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Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Petition for Rulemaking to Address Excessive Access Fees in the Options Markets

Dear Ms. Morris:

Citadel Investment Group L.L.C. ("Citadel") urges the Securities and Exchange Commission to address distortions in the options markets caused by the excessive fees that may be charged by options exchanges using maker-taker pricing. Specifically, Citadel petitions the Commission to institute a rulemaking proceeding to limit the fees that options exchanges may charge non-members to obtain access to quotations to \$.20 per contract.[1] The text of a draft rule designed to implement such a fee cap is attached as Exhibit A. Limiting the fees that options exchanges may charge to obtain access to their quotations ("Taker Fees") would ensure the effectiveness of quotations in the options markets and address many of the same concerns that the Commission addressed in the equity markets when the Commission adopted Rule 610(c) of Regulation NMS to cap access fees in those markets.[2]

We are a firm believer in the power of free markets. In our view, free and fair competition generally serves investors better than prescriptive regulations. Regulation of fees, in particular, should be undertaken only in extraordinary circumstances.

Competitive forces, however, are not fully effective to combat excessive Taker Fees in the options markets because regulations limit competition for order flow in important ways. In many cases, rules that prohibit trade-throughs, rather than pure competitive forces, dictate how orders must be routed in the options markets. Regardless of one's view on the advisability of rules prohibiting trade-throughs, all of the options exchanges have such rules pursuant to the Options Intermarket Linkage Plan ("Linkage Plan"). As discussed below, rules limiting fees to obtain access to quotations are a necessary and logical consequence of rules prohibiting trade-throughs.

The Commission's consideration of these issues is particularly timely. The Commission is currently considering proposals from each of the options exchanges to replace the Linkage Plan with a new plan with trade through and locked and cross market provisions modeled on the same provisions in

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1 We submit this rulemaking petition pursuant to Rule 192 of the Commission's Rules of Practice.

2 The Commission has the authority to adopt this or a similar rule pursuant to Section 11A of the Securities Exchange Act of 1934 ("Exchange Act") and, among other provisions, Section 11A(c)(1)(B) of that Act.

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Regulation NMS.[3] Because the Commission already is considering whether the options markets would benefit from key provisions of Regulation NMS, we hope the Commission will not delay its consideration of whether an access fee cap is such a provision.

I. Overview

Under a maker-taker fee structure, firms must pay a fee to execute against an exchange's quotations ("Taker Fees"), and firms who quote passively receive a rebate when their orders are executed ("Maker Rebates"). Taker Fees are analogous — if not identical — to access fees in the equity markets, which have been capped by Rule 610(c) of Regulation NMS. Indeed, Taker Fees in the options markets meet the operative portion of the definition used in Rule 610(c): fees for the execution of an order against a quotation.

Because several options exchanges recently have implemented maker-taker pricing for the first time, the Commission should adopt rules limiting Taker Fees in the options markets to address the same issues the Commission addressed by capping access fees in the equity markets. As developed more fully below, limits on fees charged to obtain access to quotations are a necessary consequence of rules that prohibit trade-throughs, regardless of whether the quotations are for shares of stock or for options contracts. Absent a reasonable limit on Taker Fees, maker-taker fee structures also encourage market participants to lock the market.

Commission action is necessary because several of the options exchanges are imposing excessive Taker Fees, with three exchanges imposing fees of nearly $.50 per contract.[4] Limiting Taker Fees would

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3 *See* File No. 4-546: Proposed Options Order Protection and Locked/Crossed Market Plan by Amex, BSE, CBOE, ISE, Nasdaq, NYSE Arca, and Phlx.

