April 13, 2004

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street NW
Washington, DC 20549-0609

Re: Release No. 34-49175; File No. S7-07-04 —
<u>Competitive Developments in the Options Markets</u>

Dear Mr. Katz:

Citadel Investment Group, L.L.C. ("Citadel Group") welcomes this opportunity to comment on Commission Release No. 34-49175 (the "Release"). The Release discusses recent changes in the listed options markets and seeks public comment on whether the Commission should take action to improve efficiency and competition in these markets.

Volume has increased in listed options markets in recent years due to improvements in liquidity, transparency, and competition in these markets. The ability of investors to efficiently use the listed options markets is an important cornerstone of our national market system. It is thus crucial that the Commission implement reforms that will further this trend. Specifically:

- The firm quote rule would best serve liquidity and transparency if it applied to all listed option order types up to the displayed size of any quote.

- The practice of payment for order flow creates serious conflicts of interest and should be banned.

- Internalization without meaningful price improvement reduces competition, limits price discovery, leads to market fragmentation, and should be banned.

- The Commission should not yet require the listed options markets to quote in decimals because decimalization would overload systems already pushed to their limits and lead to less transparent and shallow markets.

Citadel Group welcomes the issuance of the Release and the Commission's other efforts to consider and open for discussion fundamental issues relating to market structure and regulation. The Commission's willingness to focus on these difficult issues and ask the hard questions works to ensure that the U.S. markets remain the strongest and most efficient in the world.

I. Citadel's Activities and Interests

Citadel Group and its affiliates have approximately 700 employees, with headquarters in Chicago and offices in New York, San Francisco, London and Tokyo. Citadel Group provides administrative and investment-related services to a number of private investment funds and investment vehicles. Citadel Group's affiliate, Citadel Limited Partnership ("Citadel LP"), acts as portfolio manager for or general partner to these investment funds and vehicles. Citadel LP is registered with the Commodity Futures Trading Commission as a commodity trading adviser and commodity pool operator.

Citadel LP is the portfolio manager for, and Citadel Group provides administrative and investment-related services to, Citadel Derivatives Group LLC ("Citadel Derivatives Group"). Citadel Derivatives Group is registered with the Commission as a broker-dealer and is a member of the International Securities Exchange ("ISE"), the Chicago Board Options Exchange ("CBOE"), the Philadelphia Stock Exchange, the American Stock Exchange, and the Boston Options Exchange. As an options market maker, Citadel Derivatives Group is most active on the ISE. On the ISE, Citadel Derivatives Group is a primary maker in 2 bins, and a competitive market maker in 9 bins.

Citadel Group's interests are aligned with the Commission's objectives. As a buy-side "user" of the listed options markets on behalf of the firm's various investment funds and vehicles, Citadel LP seeks liquidity, quick and reliable executions at good prices, and reasonable transaction costs. As an options market maker, Citadel Derivatives Group is not tainted with the conflicts of interest and other anti-competitive practices that the Commission has identified in the Release. Citadel Derivatives Group does not have a "customer business," and, therefore, does not internalize customer orders or accept payment for order flow.

II. Response to Request for Comments

A. Firm Quote Rule

Citadel Group urges the Commission to require that size be displayed for disseminated listed options quotes, and that displayed quotes be firm for all orders. Although the Commission's Firm Quote Rule requires that listed options quotes be firm for public customer orders, the Rule does not require that quotes be firm for professional orders for more than 1 contract. A professional trader is thus often unable to assess whether quotes are real or ephemeral, or obtain reliable executions, because the displayed size may not be firm for orders placed by a professional trader.

A robust and consistently applied firm quote rule is essential to price discovery, aggressive price competition, and best execution. The national best bid or offer

("NBBO"), which is the fundamental indicator of market supply and demand, has less meaning without a robust and enforced Firm Quote Rule. As the Commission observed in its release proposing to apply the Firm Quote Rule to listed options:

> 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.[1]

The existence of a uniform firm quote requirement in the equities markets has greatly benefited investors. Such benefits include tighter spreads, aggressive price discovery, and true market transparency. Broker-dealers are better able to make order routing decisions in accordance with their best execution obligations because they know that most quoted prices are reliable and instances of inappropriate backing away may result in regulatory action. The same is not true in the listed options markets.

Universal firm quotes also have achieved great success on the ISE, where "an order is an order" and all quotes must be firm for all orders. The ISE's success shows that investors do, in fact, prefer to send their orders to markets that reliably fill orders at the displayed quote. Due at least in part to the ISE's approach to firm quotes, the ISE is now the largest and most successful equity options exchange after less than four years in operation.

