BOSTON OPTIONS EXCHANGE

September 11, 2008

Ms. Florence E. Harmon
Acting Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File No. 4-562 – Comments on Petition of Citadel Investment Group L.L.C. for Rulemaking to Address Access Fees in the Options Markets.

File No. SR-NYSEArca-2008-75 – Comments on Proposed Rule Change by NYSEArca Amending Its Schedule of Fees and Charges for Exchange Services.

Dear Ms. Harmon:

The Boston Options Exchange Group, LLC ("BOX") appreciates the opportunity to comment on File Number 4-562 from Citadel Investment Group L.L.C. ("Citadel"), a Petition for Rulemaking to Address Access Fees in the Options Markets ("Citadel Petition")[1] and File No. SR-NYSEArca-2008-75, a proposed rule change filed by NYSEArca amending its fee schedule to raise the fee charged to obtain access to exchange quotations ("Taker Fees") in certain options classes. The Citadel Petition, in response to the NYSEArca filing to slightly increase its fees, urges the Securities and Exchange Commission ("Commission") to limit the Taker Fees that options exchanges may charge non-members to obtain access to quotations to $0.20 per contract and, though not specifically mentioned, an implied limit to the make liquidity transaction credit ("Maker Credit") given to the market participant who posted the quote that was executed.

Summary

Citadel puts forth two basic arguments to support its petition. First, Citadel argues that because of compliance with trade-through rules, orders must be routed to an options exchange that has Maker-Taker pricing when it is alone at the national best bid and offer ("NBBO"), yet the cost of the Taker Fee is not included in the displayed price. Citadel thus argues that what may seem to be a better price may not actually be a better price once trading fees at the away options exchange are taken into account. Second, Citadel suggests that Taker Fees have caused a "dramatic increase in locked and crossed markets." [2]

As discussed further below, BOX opposes the Citadel Petition and any limit on Taker Fees, and supports NYSEArca's right to amend its fee schedule as set forth in their proposed rule, for the following reasons:

[1] *See* Commission File Number 4-562, Petition for Rulemaking To Address Access Fees in the Options Markets from Citadel Investment Group L.L.C.; available at http://www.sec.gov/rules/petitions/2008/ petn4-562.pdf.

[2] *See* Petition at page 2.

100 Franklin Street, Boston, MA 02110
Tel.: 617-235-2291 ■ Fax: 617-235-2253
www.bostonoptions.com
190 S. LaSalle Street, Suite 2110, Chicago, IL 60603
Tel.: 312-251-7000 ■ Fax: 312-251-7001

1. When BOX, or any other options exchange using a Maker-Taker pricing model, is alone at the NBBO, its transaction price is still the better price for the customer, even when the full Taker Fee is taken into account.

2. BOX believes that market forces should determine exchange fees and that the Commission should not be drawn in to price fixing. However, if the Commission does decide to place fee caps, then BOX believes a cap on Taker Fees is only acceptable to the extent that other options exchanges are willing to accept a comparable limit on payments and fees associated with exchange payment for order flow programs.

3. BOX does not believe that there is a dramatic increase in locked and crossed markets as a result of the implementation of Maker-Taker pricing and insists that Citadel prove this assertion.

Furthermore, BOX supports Maker-Taker pricing in general as an incentive for BOX Options Participants to quote at the best possible prices, providing better prices and lower overall costs to investors. This is in contrast to the payment for order flow programs in place at many of the options exchanges which do nothing to incent any market participant (professional or not) to improve the overall quality of the options marketplace and instead result in nothing less than a transfer of money from investors to the broker-dealers acting as agents. BOX believes this latter question is actually at the heart of the Citadel Petition and provides a detailed discussion below.

Detailed Discussion of Citadel's Principal Arguments

Better Prices on BOX Outweigh Taker Fees

Citadel notes that rules pursuant to the Options Intermarket Linkage Plan that prohibit trades-through determine, in some instances, how orders must be routed in the options market system.[3] Broker-dealers and some customers are effectively required to pay Taker Fees when an options exchange that has Maker-Taker pricing is alone at the NBBO. Taker Fees are incurred when an order is routed to the Maker-Taker pricing exchange directly or when another exchange receives an order and routes it through Options Intermarket Linkage to the exchange with the best price.

When BOX is alone at the NBBO, its transaction price is still the better price for the customer, even when including the Taker Fee. If the customer order is receiving on BOX a price $0.01 better (equal to $1.00 per contract) than the other displayed options price, then the customer is better off as long as the Taker Fee is $0.99 or less. Currently, if an options class with penny quote increments is traded on BOX at a price at least $0.01 better than a competing exchange, then BOX's current Taker Fee of $0.45 still results in a $0.55 overall cost advantage to the investor.

[3] *See* Petition at pages 3-4.