4 Currently, three of the options exchanges employ a maker-taker pricing structure: the NASDAQ Options Market ("NASDAQ"), the Boston Options Exchange ("BOX"), and NYSE Arca Options ("Arca"). See Exchange Act Rel. No. 57599 (Apr. 1, 2008) (NASDAQ); Exchange Act Rels. No. 55223 (Feb. 1, 2007) and 57585 (Mar. 31, 2008) (Arca); and Exchange Act Rel. No. 57887 (May 30, 2008) (BOX). All of the exchanges' prices are on a per-contract basis. NASDAQ generally imposes a fee of $.45 to remove orders resting on the NASDAQ Options book, and provides a rebate of $.30 to those who provide passive resting orders on the NASDAQ Options book. Arca applies a maker-taker fee structure to all electronic executions in options contracts participating in the Penny Pilot Program. Generally, Arca's rebates for providing liquidity (resting quotes or orders that are filled) are as follows: $.30 to market makers and lead market makers and $.25 to customers, broker-dealers, and firms. Arca imposes a uniform Taker Fee of $.45 to take liquidity. BOX applies a two-tiered maker-taker fee structure to all options classes participating in the Penny Pilot Program. With respect to Tier 1 securities, BOX provides rebates to market participants who add liquidity to the BOX Book as follows: $.30 to market makers and $.25 to firms and customers. BOX imposes a Taker Fee of $.45 on all market participants taking liquidity in Tier 1 securities. With respect to Tier 2 securities, which include some of the most liquid and actively traded options on BOX (*e.g.*, QQQQ), BOX provides rebates to market participants who add liquidity to the BOX Book as follows: $.15 to market makers and $.10 to firms and customers. BOX imposes a Taker Fee of $.30 on all market participants taking liquidity in Tier 2 securities. While other options exchanges impose a fee to remove liquidity in certain circumstances, they do not use a comprehensive maker-taker fee structure. Moreover, their fees to take liquidity are generally lower than the maker-taker exchanges (*e.g.*, the International Securities Exchange ("ISE") assesses an $.18 fee to remove liquidity in certain circumstances; the Chicago Board Options Exchange also assesses an $.18 fee to remove liquidity in certain circumstances). Of course, these fees to take liquidity are part of more comprehensive fee structures.

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address the negative effects outlined in this petition while still allowing exchanges to experiment with different fee structures.[5]

II. The Commission Should Cap "Taker" Fees in the Options Markets for the Same Reasons the Commission Capped Access Fees in the Equity Markets

A. A Taker Fee Cap is Needed to Prevent "Outlier" Pricing

When the Commission adopted Regulation NMS in the equity markets, the Commission was concerned that absent a cap on access fees, so-called "outlier" markets might charge exorbitant fees to obtain access to their quotations, and thereby act as a "toll booth" between price levels.[6] While outlier markets would be the last markets to which orders would be routed, broker-dealers might be required to obtain access to their quotations — and pay the associated fees — due to the Order Protection Rule.[7] Requiring broker-dealers to send their orders to the markets displaying the best quotations while also requiring them to ignore the fees associated with obtaining access to those quotations would allow markets to charge excessive fees, and could result in executions at prices materially different from the displayed quotations.

While the Order Protection Rule does not apply to transactions in options, the options exchanges all have rules generally prohibiting trade-throughs, as required by the Commission.[8] After the Commission mandated that options be permitted to trade on multiple exchanges, rules limiting trade-throughs were deemed necessary to prevent market participants from "trading through" better-priced quotations.[9] To address this concern, the Commission issued an order requiring the options exchanges to develop and submit to the Commission an intermarket linkage plan that contained, among other things, "uniform trade-through rules."[10] In compliance with this order, the options exchanges have developed,

[5] While we recognize that the maker-taker exchanges published for comment proposed rule changes to adopt the maker-taker pricing model, those notices were filed under Section 19(b)(3)(A) of the Exchange Act, and thus became effective upon filing with the Commission. As a result, the issues raised in those notices have not been fully aired. Nor has the Commission taken a position on maker-taker pricing in the options markets. For all of these reasons, and because maker-taker pricing is becoming more prevalent in the options markets, it would be appropriate for the Commission to institute a rulemaking proceeding to address this pricing model.

[6] *See, e.g.*, Exchange Act Rel. No. 51808 at 188 (June 9, 2005) ("Regulation NMS Adopting Release").

[7] *I.e.*, Rule 611 under Regulation NMS, which generally prohibits trading through a displayed quotation. In addition, broker-dealers also generally are required to route their customers' orders to the options exchange displaying the best price to satisfy their duty to seek best execution.

[8] As noted above, all of the options exchanges recently filed proposed amendments to the Linkage Plan that "essentially would apply the Regulation NMS price-protection provisions to the options markets." *See* File No. 4-546: Proposed Options Order Protection and Locked/Crossed Market Plan by Amex, BSE, CBOE, ISE, Nasdaq, NYSE Arca, and Phlx.

