



May 30, 2006

Nancy Morris  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549

**Re: Boston Stock Exchange Directed Order Rule (SR-BSE-2005-52)**

Dear Ms. Morris:

Citadel Investment Group, LLC ("Citadel") submits this supplemental comment letter to address two issues raised in the recent Boston Stock Exchange ("BSE") letter to the Commission.<sup>1</sup>

First, we write to address the right of order flow providers ("OFPs") to send client orders to the Boston Options Exchange ("BOX") Price Improvement Process ("PIP"). The BSE argues that because OFPs can send orders to the PIP, Directed Orders are "ancillary" and "simply one alternative" route to the PIP.<sup>2</sup>

Although OFPs technically have the right to send orders to the PIP, this right is hollow. For an OFP to initiate a PIP auction without using the Directed Order process, the OFP must commit to price improve the customer order and transact with the customer as principal in the absence of other bidders in the PIP auction. Unlike market makers, OFPs generally are not in the business of regularly taking proprietary options positions. As a result, OFPs generally do not have the systems and personnel capable of effectively managing the market risks inherent in holding a significant number of options positions.

For this reason, we believe that the vast majority of PIP auctions on BOX have resulted from Directed Orders and not OFPs initiating PIP auctions. We urge the Commission to ask the BSE for this data, which should be readily available. We are confident that the Commission will find that rather than being "ancillary" and "simply one alternative" route to the PIP, Directed Orders are the only meaningful route to the PIP. Indeed, the BSE Letter acknowledges that over 1 in 4 orders routed to the BOX *of any kind* are Directed Orders.<sup>3</sup>

---

<sup>1</sup> See Letter to Nancy Morris, SEC Secretary, from Alden Adkins, Executive Vice President, BSE (May 12, 2006) (the "BSE Letter").

<sup>2</sup> BSE Letter at p.3.

<sup>3</sup> *Id.*



All investors should have meaningful access to potential price improvement opportunities on an anonymous and non-discriminatory basis. Limiting access to the PIP, as the BSE's proposal would do for many investors, falls woefully short of this goal.

The second issue we write to address is the BSE's reliance on the Commission's recent approval of a Pacific Stock Exchange ("PCX") rule change. The PCX rule change prohibited Archipelago Exchange ("Arca") users from sending Directed Orders to Designated Market Makers ("DMMs") without permission from the receiving DMM.<sup>4</sup>

The discriminatory impact of the proposed BOX rule change dwarfs the impact of the PCX rule change because of critical differences between the equities markets and the options markets. In the equities markets, market makers can internalize a client order—that is, trade with the client as principal—*without ever routing the order to an exchange*. The PCX rule change was simply an effort to attract to Arca some of this already commonplace internalization. Specifically, a broker-dealer receiving a client order could direct it to a specified DMM on Arca for internalization on Arca, rather than achieving the same outcome off-exchange.

In contrast, the ability to internalize order flow off-exchange does not exist in the options markets for most types of orders. All options orders must be effected on an exchange through auction mechanisms that do not unfairly discriminate among participants. The BOX proposal would change that paradigm by creating an exchange internalization mechanism expressly designed to discriminate in a way that does not exist in the options markets today.

This discriminatory impact is magnified by the nickel quoting increments in the options markets. Because the equities markets have vigorous price competition in penny increments, the PCX rule allowing DMMs to identify eligible directed order senders did not exclude market participants from meaningful price competition at all pricing levels. This is not the case in the options markets, where penny auctions such as the PIP offer the only available price competition in pennies. As a result, allowing options market makers to shut out competitors and their customers from meaningful access to penny auctions greatly harms the targets of that discrimination.

The PCX filing also has limited "precedential" value. The PCX proposal generated no public comments, and the approval order, issued by the Division of Market Regulation pursuant to delegated authority, did not explicitly analyze how the PCX proposal complied with Exchange Act Section 6(b)(5). In short, the BSE is relying on the Division's approval of an insignificant equity market rule change to support a major overhaul of the structure of the U.S. options markets.

---

<sup>4</sup> Exchange Act Rel. No. 52827 (Nov. 23, 2005), 70 Fed. Reg. 72139 (Dec. 1, 2005).



In any case, we submit that the structure of the options markets is superior to the equities markets precisely because the internalization and discrimination mechanisms like those proposed by the BOX and implemented by the PCX are largely absent from the options markets. Because of a superior market structure, trading volumes in the listed options markets have been growing explosively for years, while volumes in the equities markets have stagnated.

For these reasons and the reasons provided in our earlier comment letters, we urge the Commission to reject the BSE's proposal.

\* \* \* \* \*

If you have any questions concerning these comments or would like to discuss these matters further, please feel free to contact me at 312-395-3067.

Sincerely,

A handwritten signature in blue ink, appearing to read "Adam C. Cooper".

Adam C. Cooper  
Senior Managing Director &  
General Counsel

cc: Chairman Christopher Cox  
Commissioner Paul S. Atkins  
Commissioner Roel C. Campos  
Commissioner Cynthia A. Glassman  
Commissioner Annette L. Nazareth  
Robert L.D. Colby, Deputy Director, Division of Market Regulation  
Elizabeth King, Associate Director, Division of Market Regulation  
Brandon Becker, Partner, Wilmer Cutler Pickering Hale and Dorr