The ISE's success also demonstrates the fallacy of the most common argument against requiring firm quotes in options markets for all market participants: that "professional traders" will put market makers out of business if market makers are required to execute professional orders at quoted prices. The fact that ISE's quotes are firm for all participants—public customers and professional traders—is one of the primary reasons for the ISE's resounding success.

The absence of a firm quote requirement for professional orders also makes it more difficult to unlock or uncross away markets. Rather than being able directly to send an order against a locking or crossing quote in another marketplace, market makers often

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[1] Exchange Act Release No. 43085 (July 28, 2000), 65 FR 47918, 47925 (August 4, 2000).

must send principal orders through the intermarket linkage. This is time consuming and often leads to a "nothing done" response. These "nothing dones" are rampant despite the fact that they result from seemingly clear violations of linkage plan "trade or fade obligation (*i.e.*, to autoexecute any incoming principal order for up to 10 contracts or fade one's quote) and of the professional order Firm Quote Rule obligation (*i.e.*, to execute at least 1 contract of an incoming professional order). When an order sent through the linkage to unlock or uncross a market is not filled, there may be a significant time lag between the time a locked or crossed market is identified and the time when it is unlocked or uncrossed. While linkage plan remedies for unfilled principal orders theoretically provide some protection against the failure to execute linkage orders, these remedies, in Citadel Derivatives Group's experience, are rarely enforced.

B. Payment for Order Flow

Citadel Group urges the Commission to ban payment for order flow. This practice distorts order routing decisions, is anti-competitive, and creates an obvious and substantial conflict of interest between broker-dealers and their customers. Broker-dealers accepting payment for order flow have a strong incentive to route orders based on the amount of order flow payments, which benefit these broker-dealers, rather than on the basis of execution quality, which benefits their customers. Furthermore, the parties making such payments (either voluntarily or through an exchange-mandated program) are forced to find other ways to recoup the amounts of such payments, whether through wider spreads or a reduction in other benefits that otherwise could, and should, be provided to customers.

Payment for order flow is a practice that on its face is at odds with a broker-dealer's obligations to its customers. A broker-dealer has a fiduciary obligation to obtain the best execution reasonably available for its customers' orders under prevailing market conditions. We do not believe that a broker-dealer that accepts payment for order flow and does not pass such payments on to its customers (either directly or through reduced execution fees or commissions) can consistently fulfill its best execution obligations.

In practice, the conflict of interest caused by payment for order flow may lead broker-dealers to execute customer options orders at a "defensible" price, rather than aggressively pursuing the best possible price and seeking price improvement opportunities. Gradually, this results in the erosion of market efficiency and wider bid/ask spreads. Even in cases where execution price may not be affected, public customers whose order flow is being sold to the highest bidder, may be left with the perception that they could have gotten better execution in the absence of these payments.

Because payment for order flow creates fundamental conflicts of interest that cannot be cured by disclosure, the Commission should ban payment for order flow altogether. It is crucial that this ban include not only exchange-sponsored programs, but also payment for order flow arrangements entered into privately between order flow providers and market centers. Individually negotiated payment for order flow arrangements lack transparency and are more difficult to police. For this reason, a ban of only exchange sponsored payment for order arrangements would be worse than the status quo on the ISE and CBOE because these markets have multiple independent quoting firms.

If the Commission continues to allow the practice of payment for order flow in any form, the Commission should require that broker-dealers pass on to their customers the benefit of any such payments, regardless of the form the payment takes. If the Commission takes this approach, the Commission would need to develop a framework for identifying, valuing, and policing non-cash benefits provided in lieu of, or in addition to, actual cash payments or credits. Because a market maker can provide a wide range of non-cash benefits that may be difficult to police and value (*e.g.*, entertainment or discounts on unrelated services), such an undertaking would be difficult at best—another reason why an outright ban on payment for order flow is preferable.

C. Internalization

Citadel Group urges the Commission to ban the increasingly common listed options market practice of order internalization at prices not meaningfully better than market prices. If an order flow provider is willing to beat the best price by the allowable quoting increment, after an order is exposed to robust public price discovery, then the order flow provider should be allowed to internalize the order. There is, however, no justification for allowing an order flow provider to internalize any portion of a customer order if the order flow provider simply matches the best market price. Similarly, an order flow provider should not be allowed to internalize a customer order if the order flow provider simply beats the best price market price by a penny where the option is quoted in nickels or dimes. Price improvement that is not meaningful does not justify internalization. Price improvement that is a smaller increment than the allowable quoting increment is not meaningful because there is no way to know whether the market would have been willing to trade at the improved price.

