated SROs, on the other hand, is a distinction without a difference.

For competitive reasons, parent companies of an equity or options exchange often seek to establish an additional market or markets to trade the same securities, but with different pricing structures or other features, in an effort to attract different order flow than their other exchange attracts. In practice, this has been accomplished through establishing separately registered exchanges. We understand that the choice to accomplish this through separate exchanges, rather than as a separate market within the same exchange entity and SRO, has been driven, at least in part, by concerns that the Commission staff have informally expressed regarding operational, rather than substantive considerations. Specifically, we understand that there are concerns that if one exchange were to operate two markets that trade in the same securities, there could be two different top-of-book quotes for a security emanating from same exchange, one from each market, potentially leading to operational confusion with respect to avoiding and monitoring for trade-throughs. As a result, the Commission has permitted an exchange to operate, within the same exchange SRO entity, separate options and equities markets (such as NASDAQ Stock Market LLC and its NOM options market, or the Chicago Board Options Exchange, Inc. and its CBOE Stock Exchange market), but not multiple equities or multiple options markets.

As the reason that affiliated exchanges exist as separate exchange SROs is purely due to operational considerations and at the Commission's insistence, it would be an anomalous result if owners of affiliated exchanges were to be penalized for this structure and prohibited from distinguishing in exchange fees between transactions effected on affiliated exchanges versus third-party competing exchanges. To the contrary, the Commission should encourage this type

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<sup>16</sup> See Rule Filing at 25-26 (discussing rebates on NOM for activity on both NOM and the NASDAQ Stock Market LLC's equities market).

<sup>17</sup> See Exchange Act Release No. 50787 (Dec. 2, 2004) (File No. SR-NASD-2004-170) (approving a fee and rebate volume tier schedule for executions based on *combined* average daily shares on the Nasdaq Stock Market, Inc.'s Nasdaq Market Center and its affiliated BRUT trading facility).

<sup>18</sup> The Commission has permitted one affiliate exchange to waive a fee where the member is already paying an affiliated exchange for a related service. See, e.g., NYSE Arca Options Fees and Charges: Co-Location Fees (Nov. 8, 2013), available at <https://globalderivatives.nyx.com/nyse-arca-options/fees-charges> (noting that "a user that incurs co-location fees for a particular co-location service pursuant to this Fee Schedule shall not be subject to co-location fees for the same co-location service charged pursuant to the NYSE Arca Equities Fee Schedule or by the Exchange's affiliates NYSE MKT LLC and New York Stock Exchange LLC").

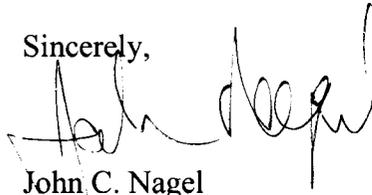
of fee structure, as it promotes actual competition between competitors and lowers costs for investors.

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As the Proposal will enhance competition among exchanges, reduce costs for market participants, and is consistent with the statutory requirements set forth in Sections 6(b)(4), 6(b)(5) and 6(b)(8) of the Exchange Act, Citadel urges the Commission to reinstate and approve the Rule Filing.

If you have any questions, please do not hesitate to contact me at (312) 395-2100.

Sincerely,



John C. Nagel  
Managing Director and General Counsel  
Citadel Securities