[9] *See generally* Concept Release: Competitive Developments in the Options Markets, Exchange Act Rel. No. 49175 (Feb. 3, 2004).

[10] Exchange Act Rel. No. 42029 (Oct. 19, 1999) (while the Commission did not "mandate[] the details of a linkage," it observed that ". . . to operate effectively any Linkage Plan submitted by the Options Exchanges for approval by the Commission must contain [uniform trade-through rules]").

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and the Commission has approved, the Linkage Plan, which generally prohibits its participants from effecting trade-throughs.[11] All of the options exchanges are participants in the Linkage Plan.

As a result of these regulatory obligations, broker-dealers (and their customers) are effectively required to pay Taker Fees when an exchange using maker-taker pricing is alone at the national best bid or offer ("NBBO"). Taker Fees must be paid when an order is routed to the maker-taker exchange directly or when another exchange receives an order and routes it to the maker-taker exchange through the Linkage. Because regulations require that orders be routed to the options exchange with the best price, regardless of the size of any Taker Fee, competition and free market forces cannot eliminate the incentive for outlier markets to charge excessive Taker Fees.

In addition to the Commission's concern that outlier markets might act as a "toll booth" between price levels, we note that outlier markets charging excessive Taker Fees are able to use a portion of their excessive fees to pay market participants Maker Rebates as an incentive to submit orders at a price better than the NBBO. Paying Maker Rebates to price makers and charging excessive Taker Fees to those who are forced by law to become price takers on a maker-taker exchange effectively allows an exchange to capture the spread between the Taker Fees and Maker Rebates, and allows the recipient of the Maker Rebates to collect an indirect toll from the firm paying the Taker Fee.

B. Excessive Taker Fees Distort Quotations

As the Commission observed regarding access fees in the equity markets, "[f]or quotations to be fair and useful, there must be some limit on the extent to which the true price for those who access quotations can vary from the displayed price."[12] The Commission observed that fair and useful quotations are important to investors as well as to broker-dealers, who may be required to obtain access to quotations with substantial access fees due to the Order Protection Rule and their duty to seek best execution.[13]

Indeed, in discussing Rule 610(c) of Regulation NMS, the Commission explicitly recognized the tension caused by requiring broker-dealers to route their orders to the market with the best displayed quotations while also allowing that market to charge additional fees not included in its quotations. The Commission concluded that the purpose of the Order Protection Rule would be "thwarted if market participants were allowed to charge exorbitant fees that distort quoted prices."[14] The Commission similarly observed that disparate access fees — *i.e.,* where different markets charge varying prices to

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11 *See* Exchange Act Rel. No. 43086 (July 28, 2000) (order approving the Options Intermarket Linkage Plan submitted by the American Stock Exchange LLC, Chicago Board Options Exchange, Inc., and International Securities Exchange LLC).

12 Regulation NMS Adopting Release at 189.

13 *Id.* ("[T]he fee limitation is necessary to further the statutory purpose of enabling broker-dealers to route orders in a manner consistent with the operation of the NMS.")

14 *Id.*

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obtain access to their quotations — render quotations less useful and accurate, in that such fees make it difficult or impossible meaningfully to compare quotations across markets.[15]

All of these concerns apply in the options markets. Participants in the options markets also rely on the integrity and usefulness of quotations to allow them to comply with rules prohibiting trade-throughs and to allow broker-dealers to fulfill their obligation to seek best execution of their customers' orders. Put simply, if market participants must base their conduct on published quotations, those quotations should reflect accurately the true price at which the underlying securities can be purchased or sold. Market participants also should be able to compare quotations across markets. Limiting Taker Fees as described in this petition would further both of these goals in the options markets.

Indeed, Director Sirri's recent remarks at the 2008 Options Industry Conference make clear that these concerns are equally applicable to the options market. At that conference he stated his belief that "an [options] exchange's prices should reliably represent the true prices that are actually available to investors," and that "the benefits of intermarket price protection could be compromised if [options] exchanges were able to charge substantial fees for accessing their quotes."[16] It follows that the Commission should limit Taker Fees to assure that quotations are fair and useful in the options markets for the same reasons it limited access fees in the equity markets.

