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November 8, 2005

Jonathan G. Katz
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Chicago Board Options Exchange Automated Improvement Mechanism Proposal (SR-CBOE-2005-60)

American Stock Exchange Price Improvement Auction Proposal (SR-AMEX-2004-107)

Dear Mr. Katz:

Citadel Derivatives Group LLC ("Citadel Derivatives")[1] appreciates the opportunity to express its concerns to the Securities and Exchange Commission ("Commission" or "SEC") about the recent proliferation of internalization auctions in the options markets, which we view as harmful to the interests of investors. The latest aspirants to the auction business, the Chicago Board Options Exchange, Inc. (the "CBOE") and the American Stock Exchange LLC ("Amex"), have submitted proposals for internalization auctions to the SEC. Citadel Derivatives believes that the trading process contemplated by these proposals will harm the options markets; internalization hinders price discovery and thereby provides investors with worse options prices overall. Therefore, Citadel Derivatives strongly urges the Commission to reject the new auction proposals, and to reevaluate the previously proposed auction processes at the other exchanges.

I. Introduction

The internalization auctions made their debut in 2004, with the introduction of the Boston Options Exchange's ("BOX") Price Improvement Period – despite significant practical and policy concerns with the proposal.[2] As predicted – and feared by – other market participants, the

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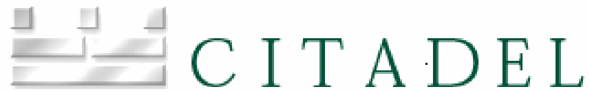
[1] Citadel Derivatives is one of the most active listed options market makers in the United States. Citadel Derivatives is an affiliate of Citadel Investment Group, L.L.C. which, with its affiliates, operates one of the world's largest alternative investment firms. On an average day, Citadel affiliates account for approximately 3% of the daily volume on the NYSE and Nasdaq.

[2] Securities Exchange Act Rel. No. 49068 (Jan. 13, 2004), 69 Fed. Reg. 2775 (Jan. 20, 2004) ("BOX Approval Order").



other exchanges have quickly joined in this competitive race to the bottom.[3] Shortly thereafter, the International Securities Exchange received approval for its auction.[4] Now, the CBOE and Amex have responded with auction proposals of their own – namely, the Automated Improvement Mechanism ("AIM") and the Price Improvement Auctions ("PIA"), respectively (collectively, the "Mini-Auctions").

The various electronic auctions operate in a similar manner, with some minor variation. In general, when an order is submitted to the system by a member, a Mini-Auction of three to five seconds is activated. Only certain market participants are provided with the opportunity to enter orders in penny increments to compete for the execution of the order.[5] In general, the member representing the submitted order is guaranteed at least forty percent (40%) of the execution of the order, provided the member matches the best price in the auction.[6]

As discussed in more detail below, we believe that such Mini-Auctions impair price discovery, discourage aggressive quoting, and fail to provide meaningful price improvement, to the detriment of the options markets and investors generally. Indeed, the very exchanges that now propose the Mini-Auctions agree with this assessment. The CBOE previously argued that the "dangers" of such auctions were "clear and real," and that the SEC would be "unwise" to allow such an auction to proceed.[7] The Amex asserted that such auctions create a "crossing or internalization market to the detriment of the auction process and the public customer."[8]

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[3] Letter to Jonathan G. Katz, Secretary, SEC, from William J. Brodsky, Chairman and CEO, CBOE (Sept. 16, 2003), at 2, 3 (comment letter on BOX's PIP) (available at http://www.sec.gov/rules/sro/bse200215/srbse200215-247.pdf) ("CBOE Letter").

[4] Securities Exchange Act Rel. No. 50819 (Dec. 8, 2004), 69 Fed. Reg. 75093 (Dec. 15, 2004) ("ISE Approval Order").

[5] The CBOE's AIM allows market makers and members representing agency orders to participate, and the Amex's PIA allows specialists and registered options trades who are quoting in an options series on the Amex New Trading Environment ("ANTE") to participate.

[6] See Proposed CBOE Rule 6.74A; and Proposed Amex Rule 937.

[7] See, e.g., CBOE Letter at 2.

[8] Letter to Jonathan G. Katz, Secretary, SEC, from Michael J. Ryan, Jr., Executive Vice President and General Counsel, Amex (Sept. 12, 2003), at 3 (comment letter on BOX's PIP) (available at http://www.sec.gov/rules/sro/bse200215/srbse200215-229.pdf).

