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September 10, 2008

Nancy M. Morris  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, NE  
Washington, D.C. 20549-1090

Re: Rule Petition 4-562 – Citadel Investment Group L.L.C. – Petition for Rulemaking to Address Access Fees in the Options Markets;  
Release No. 34-58295; File No. SR-NYSEArca-2008-75 – NYSE Arca, Inc.  
Proposed Rule Change Amending its Schedule of Fees

Dear Ms. Morris:

Wolverine Trading, LLC (“Wolverine”) is an options market-maker on all U.S. options exchanges.<sup>1</sup> Wolverine submits this letter in response to (i) the proposed rule petition dated July 15, 2008<sup>2</sup> (the “Rule Petition”) submitted by Citadel Investment Group L.L.C. (“Citadel”) in relation to certain “access” fees levied by the U.S. options exchanges; and (ii) Release No. 34-58295; File No. SR-NYSEArca-2008-75<sup>3</sup> (the “Rule Proposal”) in which NYSE Arca, Inc. (“Arca”) proposed to increase certain “Transaction Fees”.

In the Rule Petition, Citadel urged the U.S. Securities and Exchange Commission (the “Commission”) to address “distortions in the options market caused by the excessive fees that may be charged by options exchanges using maker-taker pricing” by instituting a rulemaking proceeding that would limit the fees charged by the exchanges to non-members to obtain access to quotations to \$0.20 per contract.<sup>4</sup> Citadel further indicated

<sup>1</sup> As a market maker and exchange member firm, Wolverine is subject to both the make-take fees/rebates and the payment for order flow fees discussed herein. Wolverine does not operate a customer business, and therefore, is not eligible to receive payments for order flow from the exchanges. Wolverine’s affiliate, Wolverine Execution Services, LLC, an order routing and execution broker, is eligible to accept such payments; however, it does not accept them from any exchange.

<sup>2</sup> Rule Petition 4-562, <http://www.sec.gov/rules/petitions/2008/petn4-562.pdf>.

<sup>3</sup> Release No. 34-58295; File No. SR-NYSEArca-2008-75, which became effective upon filing, [http://apps.nyse.com/commdata/pub19b4.nsf/docs/163202459EE49DB08525749D004D0CC5/\\$FILE/NYSEArca-2008-75%20SECAppOrd%208.4.08.pdf](http://apps.nyse.com/commdata/pub19b4.nsf/docs/163202459EE49DB08525749D004D0CC5/$FILE/NYSEArca-2008-75%20SECAppOrd%208.4.08.pdf).

<sup>4</sup> Rule Petition 4-562, Page 1.

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that it believes that such a proceeding would “ensure the effectiveness of quotations in the options markets and address many of the same concerns that the Commission addressed in the equity markets when the Commission adopted Rule 610(c) of Regulation NMS to cap access fees in those markets.”<sup>5</sup> In the Rule Proposal, Arca raised its “Take Liquidity” fee in certain classes for all market participants and raised the “Post Liquidity” credit in certain classes by varying amounts depending on the type of market participant.<sup>6</sup>

We support Arca’s proposed fee amendments because we believe the amendments will result in cost savings for customers.<sup>7</sup> On the other hand, we agree with Citadel’s general contention that excessive “access” fees could lead to distortions in pricing in the options markets. Arguably, any fee will cause price distortions and, in fact, maker-taker fees currently are not the only cause of such distortions in the options markets. Rather, while such fees are one of the more tangible costs associated with trading in options (i.e., a flat fee per transaction, the cost of which generally is available on an exchange’s website<sup>8</sup>), there are other fee-related costs that also impact pricing, as well as competition, in a material way. Accordingly, Wolverine believes that a meaningful discussion of the impact of fees in the options markets cannot simply be limited to, or addressed by, a cap on maker-taker fees, but rather, must encompass other factors as discussed more fully below.

