CITADEL

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Mr. Jonathan G. Katz
Secretary
United States Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: File No. SR-ISE-2005-17 -- Short Dated Options Proposal

Dear Mr. Katz:

Citadel Derivatives Group LLC ("Citadel Derivatives") submits this letter in response to File No. SR-ISE-2005-17, the proposal by the International Securities Exchange ("ISE") to begin listing "Short Dated Options" ("SDOs"), that is, options with an expiration date of one week or less. Citadel Derivatives is an options market maker, active on all six options exchanges, including acting as a specialist on the ISE, the Chicago Board Options Exchange, the Philadelphia Stock Exchange, and the Pacific Stock Exchange. Citadel Derivatives opposes the listing of SDOs by the ISE and all other options exchanges for two reasons. First, the quoting of SDOs will exponentially increase the strain on the already over-taxed market data systems of the individual exchanges and the Options Price Reporting Authority (OPRA), thereby threatening the proper functioning of the entire market and limiting expansion into truly new products. Second, SDOs will offer very little utility.

1. The ISE's Proposal

On July 20, 2005, the ISE announced its preparations to issue SDOs. In relevant part, the announcement states:

> We want to take the opportunity to discuss Short Dated Options, or "Weekly's," given that ISE, OCC, and a number of options exchanges have recently received SEC approval to begin trading them. Further, it is important that the market maker community understand the ISE's position with regard to this particular product.
>
> The ISE has determined that it will not take a lead role with respect to commencing trading in Short Dated Options. However, it is an ISE philosophical cornerstone to compete aggressively across all option product lines. Thus, should another exchange offer Short Dated Options in a class of

> options also traded by the ISE, we believe that we must offer the same options in order to maintain our competitive position.
>
> The ISE will be capable of trading Short Dated Options in early August, with the OCC making its final preparations soon thereafter. It is therefore critical that market makers prepare themselves to trade the product in the event that circumstances dictate a competitive response from the ISE. Please be aware that we will view, Short Dated Options as options series that market makers must quote consistent with their quotation obligation detailed in ISE Rule 804.

We understand that most or all of the other options exchanges are similarly prepared or preparing to list short dated options if necessary but do not plan to make the first move. It would be best for the industry and investors if none ever does.

2. Short Dated Options Will Chew Up Available Bandwidth, Eroding Performance and Limiting New and Existing Products

The proper functioning of the options markets depends, in part, on the ability of quote updates, execution information and other price-related data to be transmitted instantly and accurately. But the introduction of SDOs in which market makers are required to provide continuous quotes will substantially increase the amount of bandwidth currently being used to communicate pricing information. Not only will that pose a serious challenge to OPRA itself, it will pose an enormous challenge to the computer systems of each individual exchange. It is well documented that the mandated linkage among options exchanges means the entire market is thrown into crisis if one exchange is unable timely and properly to update its quotes and receive current market data. Thus, the stability of the options market is only as great as the weakest link in the Intermarket Linkage Plan.

Active concern regarding bandwidth capacity constraints in the options market have been raised by market makers, exchanges, customers and the SEC itself. For example, in a recent speech, Elizabeth King, the Associate Director of the SEC's Division of Market Regulation, highlighted the SEC's concerns regarding the fragility of the options price reporting systems in the face of increased bandwidth demands:

> As I'm sure you know, options message traffic is already growing at a blistering pace. Penny pricing would dramatically increase quote traffic and the corresponding burden on systems could diminish the quality and timeliness of options quote information. While pennies may ultimately be the answer, we

> continue to evaluate whether the potential benefits of penny quoting would justify the risk of less accurate information being disseminated.[1]

Similarly, in discussing the possible introduction of penny quoting, the Government Accountability Office (GAO) noted opposition to penny pricing from "[a]ll of the options exchanges and virtually all of the options firms we spoke with, as well as 15 of the 16 organizations and individuals that submitted public comments" and that "[o]ne of the primary reasons for this opposition was that the trading of options contracts in 1-cent increments would significantly increase quotation message traffic, potentially overwhelming the capacity of the existing systems that process options quotes and disrupting the dissemination of market data."[2]

The GAO noted that "[t]he OPRA system has been experiencing message capacity issues for several years." In fact, practical capacity limits have effectively already been reached, with OPRA going so far as to ask the options exchanges "to reduce quotation traffic by having the options exchanges engage in quote mitigation," that is "prioritize their own quotes and trade report message volume so that the amount of traffic submitted does not exceed a specified percentage of the system's total capacity."[3]

The fact that OPRA is already asking exchanges to limit existing quoting (via the euphemism of "quote mitigation") shows how fragile the current system is. It also shows how likely it would be that the massive demands of SDO quoting would not only make the options market unstable but likely result in the further curtailment of existing quoting, perhaps even the flat delisting of certain currently quoted options.

The fact that the exchanges are able to greatly increase the strains on the options market communication systems without first being required to create offsetting capacity is a classic problem of the commons. That is particularly true in circumstances such as this where each exchange desires not to list the options but commits to do so if any other exchange lists them. As soon as one exchange begins chewing up the limited resource of bandwidth capacity, all of the other exchanges will jump in to claim their share as well, thereby further depleting capacity and degrading the system, causing increasing amounts of inaccurate and stale information to be disseminated.

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[1] Speech by SEC Staff: Remarks before the 2005 0ptions Industry Conference by Elizabeth King, Associate Director, Division of Market Regulation U.S. Securities and Exchange Commission (Bonita Springs, FL, May 13, 2005).

[2] Securities Markets: Decimal Pricing Has Contributed to Lower Trading Costs and a More Challenging Trading Environment, GAO-05-535 Securities Markets at p. 68. Washington, DC: May 2005.

[3] *Id.* at 69.

3. Short Dated Options Offer Little Benefit To The Market

If SDOs were a truly beneficial new product then there would be some offsetting benefit to the bandwidth constraints and market instability they are likely to cause. But they would offer little utility. Notable is the ISE's clear reluctance to list them, expressed in the very document announcing the potential listing of SDOs.[4] That the ISE will list them only if another exchange also lists them is hardly an endorsement of their utility. But one must keep up with the Joneses, even against one's better judgment.

Investors already have the ability to purchase currently-listed longer-dated options in their final month, including their final week, before expiration. As with the ISE, we see little benefit to the market of offering products that expire more frequently than that.

Accordingly, we oppose the listing of SDOs by any exchange and ask the SEC to block their introduction, at least until such time as there is sufficient bandwidth to list them without degrading performance and limiting existing products or the introduction of truly new products.

Thank you for your consideration.

Sincerely,

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

[4] *See* Section 1, *supra*.