Internalization allows a broker-dealer to view a customer's order and determine if the broker-dealer wishes to match or cross some or all of the order by matching or providing minimal price improvement over the market, without exposing the order to a robust and transparent price discovery process. This practice substantially reduces the opportunity for investor orders to interact and contributes to harmful fragmentation of the market. This reduced order interaction also interferes with the process of price discovery and detracts from a market participant's ability to provide best execution. As a result of internalization, orders remaining in the market are subject to an incomplete price discovery process, which causes the displayed prices to be unreliable and impairs market transparency. Given that investors, especially retail investors, rely on displayed quotations in making investment decisions, displayed quotations should represent the entire market's supply and demand at any given time.

Moreover, because internalization provides order flow providers with a guaranteed source of order flow, it also eliminates the need for them to compete aggressively for orders on the basis of their displayed quotations. Instead, order flow providers can simply match market prices after-the-fact. Price-matching takes advantage of the public price discovery process but does not contribute to the process. Moreover, if a substantial portion of the total order flow in an option is being internalized, the ability of other broker-dealers to compete successfully for order flow on the basis of their displayed quotations is dramatically reduced. Those market participants that are willing to participate in public price discovery by displaying firm trading interest at their best prices are thus not fully rewarded for their aggressive quoting. This creates disincentives for vigorous price competition, which can lead to wider bid-ask spreads, less depth, and higher transaction costs. If this occurs, all orders are likely to receive inferior executions, not just those that are internalized.

In this regard, Citadel Group urges the Commission to reconsider the price improvement period ("PIP") on the Boston Options Exchange ("BOX") and similar mechanisms proposed by other exchanges. The BOX's PIP facilitates the most egregious and aggressive form of internalization. This PIP allows order flow providers to automate the internalization of retail customer order flow without robust price competition.

At the core of BOX's PIP is a three-second electronic auction during which order flow providers and market makers enter orders at a price at least one penny better than the current NBBO. The originator of the order is guaranteed at least forty percent (40%) of the order if the originator matches the best price in this mini-auction. Because the originator has the right to match any price improvement offered by other market participants, the originator has no incentive to display its best price at the outset of the auction. Likewise, other market participants have less incentive to quote better prices, knowing that originators can supersede any posted price by a penny (even though the allowable quoting increment may be significantly larger than a penny). The PIP thus encourages market participants to widen spreads and wait for a second chance to better their initial quotes, rather than quoting aggressively the first time around. Because such programs threaten price competition and transparency, Citadel Group strongly opposes the type of mini-auction represented by the PIP.

D. Decimalization

Citadel Group urges the Commission not to adopt decimalization in the listed options markets. The listed options markets are not yet ready for a move to decimalization. A move to penny pricing would overwhelm outdated systems that are already overburdened and incapable of processing all necessary information in a timely way.

In addition, the listed options markets are not yet deep enough to support a move to decimalization. A move to decimal pricing would jeopardize the incentives for market makers to commit capital to making continuous two-sided markets in all but the most liquid listed option series. Rather, market makers would be inclined to simply disseminate wide quotes and attempt to jump in and participate in an order, by bidding one penny higher, when such order is displayed. A rational market participant will not consistently disseminate its best price if it knows it will have another opportunity to better the price. As a result of this disincentive to aggressive quoting, investors are unlikely to get the best possible price.

In this regard, we strongly believe that the commitment of capital is far more important in the listed options markets than it is in the equity markets. As the Commission knows, in options markets there may be hundreds of series of options for one underlying stock and many of those series trade infrequently. If, due to decimalization, market makers have little incentive to commit capital by making aggressive continuous two-sided markets, there potentially could be thousands of options series with little or no price information and no one willing to provide liquidity. Certainly, this would be an undesirable outcome.

The Commission also should consider how poorly options markets function in Europe, where there are no consistent two-sided markets. As a result, no retail market for options has developed and there is virtually no effective price discovery. This could be the unintended consequence in the U.S. options markets if a move to decimalization results in unwillingness of market makers to aggressively commit their own capital.

III. Conclusion

For our listed options markets to reach their potential, the Commission must prohibit practices that create conflicts of interests between broker-dealers and their customers and that inhibit competitive, transparent, and deep markets. Market participants and exchanges should be required to display firm quotes and be held accountable for failing to honor quotes. Payment for order flow and internalization without meaningful price improvement should be banned because they disadvantage customers, undermine competition, and distort market prices. While taking these important steps, the Commission should refrain from implementing decimalization until the options markets are deep enough and until critical market systems have adequate capacity.

Again, we appreciate the opportunity to comment on these critically important issues. We would be happy to answer any questions or provide further insights if that would be helpful.

Sincerely,

Adam C. Cooper
Senior Managing Director and
General Counsel

cc: Chairman William H. Donaldson
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid
Annette L. Nazareth, Esq.
Robert L. D. Colby, Esq.
Elizabeth King, Esq.
Richard Strasser, Esq.