C. Excessive Taker Fees Cause Locked and Crossed Markets

In discussing access fee caps in the equity markets, the Commission was concerned that access fees were linked to the dramatic increase in locked and crossed markets. The Commission reasoned that rather than pay a fee to obtain access to displayed limit orders, market participants might submit their own limit orders that would lock the market. That way, the market participant would receive a rebate when another market participant unlocked the market, rather than pay an access fee to obtain access to a displayed quotation. The difference between paying an access fee and receiving a liquidity rebate creates an incentive to lock the market.

These same incentives exist in the options markets and our experience suggests that locked and crossed markets have become more common in the options markets as a result of maker-taker pricing. After the launch of maker-taker pricing, we observed a spike in the frequency and duration of market locks and crosses, as a result of a non-maker-taker exchange locking with a maker-taker exchange. For example, at times we observed such market locks in QQQQ options as much as 4% of the time, with some market locks lasting for more than 10 seconds.

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15 *Id.* at 183. *See also id.* at 189 (noting that a limit on access fees applicable to all markets would "further the statutory purposes of the NMS by harmonizing quotation practices and precluding the distortive effects of exorbitant fees").

16 *See* Erik Sirri, Director, Division of Trading and Markets, Securities and Exchange Commission, Remarks at the 2008 Options Industry Conference (May 2, 2008) (http://www.sec.gov/news/speech/2008/spch050208ers.htm).

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D. Taker Fees are Most Frequently Imposed on Retail Customer Orders

Taker Fees are most frequently imposed on retail customer orders because retail customers are generally taking and not providing liquidity.[17] It seems especially inappropriate to require retail customer orders to bear these costs, because they essentially are unavoidable when an exchange using maker-taker pricing is quoting alone at the NBBO.[18] Recognizing this, a representative of optionsXpress reportedly stated that it no longer trades on NYSE Arca (which employs maker-taker pricing), and that "if [maker-taker pricing] spreads, it would probably become an impediment for the retail sector to continue its growth."[19]

Even if maker-taker pricing leads to better prices as its proponents claim, absent a limit on Taker Fees, there is no assurance that these better prices will outweigh the associated Taker Fees. Ironically, better prices on maker-taker exchanges may ensure only that more orders are subject to Taker Fees — fees which may result in executions at prices materially different from the displayed quotations that attracted the orders in the first place.

E. The Need for a Taker Fee Cap is More Compelling in the Options Markets than it Was in the Equity Markets

In the equity markets, a market maker is able to shield a customer order from excessive Taker Fees by executing the customer order internally because off-exchange transactions generally are permitted in the equity markets. In contrast, internalization in the options markets is only permitted in certain very narrowly prescribed circumstances, such as through price improvement auctions or order crossing facilities.[20] As a result, a broker handling a customer option order has only a limited ability to shield that order from Taker Fees.

III. The Commission Should Cap Away Market Taker Fees at $.20 per Contract

The Commission should limit the Taker Fees that options exchanges may impose on non-members who often have no choice but to pay Taker Fees. While maker-taker pricing may be beneficial

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17 *See, e.g.*, Nina Mehta, *Options Maker-Taker Markets Gain Steam*, TRADERSMAGAZINE.COM, http://www.tradersmagazine.com/issues/20071004/2933-1.html (quoting a CBOE executive as describing maker-taker pricing as "the 'reintroduction of customer fees' since public customers are primarily liquidity takers").

18 While Taker Fees are not directly borne by the customer, excessive Taker Fees will inevitably be passed on to customers in some form.

19 Veronica Belitski, *CBOE, ISE Ponder Trading Fee Overhaul*, WALL STREET LETTER, Aug. 3, 2007.

20 *See, e.g.*, ISE Rule 723 (price improvement auction facility) and ISE Rule 716 (crossing facility). The ISE recently amended its rules governing its Price Improvement Mechanism to allow an order flow provider to internalize a customer order at the NBBO, rather than route the order to another exchange that imposes Taker Fees. SR-ISE-2008-29 (May 21, 2008). While this is a step in the right direction, most order flow providers will be unable to take full advantage of this development. Most order flow providers do not have the technology, expertise, or resources to price and risk manage a large volume of options positions on a regular basis, and market making desks that are in the business of pricing and risk managing proprietary options positions are required to be walled off from order flow providing businesses. *See, e.g.*, ISE Rule 810.

