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March 17, 2006

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

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

Dear Ms. Morris:

Citadel Investment Group, LLC ("Citadel") appreciates the opportunity to comment on Boston Options Exchange ("BOX") Amendment 4 to proposal SR-BSE-2005-52. We urge the Commission to reject the amended proposal. It allows the same type of discrimination as did the original proposal and does so through an equally objectionable means.

The original proposal sought to facilitate discrimination at the time of receipt of each order by eliminating order anonymity. The BOX withdrew this proposal after commenters overwhelmingly opposed it.[1] The amended proposal does little more than put a fresh coat of paint on a bad idea by moving the proposed discrimination device to the front door. The amended proposal would allow BOX market makers to entirely block competitors and their customers from sending directed orders.

One improvement in the amended proposal is that it now expressly describes the BOX's goals. The BOX wants to offer access to its core trading system—and what would become the true "inside" market in the United States—on a highly discriminatory basis. But the Commission's Staff has rejected similar efforts in the past, including a recent Philadelphia Stock Exchange ("PHLX") proposal that had flaws identical to those in the BOX proposal. We agree with that conclusion, and it should apply here.

[1] *See* Letters to Nancy Morris, Secretary, Securities and Exchange Commission, from: Adam C. Cooper, Senior Managing Director & General Counsel, Citadel (Jan. 11, 2006 and Jan. 12, 2006) ("January Comment Letter"); Michael J. Simon, Secretary, International Securities Exchange (Jan. 19, 2006); James Gray, Chairman, optionsXpress Holdings, Inc. (Jan., 19, 2006); David Chavern, Vice President and Chief of Staff, U.S. Chamber of Commerce (Jan. 25, 2006); and Neal L. Wolkoff, Chairman & Chief Executive Officer, American Stock Exchange (Feb. 3 and 7, 2006).

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The Commission also should reject the BOX's argument that its market makers need the ability to shut out their competitors and competitors' customers. The Commission and our national securities exchanges are required by law to encourage competition, not stifle it.

Beyond these new BOX arguments, not much has changed from the original proposal. The amended proposal would preserve only a scintilla of order anonymity, and would facilitate discrimination and stifle competition as effectively as the original proposal.

Approval of the amended proposal would have disastrous consequences for all investors. Market liquidity, transparency, and quoting spreads would suffer. The biggest loss would be the commitment to one national market system in which the best prices are available to all investors. Instead, we would end up with a series of private markets in which the true best prices are available only to the friends and families of market makers.

I. The Commission Should Reject the BOX Proposal to Offer Access to the Core BOX Trading System on a Discriminatory Basis

The BOX directed order process permits an order flow provider to direct an order to a particular BOX market maker. A market maker receiving a direct order must send the order either to the Price Improvement Process ("PIP") (a three-second penny increment auction) or to the BOX's order book.[2] A market maker that decides to "PIP" a directed order agrees to trade with the order at a penny better than the national best bid or offer ("NBBO") absent comparable or better quotes during the PIP auction.[3] Current BOX rules require anonymity in the BOX's directed order process.[4]

The original proposal would have eliminated this order anonymity requirement.[5] Disclosing order senders' identities would have destroyed the equality, transparency, and efficiency gains the Commission and the options markets have worked so hard to achieve in recent years. The comment letters the Commission subsequently received overwhelmingly opposed the proposed rule change, citing the discriminatory behavior a lack of order anonymity would foster. In response, the BOX withdrew its proposal and replaced it with this amended proposal to allow BOX market makers to block the directed orders of competitors and competitors' customers.

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[2] Chapter IV, Section 5(c)(ii)(1) of the BOX Rules.

[3] *Id.*

[4] Chapter IV, Section 5(c)(i) of the BOX Rules; Chapter V, Section 14(e) of the BOX Rules.

[5] The original proposal was submitted to the Commission for comment in December 2005. See Exchange Act Release No. 53015 (Dec. 22, 2005).

In its filing the BOX emphasizes that a broker-dealer is not prohibited from choosing which firms to offer discretionary services. The BOX then declares that the directed order process is a discretionary service that market makers "may choose to provide or not, above and beyond satisfying their core market maker obligations of providing continuous two-sided firm quotations on a non-discriminatory basis."[6] By extension, the BOX claims, market makers on the BOX "also may identify the firms they may choose to provide such discretionary services."[7]

The BOX's assertion that the directed order process and PIP is simply a discretionary service provided by BOX market makers ignores the fact that the directed order and PIP processes are core exchange trading functions offered by the exchange and not market makers. Indeed, they are of paramount importance to the BOX. Investors and broker-dealers visiting the BOX website, for instance, are barraged with information about the PIP. It is disingenuous for the BOX to characterize directed orders and the PIP as a marginal discretionary service offered by members. They are central to the BOX and constitute its greatest attraction for market share.

