CITADEL

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

Re: Chicago Board Options Exchange Simple Auction Liaison Mechanism Proposal (SR-CBOE-2005-90)

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 proposal by the Chicago Board Options Exchange, Inc. (the "CBOE") to adopt a Simple Auction Liaison ("SAL") system. SAL is the most recent in a rash of opaque Mini-Auctions in the options markets, which we view as harmful to the interests of investors. Citadel Derivatives believes that the trading process contemplated by this proposal will harm the options markets because Mini-Auctions hinder price discovery and thereby provides investors with worse options prices overall. Therefore, Citadel Derivatives strongly urges the Commission to reject the new auction proposal and to reevaluate the previously proposed auction processes at the other exchanges.

We have addressed our general concerns with Mini-Auctions in prior letters and ask that those statements be considered here (*see, e.g.*, letter of November 8, 2005 regarding the CBOE's Automated Improvement Mechanism Proposal (SR-CBOE-2005-60) and the American Stock Exchange Price Improvement Auction Proposal (SR-AMEX-2004-107)). In light of those prior statements, we will address our concerns with SAL succinctly.

I. Introduction

We believe that Mini-Auctions, such as SAL, 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 exchange that now proposes SAL

[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.

previously spoke out strongly and eloquently against Mini-Auctions and their negative effect on price transparency and the aggressiveness of quotes making up the NBBO.[2]

A. SAL Will Hinder Price Discovery — What Happens In SAL Stays In SAL

Price discovery is integral to efficient and equitable options trading. Price discovery requires transparency. The public dissemination and interaction of quotations in the open market leads to stable and reliable prices, which in turn bolsters investor confidence and encourages trading activity. Under SAL, many if not all orders will be automatically shunted into an auction of up to two seconds in length. But what happens inside of SAL will not be known to the general public. Rather, proposed Rule 6.13A(b)(i) provides that auction responses "shall not be disseminated to OPRA" and the commentary to the rule provides that "[d]isseminating information regarding auctioned orders to third parties will be deemed conduct inconsistent with just and equitable principles of trade…." In other words, SAL is *designed to reduce transparency* and therefore will hinder price discovery and efficient and equitable trading. It will simply be impossible for other market participants to know the sizes and prices of the best executions on the CBOE.

B. SAL Promotes Discrimination

As proposed, the SAL rules permit the CBOE's Floor Procedure Committee to exclude various types of market participants from participating in SAL (permitting the Committee to choose among public customer orders, non-market maker broker-dealer orders and market maker broker-dealer orders) (Rule 6.13A(a)). This type of discrimination leads to further fragmentation and complication of the market and therefore lack of transparency regarding pricing. If Mini-Auctions are to occur, they ought to be accessible to all market participants.

C. SAL Will Freeze Quotes For Two Seconds, Thereby Increasing Risk and Lessening Aggressive Quoting

The SAL process will increase risk for those market makers quoting at the NBBO by preventing them from moving their quotes to an inferior price or size while the auction is

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

occurring, *even where they have chosen not to participate in the auction. See* proposed rule 6.13A(b). This will expose market makers to the risk of market swings to which they will be unable to react during the freeze. It will also expose them to the risk of receiving larger fills than desired in light of their activity on other exchanges – once a market maker enters into the number of transactions it desires across all exchanges, the market maker updates its quotes to adjust to the amount of risk taken on. But CBOE market makers subject to the SAL rules will be unable promptly to update their quotes on the CBOE and therefore risk getting numerous fills they do not desire. The net result of this penalty for quoting the best prices will be to discourage aggressive quoting.

D. SAL Will Discourage Aggressive Quoting and Will Raise Baseline Prices Over Time Even Absent the Quote Freeze Feature

The essence of SAL is to create a market structure in which the actual price competition for orders occurs quickly, out of sight, and between just a few market participants. Those market participants quoting at the NBBO will know that they should reserve their best prices not for display to the general market but for use in the opaque SAL Mini-Auctions. The National Best Bid and Offer ("NBBO") used to be synonymous with the best price available and every market maker knew that the only way to garner a larger market share was to post aggressive prices in large sizes and therefore become a large percentage of the NBBO. But that will no longer be true; market makers will no longer be incented to display their best prices, thereby setting the NBBO artificially wide of the "true" prices at which market makers are actually willing to trade.

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, including SAL. Mini-Auctions will result in wider spreads from which any market maker would be pleased to offer the minor discount provided by penny-increment Mini-Auctions such as SAL. This will leave naïve investors with the misimpression that they are getting great deals from the Mini-Auctions, just as used car purchasers are thrilled when salesmen give them discounts off inflated sticker prices.

II. 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 SAL. Instead, we urge the Commission to fully evaluate the effects of the existing Mini-Auctions on the options markets, and determine whether any Mini-Auctions should be allowed to operate at all.

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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