## **I. The Current Fee Environment**

It appears that Citadel supports a cap on make-take fees because it believes that such a cap would address many of the same concerns addressed with the adoption of Rule 610(c) of Regulation NMS. On the surface, the stated goals of both Reg NMS and the Rule Petition – capping access fees in the equity and options markets, respectively – sound impressive in terms of their potential impact on trading fees paid by market participants. However, practically speaking, the passage of the Rule Proposal (or any similar rule) would not have the same impact on the listed options marketplace that Regulation NMS had on the listed equities marketplace when the significant disparities

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<sup>5</sup> Id.

<sup>6</sup> The Rule Proposal also eliminated the “Market Maker Post Liquidity Incentive Credit,” however, that aspect of the Rule Proposal was not relevant for purposes of this letter.

<sup>7</sup> Assuming the total cost of the take fee does not exceed the minimum trading increment for the option.

<sup>8</sup> E.g., NYSE Arca Inc.’s fee schedule is located at [http://www.nyse.com/pdfs/Options\\_Fee\\_Schedule.pdf](http://www.nyse.com/pdfs/Options_Fee_Schedule.pdf), and the Boston Options Exchange’s fess schedule is located at [http://www.bostonoptions.com/box\\_regulations/PDF/feeschedjan06.pdf](http://www.bostonoptions.com/box_regulations/PDF/feeschedjan06.pdf).

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that exist between the equity market structure in place at that time and the current options market structure are taken into consideration.

Unlike the equity markets, in the current options market environment, two separate and distinct exchange-mandated structures exist – (i) the so-called “make-take” structure, where market participants are assessed a fee for taking liquidity and/or given a credit or a rebate for providing (or making) liquidity; and (ii) the marketing fee structure (i.e., payment for order flow (“PFOF”)), where members are assessed a fee for trading with customer bids or offers on the exchanges, and a portion of the fees are rebated to order routing firms. Both types of programs are established, monitored and administered by the exchanges and participation in each program is mandatory, as it applies to the specific exchanges. Although the Rule Proposal addresses capping make-take fees, it ignores the PFOF structure altogether.

## **II. Impact of Fees on Market Participants and the Marketplace**

### **A. Difference Between the Effect of Fees Under Both Structures**

The Rule Proposal refers to take fees as “access” fees, but it does not address other exchange fees, such as PFOF fees, that also may be considered “access” fees. Both are assessed against certain participants that “take” or “make” liquidity. In fact, we would argue that make-take fees are simply exchange fees because they apply equally to all market participants. On the other hand, PFOF fees do not apply equally across the board, and therefore, function as an access fee to those market participants that are required to pay them. In the case of exchanges that operate under the make-take structure, however, all market participants have the same opportunity to earn a credit or rebate if they provide liquidity.<sup>9</sup> Under the make-take structure, the playing field is more level because the fees apply uniformly across the board (e.g., members, non-members, customers, firms, broker-dealers all pay the same take fees and receive the same make rebates). Furthermore, for participants that take and make liquidity on a periodic basis, the effect of the take fees is reduced over time.

On the other hand, under the PFOF structure, fees are assessed against members that interact with customer orders and subsequently are rebated (at least in part) to order flow providers as the exchanges, or their specialists as the case may be, see fit. When PFOF fees are rebated to order flow providers, they are not obligated to pass the revenues along to their customers, resulting in costlier executions to those customers who do not receive

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<sup>9</sup> The take fee typically is higher than the make rebate/credit, resulting in a spread between the two fees.

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such rebates (e.g., in the form of reduced brokerage fees). These customers also miss out on the savings that they would have received if they were providing liquidity under the make-take structure.