Similarly, the BOX's claim that its market makers are simply broker-dealers providing a discretionary service de-emphasizes the important relationship between the BOX and its market makers. Unlike many exchanges, the BOX does not have specialists. Instead, the BOX relies solely on market makers to provide two-sided quotes. BOX market makers that choose to accept directed orders essentially function as specialists, briefly handling the directed orders they receive on an agency basis. Similarly, specialists often have limited order handling obligations with respect to orders sent to their bin or post. The Commission should not allow BOX market makers to discriminate among market participants in a way that would be unacceptable for specialists acting in a similar capacity.

These issues are not novel. The Commission's Division of Market Regulation recently rejected a PHLX proposal that presented identical issues. The PHLX proposed to modify its AUTOM trading system to permit its options specialists to adjust their automatic execution guarantees on a firm-by-firm basis.[8] We understand that the Division of Market Regulation concluded that the PHLX proposal did not comply with the Exchange Act Section 6(b)(5) prohibition against exchange rules that foster discrimination. Indeed, the Division of Market Regulation refused even to publish the PHLX proposal for public comment on this basis and the PHLX withdrew it. We agree with this conclusion.

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[6] Exchange Act Release No. 53357 (Feb. 23, 2006), 71 Fed. Reg. 10730, 10731 (Mar. 2, 2006) ("BOX Proposal").

[7] *Id.*

[8] *See* SR-PHLX-00-105.

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The arguments made by the PHLX—and rejected by the Division of Market Regulation—are strikingly similar to those made by the BOX. PHLX essentially argued that allowing its specialists to discriminate against certain firms would enable its specialists to selectively offer larger automatic execution guarantees. PHLX specialists could do so because they could use the exchange's systems to protect themselves from having to give fast, certain executions to smarter and faster competitors. That way, PHLX specialists could attract more desirable order flow from friendly order flow providers and not competitors. The Commission Staff's rejection of the PHLX proposal and any approval of the BOX proposal cannot be reconciled.

We also note that the Commission reached a similar conclusion when considering the Nasdaq's application to become an exchange. The Nasdaq's exchange application originally met with heavy criticism of, and Commission concern about, the notion that the Nasdaq could become an exchange without establishing strict price and time priority to prevent discriminatory treatment of orders.[9] As a result, and unlike the current Nasdaq market,[10] the Nasdaq was required to propose rules prohibiting a member from executing trades against itself irrespective of price and time priority.[11]

Whether a broker-dealer can choose its customers or counterparties or engage in preferencing is not the question before the Commission. Rather, the question is whether ***an exchange*** may offer access to its fundamental trading system on a discriminatory basis, thereby creating the same sort of fragmented market structure that would have characterized the Nasdaq absent the amendment of its proposed trading rules to require strict price and time priority. The Commission rightly concluded that individual market makers should not be able to post artificially wide quotes while giving better prices to insiders. Such an approach would draw us back into a world of representative bids and offers.[12]

Each exchange is required under Section 6(b)(7) of the Exchange Act to provide fair procedures for the limitation by the exchange of any person's access to services offered by the exchange or a member of the exchange. By implementing the proposed rule, the BOX effectively would be unfairly denying market participants access to the BOX's services without a fair procedure in violation of the Exchange Act.

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[9] *See* Exchange Act Release No. 53128 (Jan. 13, 2006), 71 Fed. Reg. 3550 (Jan. 23, 2006) ("Nasdaq Exchange Approval").

[10] *Id.* at 3559 n.141.

[11] *Id.* at 3558-59.

[12] *See* Exchange Act Release No. 16590 (Feb. 18, 1980) (adopting Rule 11Ac1-2 and prohibiting the display of the representative bid or offer under Rule 11Ac1-2(c)(2)(vi).).

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The Commission previously has acknowledged the importance of fair access to services in other contexts as well. In Regulation ATS, for instance, the Commission required the most active alternative trading systems to provide access to all of their services in a manner that is fair and not discriminatory.[13] The Commission observed that while fair access might not be as important "when market participants are able to substitute the services of one alternative trading system with those of another," fair access may be more important when an ATS reaches certain trading thresholds.[14] If fair access is required for an active ATS, it should certainly be required for a facility of a national securities exchange like the BOX, particularly given the volume of directed orders sent to BOX market makers and the centrality of the PIP to the BOX.