II. Mini-Auctions Harm the Options Markets and Investors

A. Mini-Auctions Hinder Price Discovery

Price discovery (which requires price transparency) is integral to efficient and equitable options trading. The public dissemination and interaction of quotations in the open market leads to stable and reliable prices, which in turn bolster investor confidence and encourage trading activity. In such contexts market makers know that they must display their best prices to the entire market if they wish to trade. By taking quotations out of the general quote stream, where they would be available to all market participants, and isolating them in their much smaller auction pools with fewer participants, the Mini-Auctions hinder price discovery for orders both inside and outside the auction process, allowing market makers to hold their best prices and quantities in reserve.

Within the auction process, orders are visible only to certain Mini-Auction participants, and only for a very limited period of time (i.e., several seconds). During this brief time period, those Mini-Auction participants need only match the quotation or improve on it in penny increments, rather than subject the quotation to robust price competition, in order to receive part, or all, of the fill. Correspondingly, if a firm submits a customer order to the Mini-Auctions, it is neither publicly disseminated nor publicly accessible. Because of this reduced order interaction, orders in the greater market are subject to an incomplete price discovery process, leading to less reliable, less competitive prices overall.

B. Mini-Auctions Discourage Aggressive Quoting and Will Raise Baseline Prices Overtime

The internalization mechanism of the Mini-Auctions discourages aggressive quoting both within, and outside, the Mini-Auctions. The rules of the Mini-Auctions encourage the auction participants to quote worse prices initially, and subsequently to improve on those prices in penny increments, rather than provide their best prices at the outset of the auction. The Mini-Auctions guarantee the auction originator at least 40% of the order if it matches the best price, and it has the right to match any price improvement offered by another market participant. As a result, the originator has no incentive to display its best price at the outset of the auction, setting the starting quotation of the auction artificially wide of the "true" price at which the originator is actually

willing to trade. Correspondingly, the originator's right to supersede any posted price by a penny provides little incentive for other participants in the auction to quote aggressively.[9]

The internalization process also adversely affects competitive quoting in the greater options market. Participants with a guaranteed source of order flow through internalization opportunities do not need to compete for orders on the basis of their displayed quotations.[10] As a result, they are incented not to display their best quotes to the open market. Displaying a better quote will "only" improve the overall market price, which is the last thing a market maker wants to do if it has captive order flow that it can internalize. Improving the market price will simply lessen the amount of money it can extract from internalized orders. Moreover, the price uncertainty – that is, the lack of transparency – caused by excessive internalization forces other market participants to add a risk premium to their public quotations, which increases bid-ask spreads in the public market and generates even more price instability. This, in turn, prompts market participants to internalize more of their order flow, creating a vicious circle of diminishing price discovery that degrades the options markets, not enhances them.

This lessening of competition and the effect that it will have on baseline price levels over time is the most insidious aspect of the entire Mini-Auction phenomenon. Reduced transparency and therefore reduced competition will result in wider spreads (that is, higher baseline prices), from which any market maker would be pleased to offer the minor discount provided by Mini-Auctions. This will leave naïve investors with the misimpression that they have gotten a great deal, just as used car purchasers are thrilled when the salesman gives them a discount off an inflated sticker price.

C. The Proliferation of Mini-Auction Systems Jeopardizes the Options Markets

The recent proliferation of auction systems in the options markets exacerbates the problems related to price discovery and quoting practices. The issues created by the operation of just one auction system rise exponentially with the addition of each new system. As more and more orders are internalized and hidden from the greater market, the public options markets increasingly are degraded. Public prices reflect the interaction of the supply and demand for fewer and fewer orders, and the incentive to quote aggressively diminishes even further.

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[9] Securities Exchange Act Rel. No. 49175 (Feb. 3, 2004), 69 Fed. Reg. 6124 (Feb. 9, 2004) ("Options Concept Release"), at 6130 (noting that "[r]ules or practices that permit or encourage internalization may also reduce intramarket price competition and, therefore, cause spreads to widen").

[10] Options Concept Release at 6130 (noting that internalizing market participants "will have less need to quote aggressively to attract order flow, and as a result, spreads may be wider than they otherwise would be").

Therefore, we urge the Commission to consider this compounding effect of the proposed Mini-Auctions on the markets as a whole.