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in some instances, and exchanges generally should be permitted to experiment with different fee structures, competition alone will not ensure that Taker Fees are reasonable. Regulatory obligations — namely rules prohibiting trade-throughs — essentially require broker-dealers to ignore Taker Fees in making routing decisions.

We are not suggesting that the Commission prohibit options exchanges from using maker-taker pricing. We are also not suggesting that the Commission limit the Taker Fees or other fees that options exchanges may charge their members who initiate transactions on their exchanges. In our view, fees charged only to exchange members currently do not raise the same degree of concern as Taker Fees charged to non-members routing from other exchanges, because members may avoid fees by voting with their feet. At any time, a member of an exchange can stop doing business as a member of one exchange and move to another. Competition between the exchanges, and between existing exchanges and potential new exchanges, should thus be sufficient to ensure that exchange fees are reasonable. We believe that regulations limiting fees only should be adopted in extraordinary circumstances and when adopted, should be narrowly tailored.

In determining the appropriate maximum access fee, the Commission should assess Taker Fees as a percentage of the minimum quoting increment. Under the Penny Pilot Program, many of the most actively-traded options are now being quoted in pennies, and the minimum quoting increment in these options is $.01 per underlying share.[21] The Taker Fees imposed by certain of the exchanges amount to nearly 50% of this minimum quoting increment. In comparison, equity securities trade with a minimum quoting increment of one penny per share, and access fees in the equity markets are limited to 30% of this minimum quoting increment or $.003 per share.

While 30% of the minimum quoting increment is a reasonable access fee cap for the equity markets, which allow internalization as a defense to excessive access fees, we believe a lower cap is needed in the absence of rules permitting internalization. As discussed above, in the equity markets a market maker can avoid paying Taker Fees with respect to customer orders by internalizing those orders. Because internalization is generally not permitted in the options markets, we submit that limiting the Taker Fees to 20% of the minimum quoting increment (*i.e.*, $.20 per contract) would be more appropriate.

Capping the Taker Fees that options exchanges may charge non-members at $.20 per contract would allow the options exchanges to continue to experiment with maker-taker pricing without causing distortions in the options markets. Moreover, this approach would be consistent with the Commission's approach in the equity markets, where the Commission chose to limit access fees to a level that would permit maker-taker pricing to continue while at the same time preventing the negative consequences of unreasonably high access fees.

While the options exchanges using maker-taker pricing currently are charging more than $.20 per contract to obtain access to their quotations, fees at this level are causing distortions in the options markets, and in particular are leading to an increase in locked and crossed markets. We believe that the current Taker Fee levels are not supported by competitive dynamics, but rather are a regulatory arbitrage designed to take advantage of rules that govern order routing to capture the spread between rebates paid

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21 Because an options contract overlies one hundred shares of the underlying security, the minimum spread per *contract* is $1.00.

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to market participants to improve the NBBO and fees collected from market participants forced to access the improved price.

We appreciate your consideration of this petition for rulemaking and will make ourselves available at your convenience to discuss the issues raised in this petition.

Sincerely,

John C. Nagel
Managing Director & Deputy General Counsel

Cc: Erik R. Sirri, Director, Division of Trading and Markets
Robert L.D. Colby, Deputy Director, Division of Trading and Markets
Elizabeth K. King, Associate Director, Division of Trading and Markets

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Exhibit A

Rule __. Access to Quotations in Listed Options Contracts

(a) *Non-member exchange fees for access to quotations.* A national securities exchange disseminating quotations in listed options contracts shall not impose, nor permit to be imposed, except on a member of that exchange for transactions initiated on that exchange, and not sent to that exchange through the facility of another exchange, any fee or fees for the execution of an order against a quotation for a listed options contract that exceeds or accumulates to more than $.20 per contract.

(b) *Definitions.*

1. "National securities exchange" means any exchange registered pursuant to section 6 of the Securities Exchange Act of 1934 ("Act").

2. "Listed options contract" means any options contract traded on a registered national securities exchange or automated facility of a national securities association.