### **B. Quote Distortion, Latency Issues and Additional Fees**

We believe that PFOF fees result in costlier executions in other ways as well. For example, if an exchange charges a market maker a PFOF fee to interact with customer orders, the market maker will “make up” for the added fee by increasing the spread between its quoted bids and offers, i.e., the cost will simply be passed along to other market participants by way of less favorable execution prices. This increase affects all market participants that trade on PFOF exchanges, not just those participants that accept PFOF rebates.<sup>10</sup> Essentially, the goal of PFOF is to attract market orders via payments to brokers – through its very structure PFOF is not conducive to providing customers with better prices or less costly executions. Rather, brokers route orders automatically to exchanges based on the amount of PFOF rebates allocated to those brokers by the exchanges without regard to the actual markets disseminated on the exchanges. At the PFOF exchanges, no incentives exist for market makers to disseminate better markets because the PFOF attracts the orders, not the markets. In order to participate on these orders, members may be forced to step up to the NBBO, but no incentive exists to improve markets beyond this price. Furthermore, if orders are routed to an exchange not at the NBBO, the orders must be routed away to the best market for execution. This results in additional routing time<sup>11</sup> and possibly, additional execution fees for these orders. We strongly believe that the practice of accepting PFOF calls into question whether a broker is fulfilling its fiduciary duties to its customers when it routes orders to an exchange solely based on the fact that it is being paid a PFOF fee to route its orders to a particular place. When a broker accepts PFOF, it does not have to take the effect of fees, time for execution or the best disseminated markets into consideration. Rather, brokers can simply make mindless routing decisions and reap the benefits of PFOF rebates.

We believe the make-take structure attempts to attract liquidity takers via better prices and more aggressive quoting. Specifically, although there is a cost to market participants because of the take fee, there is the additional benefit of the make rebate. Because of the make rebate, we believe members disseminate tighter quotes because of the overall

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<sup>10</sup> For example, customers of brokers that do not accept payment for order flow bear the cost of these fees via artificially high prices, without the benefit of a rebate.

<sup>11</sup> This may cause the order to miss the price before it reaches the second exchange.

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reduction of fees under this structure.<sup>12</sup> The result of these tighter quotes is better executions for all market participants.

Another factor that is difficult to measure under the PFOF structure is the exact additional cost that is being passed along to market participants. While a market participant (in particular, a non-sophisticated market participant), can readily determine what fees and rebates are in effect on a make-take exchange, clear latency issues exist with respect to the effect of the cost of PFOF fees on market participants on those exchanges. For example, when an order flow provider routes an order to a PFOF exchange, there is no way for the broker to know with whom that order is interacting (i.e., whether they are interacting with a customer resulting in no PFOF rebate, or with a market maker order that is subject to the PFOF charge). There is no real way to measure the amount of PFOF fees that are being passed along via a disseminated quote. This subsequently impedes a participant's ability to meaningfully compare quotes across all exchanges. Additionally, as noted above, brokers are not required to pass along PFOF rebates and therefore, it is more difficult for customers to determine what their cost of execution may be in terms of fees paid for brokerage. Lastly, we would note that customers of brokers that do not accept payment for order flow ultimately bear the biggest burden because they are forced to pay artificially wide prices, effectively subsidizing the PFOF model, without receiving any added benefit (e.g., lower brokerage fees that may be enjoyed by customers of brokers that do accept PFOF fees).

Ultimately, we believe the effect on quote spreads described above may have a material impact on a participant's costs. Most likely, PFOF leads to the passing-along of exchange fees in the form of increased execution costs that could be avoided if all "access" fees are capped.

Finally, we believe that exchanges that operate the PFOF model also charge separate execution fees per contract to non-members for orders executed on their exchanges, resulting in added execution costs for non-members. These fees also do not fall under the cap proposed by the Rule Petition, resulting in an additional "access" fee burdens for non-members attempting to trade on PFOF exchanges despite their obligations to do so under current linkage rules.

### **C. Effect on Competition and Membership**

In regards to structure and competition, we believe the proposed fee cap would place the exchanges that operate under the make-take structure at a competitive disadvantage.

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<sup>12</sup> These rebates would serve as credits to offset other costs.