Locked and Crossed Markets

As noted in the Citadel Petition, the Commission is currently considering proposals from the options exchanges to replace the Options Intermarket Linkage Plan with a new plan that contains provisions regarding locked and crossed markets that are modeled on those within Regulation NMS.[4] BOX believes that Taker Fees work along with the new linkage plan, moving the industry towards order routing that provides additional benefits to investors through access to better prices and where orders are executed at the best price. Citadel opines that a Maker-Taker fee structure encourages market participants to lock the market, claiming that Taker Fees have resulted in a "dramatic increase in locked and crossed markets."[5] BOX has not observed a dramatic increase in locked and crossed markets as a result of the implantation of its Maker-Taker pricing structure. BOX has rules in place, as does each options exchange, that require Options Participants to unlock and uncross the market if such a happenstance occurs. BOX believes that these rules are effectively allowing the exchanges to function without a significant increase in locked and crossed markets and aims to continue to provide the best possible prices to investors. BOX insists that Citadel prove this assertion (that locked and crossed NBBO has become more frequent) and, if proven, that this is due to Taker Fees and not simply the implementation of the Penny Pilot.

Maker-Taker versus Payment for Order Flow

As stated earlier, BOX believes that the Citadel Petition is really about the differences between two exchange transaction pricing models and their impact on the overall quality of markets available to options investors.

Maker Credits Encourage Better Prices

Though not specifically addressed in the Petition, there is an implied call to limit the Maker Credit given to the market participant that added liquidity to the market and who posted the quote that was executed. This is because Maker Credits are paid for by Taker Fees, and any limit on Taker Fees would effectively create a cap on Maker Credits. BOX believes this Maker Credit provides market makers, as well as broker-dealers and customers, with incentives to aggressively quote and narrow the NBBO in order to post the best prices to try to earn the Maker Credits.

Like other Maker-Taker pricing exchanges, BOX's egalitarian and transparent market structure rewards anyone who provides liquidity, whether market maker, broker-dealer or customer. BOX believes that this leads to better prices to the benefit of investors. By providing customers with the best possible prices, we believe BOX is rewarded. BOX believes this is how competition should function. An exchange like BOX should be rewarded for providing what is best for the people it serves, investors.

Customer limit orders that add liquidity to the market are eligible to receive Maker Credits, though it is unclear whether most brokers directly pass this Maker Credit through to customers. However, unlike payment for order flow arrangements, whose exact payment terms

---

[4] *See* Petition at pages 2-3.

[5] *See* Petition at page 2.

and amounts are largely undisclosed and opaque to customers, Taker Fees and Maker Credits are clearly published and fully transparent to the public. Customers can see exactly how much their broker was charged or credited for their option order and how much of these fees and credits were passed on to the customer. In contrast, under exchange sponsored payment for order flow arrangements, different brokers are paid varying and undisclosed amounts at the discretion of the specialist or lead market maker who handles the distribution of the exchange-collected "marketing fee" payments. These differing payments are subjective and based on the identity and status of the broker. BOX does not understand why the Commission continues to allow such variable and undisclosed payments under exchange sponsored payment for order flow arrangements, especially when those brokers who do not receive such payments and their customers are subsidizing the payments through increased execution prices.

BOX believes that increasing costs for certain options trading firms and large institutional investors as a result of Taker Fees should not dictate the Commission's action on the Citadel Petition. If the Commission applies a minimal cap on Taker Fees it will be implementing regulation that will provide an advantage to one set of market participants rather than promoting increasing competition amongst options exchanges. BOX believes these types of firms benefit most significantly from payment for order flow and, as such, that they are hesitant to embrace a new model of the options markets where price improvement and the market with the best price attracts liquidity more so than a market that pays broker-dealers for their order flow. BOX is not aware of any of these firms calling for a cap on payment for order flow because it's an unacceptable, unseen cost to investors. Likely, this is because these firms are the largest beneficiaries of the payment for order flow system.

<u>Equivalent Cap on Payment For Order Flow</u>

Citadel opines that Taker Fees are excessive and that competitive forces within the operation of an open market system are not effective enough to limit Taker Fees stating that, "Requiring broker-dealers to send their orders to the markets displaying the best quotations while also requiring them to ignore the fees associated with obtaining access to those quotations would allow markets to charge excessive fees, and could result in executions at prices materially different from the displayed quotations."[6] BOX believes that a similar statement can be made about payment for order flow. Execution fees and payment for order flow fees can end up costing brokers and market makers as much or more per contract than Taker Fees.

In addition, allowing options exchanges to provide unlimited payment for order flow to broker-dealers causes additional unseen price distortions; resulting in additional costs to investors that have their orders routed to the exchange. This is caused by market makers who must adjust their quoted prices to compensate for paying the exchange payment for order flow fees. As a result, ***the cost of payment for order flow is passed through to the investors in the form of inferior pricing.*** **In essence, the investors are subsidizing the payments to the brokers. Those investors whose brokers do not receive payment for order flow are subsidizing the other brokers who do. In most cases, even the investors whose brokers are receiving payment for order flow may not be recuperating any of these additional costs.**

---

[6] *See* Petition at page 3.