III. Mini-Auctions Eliminate Substantial Price Improvement By Diminishing Customers' Ability to Interact With One Another

Mini-Auctions also eliminate substantial price improvement by diminishing the opportunities for customers to trade with one another. This is despite the fact that the most dramatic price improvement available generally comes from other customers, not from market makers. For example, where the bid-ask spread is at $5.40-$5.70, Customer A wishing to buy may be shunted into a Mini-Auction and receive a price a few pennies better – an improvement but only a small one. Instead, a limit order could have been placed on Customer A's behalf in the open market at roughly mid-market ($5.50) – a price that is unattractive to market makers but quite attractive to other customers. Absent the Mini-Auction trap, other customers would have had an opportunity to place their own limit orders to sell mid-market and therefore trade with Customer A at a significantly better price than would be available to them in a Mini-Auction. But public customers generally have no visibility into the Mini-Auctions and no meaningful ability to enter on-going auctions to provide their own price improvement.

The result of trapping customers in Mini-Auctions is that market makers can "compete" by providing only penny price improvements while successfully eliminating their fiercest competitors – customers seeking to trade in the middle of the bid-ask spread. We agree with the Commission that opportunities for price improvement should be an integral part of providing best execution for options orders.[11] But customers should not be forced to seek out trading systems that provide price improvement in name only.

IV. Most Mini-Auctions Undercut Resting Customer Limit Orders

The SEC has long recognized the fundamental importance of customer limit orders to the health of the options and equities markets, finding them "to be a key element in promoting competition, providing liquidity, and increasing transparency."[12] But most Mini-Auctions, including the one proposed by the CBOE, undercut customer limit orders resting on the book and therefore discourage their use, thereby further lessening competition, liquidity and transparency.

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[11] Speech by Elizabeth King, Associate Director, Division of Market Regulation, SEC, 2003 Options Industry Conference (May 13, 2005) (noting need to take price improvement opportunities into account for options orders).

[12] Special Study: Report Concerning Display of Customer Limit Orders, Section III (May 4, 2000) (available at http://www.sec.gov/news/studies/limitorder.htm).

Existing Mini-Auctions and the CBOE's proposal undercut customer limit orders because they allow market makers to step ahead of resting customer limit orders to trade with incoming customer orders by providing only a penny price improvement. For example, where the bid-ask spread is at $5.40-$5.70, Customer A has a resting limit order to sell at $5.70. Customer B sends in an order to buy at $5.70 with a designation for price improvement. Absent the price improvement designation, Customer B would trade with Customer A. Instead, Customer B's order bypasses Customer A and goes into a Mini-Auction in which a market maker is able to trade with Customer B at $5.69.

The result of such mechanisms is that resting customer limit orders get either no fills at all or delayed fills. In the short run, doing so benefits the incoming customer order by a penny and therefore may be seen as merely a wealth transfer of a penny from one customer to another. But this occurs at the expense of orders that not only have time priority (they were resting on the book) but that are recognized as providing great benefits to the health of the markets. We urge the Commission not to permit the pro-competitive benefits to the market provided by customer limit orders to be cast aside in favor of Mini-Auctions. The result of doing so would be to lessen competition and therefore harm investors overall.

V. Need for Further Evaluation of the Adverse Effects of Mini-Auctions

In light of the concerns set forth above, we strongly believe that the Commission should not approve the Mini-Auctions, even as pilot programs. Instead, we urge the Commission to fully evaluate the effects of the existing auctions on the options markets, and determine whether any auctions should be allowed to operate at all. In particular, prior to any decisions regarding the Mini-Auctions, we recommend that the SEC evaluate the detailed performance data required to be submitted by the BOX and ISE on their auction processes,[13] as well as the variety of information and views collected in response to the recent concept release regarding internalization and related practices in the options markets.[14] We also suggest that the SEC consider any complaints or other regulatory problems associated with the existing auctions. Once armed with this additional information, we believe that the SEC may then make an informed judgment about the potential effect of the proposed Mini-Auctions on the options markets.

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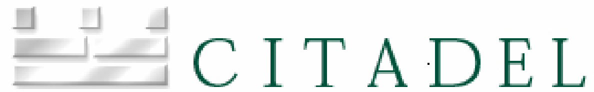
[13] See BOX Approval Order at 2792; and ISE Approval Order at 75099.

[14] See generally Options Concept Release.



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If you have any questions concerning these comments or would like to discuss these comments further, please feel free to contact me at 312-395-3167.

Sincerely,

Matthew Hinerfeld
Managing Director & Deputy General Counsel
Citadel Investment Group, L.L.C.
On behalf of Citadel Derivatives Group LLC