We agree that the BOX is not obligated to offer price improvement opportunities. We also agree that BOX market makers are not obligated to price improve any particular orders. We strongly disagree, however, that the BOX should be allowed to offer price improvement on a highly discriminatory basis so that anyone other than friends and family of BOX market makers need not apply. If the BOX offers price improvement opportunities, it should do so based on the terms of orders and not the identities of firms placing orders.[15]

II. The Commission Should Reject the BOX's Attempt to Protect its Market Makers from Robust Competition

The BOX argues that its rule proposal is necessary for two reasons: (1) to protect its market makers from "hostile competitors" and (2) to protect its market makers from "abusive"

[13] Regulation ATS, Rule 301(b)(5).

[14] Exchange Act Release No. 40760 (Dec. 8, 1998), 63 Fed. Reg. 70844, 70872 (Dec. 22, 1998).

[15] The precedents cited by the BOX in support of its proposal (see BOX Proposal at notes 9 and 11) are inapposite in a number of important respects. First, the PCX, PHLX, and Primex systems are all equity trading systems, not options trading systems. This distinction is important because equity market makers can directly internalize a customer order without routing the order to an exchange. In contrast, all listed options trades must occur on an exchange, and exchanges, unlike broker-dealers internalizing orders off exchange, are prohibited from operating trading systems that discriminate on a firm-by-firm basis. For this reason, it is also significant that the Primex system is not operated by an exchange. Second, the PCX and PHLX systems only allow market makers to have a preference in allocations based on the identity of the counterparty. They do not—as the BOX proposal would—allow a market maker to base the price at which it is willing to trade on the identity of the counterparty. Third, the ISE system referenced in note 11 of the BOX proposal only allows market makers to distinguish between customer and broker-dealer orders. We agree that exchange systems may distinguish between customer and broker-dealer orders. The ISE system does not—as the BOX proposal would—facilitate discrimination on a firm-by-firm basis.

trading practices. We are shocked that the BOX is asserting that stifling competition is a ***benefit*** of its proposal. Essentially, the BOX is arguing that any competitor with an electronic trading system that sends directed orders is an inappropriate threat to BOX market makers, necessitating BOX rules to block these competitors entirely. We have a better suggestion: BOX market makers should invest the time and resources to develop systems that intelligently decide when to price improve directed orders based on the characteristics of the orders and market conditions. That would be the kind of robust competition that is the cornerstone of our national market system.

We do not understand how fast and efficient pricing systems constitute an inappropriate "threat" that merits discrimination against the market participants that utilize them. Lawful trading strategies that seek out the best prices available make markets more efficient. The BOX and its market makers should be changing to meet advances in options markets trading, not establishing ways to stymie competition.

The BOX's assertion that it needs to protect its market makers from trading practices that are "abusive" is also unpersuasive. The BOX argues that market makers might engage in the "abusive" practice of "sending large numbers of proprietary directed orders to competitors using strategies that effectively amount to arbitraging the PIP against previous executions obtained on exchanges that do not provide price improvement opportunities."[16] The BOX does not explain why it is "abusive" to try to buy and sell at the best prices available, whether through directed orders or otherwise.

In any case, this trading "strategy" exists only in the BOX's imagination because it is impracticable to the point of absurdity. Essentially, the BOX is arguing that a market maker might take substantial market risk by trading on one market and trying to use directed orders to earn a gross spread of a penny or two—when nickel spreads are widely available. A market maker taking this approach would risk not getting PIPed and would have to hope—often in vain—that the markets do not move in the meantime. The market maker also would have to pay exchange fees, OCC fees, and clearing fees on both the acquisition and liquidation of the position even if no price improvement is obtained, resulting in a net loss.

The BOX also claims that without the ability to shut out competitors, an "unfair competitive situation" would result from the required PIP three-second quote freeze. When a market maker declines to PIP a directed order while quoting at the NBBO, the market maker is required by BOX rules to freeze its quotes for three seconds. The three seconds of market risk faced by a market maker receiving a directed order is necessary because the sender of a directed order also faces three seconds of market risk. Market makers should not be allowed to fade their NBBO while holding—and after getting a sneak peak at—a directed order that is effectively locked in for three seconds. The market can move substantially in three seconds, potentially

[16] BOX Proposal at 10731.

causing directed order senders to risk markets running away from their orders before they are released to the BOX book by the receiving market maker.[17] We agree fully that the three second delay in the directed order process is problematic and suggest that the BOX file a rule change to eliminate it. The fact that the directed order process is poorly designed, however, is not a reason to permit the wholesale discrimination the BOX has proposed.