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Specifically, the Rule Proposal is aimed at capping fees at \$0.20 for non-members under the make-take structure. We believe this likely represents a significant loss in potential revenues to make-take exchanges.<sup>13</sup> On the other hand, under the Rule Proposal, because the issue of PFOF access fees is not addressed, PFOF exchanges could continue to assess an unlimited amount of PFOF fees against their members without any disruption to their revenue stream.<sup>14</sup>

### **III. The Outlier Problem Will Still Exist**

The proposed make-take fee cap also will not eliminate the problem of “outlier pricing.” As Citadel noted in the Rule Proposal, when the Commission adopted Regulation NMS, the Commission was concerned that absent a cap on access fees, “outlier” markets might charge excessive fees to obtain access to their quotations, and thereby act as a “toll booth” between price levels.<sup>15</sup> As Citadel further noted, due to prohibitions against trade throughs, broker-dealers might be required to obtain access to quotations at these outlier markets, without regard to the associated fees.

While the proposed cap would reduce the take fees charged to non-members forced to access “outlier” markets because they are displaying the national best bid or offer (“NBBO”), members would still be forced to pay unrestricted fees.<sup>16</sup> This would continue to result in executions at prices materially different from the displayed quotations. Such a result clearly runs contrary to the purposes behind the trade through rules and the principles of best execution. Furthermore, exchange members would once again be forced to bear the burden of excessive fees.

### **IV. Alternatives to Fee Caps – Internalization and “Flash” Orders**

It appears that Citadel supports order internalization in the options markets as an acceptable alternative to combating excessive fees because it believes internalization “shields” customers from excessive taker fees in the equity markets.<sup>17</sup> As Citadel also

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<sup>13</sup> Currently, make-take exchanges may charge liquidity takers as much as \$0.55.

<sup>14</sup> The highest PFOF fees currently being assessed is \$0.75.

<sup>15</sup> Rule Petition 4-562, Page 3.

<sup>16</sup> A member firm with more than one exchange membership might be forced to go to an away market to move the market in order to prevent a trade through on an exchange in which it acts as specialist or market maker.

<sup>17</sup> Rule Petition 4-562, Page 6.

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points out, the options markets already have in place trading/crossing mechanisms that allow order flow providers to interact directly with their orders, provided that certain criteria are met.

Although we do not support internalization because it has a detrimental effect on competition and does not allow customers to seek better prices in the open market, we believe the existing mechanisms at the exchanges provide a meaningful way for customers to avoid paying excessive exchange “access” fees.

Certain PFOF exchanges also provide members with access to “flash orders,” whereby these market participants have the opportunity to interact with orders before they are linked to away markets at NBBO prices. In order to entice market participants who would have to pay the PFOF fee normally, these PFOF and other exchange fees may be waived. The fact that this waiver is used to encourage market participants to make tighter quoting decisions should serve as proof that PFOF tends to result in wider markets. In the case of “flash” orders, competition among exchanges has solved some of the problem of excessive fees without the need for additional regulation.

**V. A Uniform Approach to Fees**

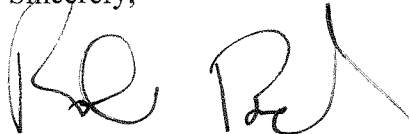
Based on the above, we feel that any cap on make-take fees should be made in conjunction with a commensurate cap on PFOF fees. If both fees have similar caps, customers could more easily weigh their options with respect to their best execution options across all exchanges. In other words, even if they are unaware of specific fees charged by the exchanges, market participants would be aware of the maximum fees that could be charged for executions and with that valuable information, make more informed decisions with respect to order routing and execution.

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Wolverine believes that before the Commission can take any action with respect to capping make-take fees in the options markets, a closer look at the entire fee structure in the marketplace is required. While we believe the above addresses many of the more important issues related to the costs associated with fees in the options markets, we would welcome the opportunity to further discuss these issues and their impact on the marketplace with the Commission. Please do not hesitate to contact us if we can provide any additional information or clarification with respect to this issue.

Sincerely,

Handwritten signature of Robert R. Bellick in black ink.

Robert R. Bellick  
Managing Director

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