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 Numbers SR-PHLX-2004-91, SR-CBOE-2004-71, and SR-ISE-2005-18

Dear Mr. Katz:

Citadel Derivatives Group LLC ("Citadel Derivatives") is submitting this letter in response to File Numbers SR-CBOE-2004-71, SR-PHLX-2004-91 and SR-ISE-2005-18 (collectively, the "Proposed Rules"), pursuant to which the Chicago Board Options Exchange ("CBOE"), the Philadelphia Stock Exchange ("PHLX") and the International Securities Exchange ("ISE") each have proposed rules to permit order flow providers to direct orders to designated market makers. Such a "preferenced" market maker would be entitled to an enhanced participation right in the directed orders, if the market maker is quoting at the national best bid or offer ("NBBO"), without any obligation to improve the market or expose the preferenced portion of the order to the marketplace. Because these proposals are substantially similar, this letter addresses our concerns with respect to all three rule filings.

Citadel Derivatives is an options market maker, active on all six options exchanges, including acting as a specialist on the ISE, CBOE and PCX. Citadel Derivatives fully supports the discussion and position taken by the ISE in its letters to the Commission opposing the CBOE and PHLX proposals (the "ISE Letters").[1] In addition, we wish to emphasize the following concerns.

1. Erosion of the Balance between the Obligations and Benefits of Being a Specialist

The overarching negative result of the proposed rules will be to erode the balance between the obligations and benefits of being a specialist. Under current and long-standing rules, specialists are the only market participants who receive automatic order preferences when they are at the NBBO. The reason they receive such preferences is to compensate them for the heavy responsibilities they undertake to the exchange and the market as a whole, responsibilities that directly benefit investors. Specialists have to open all classes every day, on time; they must

[1] Letter from Michael J. Simon to Jonathan G. Katz, dated December 31, 2004 (referencing SR-CBOE-2004-71) and letter from Michael J. Simon to Jonathan G. Katz, dated January 13, 2005 (referencing SR-PHLX-2004-91 and SR-CBOE-2004-71)

quote continuously in all classes; they have to commit substantial capital to the business; and they must police the Inter-market Linkage. Undertaking an obligation of continuous quoting in numerous series and strikes in all market conditions and for all comers places the specialist in constant peril. The heavy costs of policing Linkage and the quagmire involved in trying to get prompt fills from recalcitrant exchanges are illustrated by the petition to sanction the AMEX filed by Citadel Derivatives with the Commission in December 2004.

But under these proposals, any market participant can get a guaranteed percentage of orders so long as they are at the NBBO. They can do so even though they are just fair weather market makers—that is, they can get a guaranteed percentage even though they do not open the market, do not quote all series, do not have any Linkage obligations and do not have to meet the heavy capital requirements of a specialist. The result is to eliminate the incentive to be a specialist, thereby potentially leaving the obligations of the specialist to the market unfulfilled.

2. Reduced Size of Quotes, Wider Spreads

A direct result of the proposals will be to reduce the size of quotes and widen spreads. Currently, a large stream of undifferentiated orders come into the exchanges and the only way for regular market makers to capture substantial percentages of such orders is to provide large quote sizes—that is, to cast a large net. But the proposed rules will permit market makers backed by substantial order flow to divert hand-picked portions of the stream to themselves, no matter how small their quote sizes are.

As a result, multiple market makers backed by large order flow will end up diverting select portions of the stream to themselves, damning the overall stream until only a trickle is left running through to the open market. They will have no incentive to quote in size because of they will receive guaranteed percentages regardless of quote size. The direct result of this will be that only small sizes will be quoted at the NBBO and effective spreads will widen out substantially.

In the world contemplated by these proposals, competition among market makers will change from a focus on providing tight quotes with large sizes, which benefits investors, to establishing cozy relationships with order flow providers.

3. A Level Playing Field Is Required If These Proposals Are to be Adopted

As demonstrated above, these proposals are bad for investors and should be rejected. But if something like them is to be approved, then at least the Commission should require the establishment of a level playing field, to reduce the gap between the obligations assumed by specialists and those assumed by fair weather market makers.

In this regard, we support the proposal floated by one of the U.S. options exchange to create a category of "Super Market Makers." In our view, such market makers would have to meet minimum thresholds of capitalization; would have to publicly quote a market at the NBBO of meaningful size a meaningful percentage of the time; and would have to accept order flow from all market participants, not just cherry-picked order flow. This would help assure that the stream of orders reaching the market does not dry up, that quotes remain of substantial size, and that spreads not widen substantially. To further level the playing field, we also recommend requiring that Linkage orders be subject to Auto-Execution, which would serve to reduce the substantial friction that exists in the realm of Linkage and therefore reduce burdens on specialists. This would help to keep a balance between the benefits and burdens of being a specialist that will otherwise be upset by these proposals.

In conclusion, we do not believe that the Proposed Rules should be approved. If they are approved, we believe that they should be modified to take into account the issues address above. 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