In 2000, the Commission conducted a special study about payment for order flow and internalization in the options markets and found that "Payment for order flow is a method of transferring some of the trading profits from market making to the brokers that route customer orders to specialists for execution"[7] and funds generated from payment for order flow and internalization ideally should be passed on to the customer in the form of "reduced costs".[8] "[F]ew firms are passing along the benefits of payment for options order flow to their customers in the form of either reduced commissions or rebates."[9] In fact, the Commission determined that a more sinister development emerged with the introduction of payment for order flow into the options market:

"[P]ayment for order flow and internalization contribute to an environment in which quote competition is not always rewarded, thereby discouraging the display of aggressively priced quotes. In the multiple trading environment specialists on the competing options exchanges typically will promise to match the displayed prices of other exchanges. If widespread, these passive [price "step-up"] practices may weaken the incentive to display competitive quotes, because displaying a superior quote does not necessarily ensure attracting additional order flow. Over time, therefore, the quotes being matched may become wider, increasing execution costs to investors."[10] The Commission's Office of Compliance Inspections and Examinations ("OCIE") has also explored this area and found that "Payment for order flow has had [a negative] impact on order routing decisions."[11] The Commission's Office of Economic Analysis ("OEA") has also determined that in addition to cash payments for payment for order flow other inducements also exist, such as increased profits at affiliated firms to which order flow is directed and reciprocal order flow arrangements.

Citadel's concern is that "outlier" markets will charge excessive Taker Fees. While Citadel concedes that Taker Fees may lead to better prices, it states that, "absent a limit on Taker Fees, there is no assurance that these better prices will outweigh the associated Taker Fees."[12] BOX believes that if a limit were to be imposed, that it should be, per contract, $0.01 less than the standard trading increment of the particular options class. At such a cap level, options classes that are part of the penny-pilot and have a $1.00 per contract quote increment would have a fee limit of $0.99 per contract. For options classes that trade in $5.00 increments, BOX would accept a limit of $4.99 per contract. BOX believes in providing customers with the best price available. These beliefs underscore BOX's position that a limit of $0.01 per contract less than the respective trading increment would be acceptable.

BOX agrees with Citadel and the Commission that, "[f]or quotations to be fair and useful, there must be some limit on the extent to which the true price for those who access quotations

---

[7] SEC, *Special Study: Payment for Order Flow and Internalization in the Options Markets*, 4 (Dec. 2000), *available at* http://www.sec.gov/news/studies/ordpay.htm.

[8] *Id.*

[9] *Id.*

[10] *Id*

[11] *Id.* at 6.

[12] *See* Petition at page 6.

can vary from the displayed price."[13] BOX believes that payment for order flow affects the true cost that investors are paying for options, and that these payments are unseen by investors. Citadel noted the Commission observation that disparate access fees, i.e. where different markets charge varying Taker Fees - render quotations less useful and accurate, in that such fees make it difficult or impossible to meaningfully compare quotations across markets.[14] BOX believes, however, that allowing different exchanges to continue to provide payment for order flow in various amounts to broker-dealers actually renders quotations less useful and accurate in that such payments make it more difficult to meaningfully compare actual costs to investors across markets. As such, BOX believes a cap on Taker Fees is only acceptable to the extent that other options exchanges are willing to accept a comparable limit on payments and fees associated with payment for order flow.

Conclusion

BOX urges the Commission to consider the Petition carefully. BOX believes the arguments advanced in the Citadel Petition are without foundation, as:

- Maker-Taker fees are substantially lower than the value of a standard trading increment of price improvement (e.g. if the BOX price is $0.01 better than the price on another exchange, this $0.01 is equivalent to $1.00 to the customer per contract traded, which is double the Taker Fee charged to the customer); and

- No data is provided to support the argument that Maker-Taker pricing has caused an increase in locked or crossed options markets.

Furthermore, BOX believes that market forces should determine exchange fees and that the Commission should not be drawn in to price fixing. BOX believes that, if implemented, a cap on Taker Fees will have a negative impact on exchanges, like BOX, that are providing price improvement and overall better prices and lower costs to investors. BOX believes that implementing a low cap will be contrary to the Commission's mission of protecting investors and promoting fair, orderly, and efficient markets.

However, if the Commission does decide to enact fee caps, then BOX believes a cap on Taker Fees is only acceptable to the extent that other options exchanges are willing to accept a comparable limit on payments and fees associated with payment for order flow.

* * *

---

[13] *See* Petition at page 4 citing Securities Exchange Act Rel. No. 51808 (June 9, 2005) ("Regulation NMS Adopting Release") at 189.

[14] *See* Petition at page 5.

Again, BOX appreciates the opportunity to comment on Citadel's Petition. If you have any questions, please contact me at (312) 251-7000.

Sincerely yours,

William Easley
Vice Chairman

cc: Dr. Erik R. Sirri, Director, Division of Trading and Markets
Robert L.D. Colby, Esq., Deputy Director, Division of Trading and Markets
Elizabeth K. King, Esq., Associate Director, Division of Trading and Markets