Finally, the BOX fails to acknowledge that the discrimination its proposal would facilitate would harm innocent investors caught in the crossfire. When discriminating against competitors, BOX market makers will disadvantage ***all of the competitors' customers***, not just the competitors' proprietary trades.

III. The Amended Proposal Has the Same Fundamental Flaws as the Original

If a market maker knows ahead of time which few market participants will be able to send directed orders, then anonymity in the directed order process will be illusory at best. In fact, for those market makers that decide to accept directed orders only from an affiliated order flow provider—as we predict the largest market makers will do—order-by-order anonymity will be completely non-existent. Even if a market maker accepts directed orders from more than one firm, it will have strong incentives to do so only from firms with which it has negotiated side deals so it need not expose itself to anonymous counterparties. Such a system benefits only a portion of the market, to the detriment of market participants who are excluded from these price improvement opportunities.

We are deeply troubled by the notion that an exchange could operate a system that allows an individual market maker to enter into arrangements to provide certain order delivery firms preferential access to the "real" inside market. If the Commission approves the amended proposal, it would codify in the options markets the very vices the Commission has worked so hard to curb in the equities markets. These equity market practices facilitated quoting in public markets while simultaneously trading with affiliates or favored business partners at different and superior quotes than those available to other investors. These practices ultimately led the Commission to act against such bifurcated markets.[18]

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[17] The assertion in the comment letter filed by Interactive Brokers that "no directed order is ever prejudiced by a market maker's decision not to price improve it" is patently false.

[18] *See* Commission Report Pursuant to Section 21(A) of the Securities Exchange Act of 1934 Regarding the NASD and the Nasdaq Market (1996) ("NASD 21(A) Report") (finding that analyses of trading in the two most significant trading systems for Nasdaq securities (Instinet and SelectNet) revealed that the majority of bids and offers displayed by market makers in these systems were better than those posted publicly on Nasdaq); Exchange Act Release No. 37619A (Sept. 6, 1996), 61 Fed. Reg. 48290 (Sept. 12, 1996) (adopting the Order Handling Rules, which require a market maker or specialist to make publicly available any superior prices that it

If the Commission approves the amended proposal:

1. Large institutions and the retail investors they represent would bear the brunt of the discrimination made possible by the proposed rule changes.
2. The price you get would depend on who you are and who you know.
3. Market liquidity and transparency would diminish.
4. Market makers would have little incentive to quote aggressively.
5. Anti-competitive quoting practices—like refusing to deal with certain firms, or demands for reciprocal pricing agreements—would become more common.
6. Best execution would become more elusive.
7. These changes would infect the entire options market because other exchanges would have no choice but to adopt similar rules.

We discussed each of these impacts in detail in Citadel's January Comment Letter and underscore that they apply equally here.

For these reasons, the amended proposal would facilitate discrimination in violation of Exchange Act Section 6(b)(5), impose unnecessary burdens on competition in violation of Exchange Act Section 6(b)(8), and facilitate anti-competitive behavior in violation of the Exchange Act Section 11A(a)(1)(C)(ii) mandate for fair competition among brokers and dealers.[19]

IV. Conclusion

The amended proposal would flout the Commission's consistent dedication to efficient markets and the fair and equitable treatment of investors. Given the discriminatory and anti-competitive nature of the BOX's proposal, it fails to meet the Exchange Act's standards.

As a final point, we note that although the BOX now effectively concedes that its existing rules require the BOX to maintain anonymity in the directed order process, the BOX is still not complying with this requirement. We are deeply concerned about the uncertainty this is creating in the options markets and respectfully ask the Commission to take steps to remedy this while the Commission considers the BOX's latest proposal.

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privately offers through electronic communications networks ("ECNs"), in response in part to the findings in the NASD 21(A) Report).

[19] Implementation of such a rule in turn would violate Exchange Act Section 3(f)'s requirement that the Commission consider whether exchange rules promote competition.

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Citadel appreciates the opportunity to express its grave concerns about the BOX's proposal. 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,

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
Brian Cartwright, General Counsel, Office of the General Counsel
Chester S. Spatt, Chief Economist and Director of the Office of Economic Analysis
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