CITADEL

January 26, 2005

Via Electronic Mail
Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: Regulation NMS - File No. S7-10-04

Dear Mr. Katz:

Citadel Investment Group, L.L.C. ("Citadel") appreciates the opportunity to comment on the Securities and Exchange Commission ("Commission") re-proposal of Regulation NMS.[1] The Commission's proposed trade-through rule reforms would immediately and dramatically improve the transparency and efficiency of the markets for listed stocks.[2]

I. Executive Summary

A. For the reasons outlined in Citadel's previous comment letter, the Commission should eliminate the existing trade-through rule altogether and instead rely on market forces and robust competition to discipline inefficient market centers and ensure high execution quality.[3]

B. The proposed trade-through rule, however, would be a substantial improvement over the current regulatory framework. The Commission should thus act quickly to either eliminate the existing trade-through rule or adopt the proposed trade-through rule.

C. If the Commission were to adopt the proposed trade-through rule:

1. The proposed intermarket sweep exception is crucial and should be adopted without modification.

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[1] Securities Exchange Act Release No. 50870 (Dec. 16, 2004), 69 Fed. Reg. 77424 (Dec. 27, 2004) ("Reproposal").

[2] Citadel and its affiliates have over 900 employees, with headquarters in Chicago and offices in New York, San Francisco, London and Tokyo. Citadel affiliates manage a number of private investment funds and businesses. Citadel Derivatives Group LLC is registered with the Commission as a broker-dealer and is a member of the International Securities Exchange, Boston Options Exchange, Chicago Board Options Exchange, Pacific Exchange, American Stock Exchange, and Philadelphia Stock Exchange. On average, Citadel accounts for between one and two percent of the daily dollar volume traded on both the New York and Tokyo Stock Exchanges, and more than 10% of daily U.S. listed equity options contract volume. As an active and substantial participant in the markets, Citadel has a vital interest in the development of fair, efficient, transparent and liquid financial markets.

[3] See Letter from Kenneth Griffin to Jonathan G. Katz, Secretary (July 9, 2004), available at http://www.sec.gov/rules/proposed/s71004/s71004-436.pdf.

2. The Commission should clarify that to qualify as "automated," a trading center must automatically (i.e., immediately and without human intervention) route orders to other automated trading centers to protect the away markets' quotes and limit orders, or step up to match the better away markets' prices (unless an existing intermarket sweep order already protects away markets).

D. The fundamental market structure issues concerning the trade-through rule are identical in the listed options markets. The Commission should thus move quickly to adopt a similar solution in the listed options markets.

II. Citadel Comments

The Commission has correctly recognized the "serious weakness" in the current trade-through rule—its failure to reflect the "disparate speed of response between manual and automated quotations."[4] As the Commission stated, "[b]y requiring order routers to wait for a response from a manual market, the ITS trade-through provisions can cause an order to miss both the best price of a manual quotation and slightly inferior prices at automated markets that would have been immediately accessible."[5] The proposed trade-through rule, utilizing either the proposed top of book or depth of book alternative, would eliminate this fundamental flaw and substantially improve our national market system.

A. Treatment of Manual Quotations

The heart of the proposed trade-through rule is the absence of any requirement to chase manual quotations. Market participants should be free to route orders to manual markets if they choose to do so. Conversely, market participants who seek to trade immediately and reliably at quoted prices in automated markets should not be prohibited from doing so, as the current trade-through rule does in listed equity markets. Citadel agrees with John Thain that "[i]nvestors are best served when markets are free to compete and offer an array of execution options."[6]

B. Intermarket Sweep

The proposed intermarket sweep exception addresses most of Citadel's concerns about the Commission's initial trade-through rule proposal, and would have many benefits. This exception would increase execution speed and reliability by avoiding unnecessary message traffic and indefinite message loops. This exception also would reduce the occurrence of trade-throughs by facilitating immediate execution where there is no risk of a trade-through. Finally, this exception would increase execution speed and reliability because it would allow market

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[4] Reproposal at 77427.

[5] Id.

[6] July 21, 2004: John A. Thain, CEO, New York Stock Exchange: Testimony Before Senate Banking Committee—Proposed Regulation NMS.

participants to simultaneously and immediately sweep through multiple price levels in multiple markets.[7]

C. Core Definitions

The Commission has proposed a well-crafted, tight definition of an automated quotation. Most importantly, the proposal would require that automated quotations immediately and automatically respond to an immediate-or-cancel ("IOC") order by (a) executing against the displayed quotation up to its full size, (b) canceling any unexecuted portion, (c) transmitting a response to the sender; and (d) updating the displayed quotation to reflect any action taken. This definition would be effective and enforceable because it prohibits "any human intervention" after an IOC order is received and "precludes any coding of automated systems or other type of intentional device that would delay the action taken."[8]

The Commission also has proposed a strong definition of an automated trading center. An automated trading center must be capable of displaying and identifying automated quotations, and have reasonable standards to control when the automated or manual status of quotations can be changed.[9] In addition, an automated trading center would be required immediately to identify its quotations as manual whenever it has "reason to believe" that it cannot respond immediately to incoming IOC orders.[10] This proposed definition should go a long way towards preserving the automated/manual quote dichotomy that is fundamental to the proposed trade-through rule.

The Commission should, however, add or make explicit one additional requirement to the definition of an automated trading center. In addition to automating its quotations, it is equally important that an automated trading center automatically protect away markets. Specifically, an automated trading center should be required to immediately and automatically route orders to other automated trading centers to protect the away markets' quotes and limit orders or to step up to match the better away markets' prices (unless an existing intermarket sweep order already protects away markets). Such a requirement appears to be effectively required to at least some extent. Under the Commission's proposal, automated trading centers would have to adopt reasonable trade-through avoidance procedures, which include "objective standards that were coded into a trading center's automated systems."[11] The Commission should clarify or expand this requirement to include automated protection of away markets.

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7 As proposed, the intermarket sweep exception would apply to all protected quotes. It is crucial that if the Commission adopts the depth of book alternative, the intermarket sweep exception allow for depth of book sweeps, as the current proposal provides.

8 Reproposal at 77444.

9 Reproposal at 77346.

10 Reproposal at 77346-7.

11 See Reproposed Rule 611(a) and Reproposal at 77427 and 77445.

D. The Listed Options Markets

After taking these steps in the equities markets, the Commission should move quickly to adopt a similar approach in the listed options markets. That is, the Commission should either eliminate the trade-through rule in the options markets, or amend the trade-through rule in the options markets to closely resemble proposed Regulation NMS (with the modifications noted above).

The fundamental philosophical and market structure issues are the same in the equities and options markets. Like the listed equities markets, the quality and effectiveness of the options markets is impaired by a trade-through rule that lacks an exception for manual quotes.[12] Indeed, the problems caused by applying the trade-through rule to manual quotes are more pronounced in the options markets. Options are derivative in nature and thus must rapidly react to price changes in the underlying securities. Moreover, there are no exceptions to the options market trade-through rule like there are in the equities markets.

To address these issues in greater detail, Citadel recently filed a rulemaking petition urging the Commission to undertake trade-through rule reform in the options markets.[13]

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We appreciate the opportunity to comment on these critically important issues. If we can answer any questions or provide further insights, Citadel would be delighted to discuss these issues.

Sincerely,

/s/ Adam Cooper/jcn

Adam Cooper
Senior Managing Director and
General Counsel

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[12] See Section 8 of the Plan for the Purpose of Creating and Operating an Intermarket Option Linkage.

[13] See Letter from Adam Cooper to Jonathan G. Katz (January 22, 2005).