STATEMENT OF MATT ANDRESEN
ON BEHALF OF
CITADEL INVESTMENT GROUP, L.L.C.
BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISE
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

February 15, 2005

Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee, I am Matt Andresen, Co-Head of Citadel Derivatives Group, an affiliate of Citadel Investment Group, L.L.C. ("Citadel"). On behalf of Citadel, I welcome this opportunity to present our views on the proposed National Market System (NMS) regulations issued by the Securities and Exchange Commission (the "SEC").

Citadel manages approximately $11 billion in investment capital from its headquarters in Chicago and offices in New York, San Francisco, London and Tokyo. On average, Citadel accounts for between one and two percent of the daily dollar volume traded on both the New York Stock Exchange (NYSE) and Nasdaq, and more than 10 percent of the daily U.S. listed equity options contract volume. With nearly 1,000 employees, and as an active and substantial investor in the U.S. and throughout the world, Citadel has a vital interest in the development of fair, efficient, transparent and liquid capital markets. Because the trade-through rule implicates fundamental questions regarding the transparency and efficiency of the markets, the issues to be addressed at this hearing are of great importance to all investors. American investors, whether retail or institutional, have a vested interest in ensuring that U.S. markets remain the strongest and most efficient markets in the world.

In this statement, I will discuss Citadel's position with regard to the proposed Regulation NMS, and basic principles with respect to the so-called "trade-through" rule and then turn to the specific issues raised by the Subcommittee, including: (1) the proposed extension of the trade-through rule to all NMS stocks, (2) the top-of-book and depth-of-book alternatives, (3) the consequences if any of these proposals are adopted, and (4) the SEC's empirical justifications for the proposal.

Citadel believes that the existing trade-through rule is unnecessary and should be eliminated. Market forces and robust competition are sufficient to discipline inefficient market centers and ensure high quality executions. One need look no further than the Nasdaq marketplace for evidence of the benefits of competition among execution venues. Nasdaq lacks a trade-through rule and yet Nasdaq stocks exhibit greater liquidity than NYSE stocks, and orders in Nasdaq stocks are executed more quickly and efficiently and at better prices than their counterparts listed on the NYSE and AMEX.

The trade-through rule proposed by the SEC, however, if adopted, would be a substantial improvement over the current regulatory framework. The key components of the SEC's proposed trade-through rule are:

- The ability to bypass manual markets
- The inclusion of an intermarket sweep exception to execute large institutional orders cleanly and efficiently
- The clear definition of what constitutes an "automated market"

Citadel has asked the Commission to act quickly to either eliminate the existing trade-through rule or adopt the proposed rule.[1] In addition, given that the U.S. options markets are plagued with the same market structure problems as the NYSE- and AMEX-listed equities markets, Citadel has requested that the SEC extend its proposed trade-through changes to the options markets.[2]

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[1] Citadel has already submitted two written comments with the SEC in response to Regulation NMS: (1) Letter to Jonathan G. Katz, Secretary, Securities Exchange Commission, Re: Regulation NMS-File No. S7-10-04 (July 9, 2004); (2) Letter to Jonathan G. Katz, Secretary, Securities Exchange Commission, Re: Regulation NMS – File No. S7-10-04 (January 10, 2005).
[2] This proposal was included in a petition for rulemaking submitted by Citadel to the SEC to address shortcoming in the options markets: Letter to Jonathan G. Katz, Secretary, Securities and Exchange Commission, Re: Petition for Rulemaking to Amend the Options Intermarket Linkage Plan (January 22, 2005). See Exhibit 1.

REGULATION NMS & THE TRADE-THROUGH RULE

When the current regulatory regime was instituted back in the late 1970's, split-second electronic trading was not yet contemplated. The advent of electronic exchanges and networks has added new criteria of value to the execution process. When everything happened on a floor, the only metric that mattered was the advertised price for a security. On electronic markets, however, additional metrics are considered, such as transparency, speed, and – most important – certainty of execution.

The debate over the "trade-through" rule has erroneously been described as a trade-off between speed and price. This is not the case. In fact, the debate should instead be described as a choice between true price and advertised price.

The markets have changed dramatically in the past 20 years, and much of this change has been driven by technology. As a result, the SEC currently is in the process of reviewing and proposing changes to the National Market System (NMS). As indicated in the SEC's February 2004 Press Release, one of the key questions is whether to continue with the trade-through rule framework and, if so, on what basis. Certainty and speed of execution are important for investors. As a direct result of the trade-through rule, however, investors are limited in their choice of execution venue. Often, attempting to purchase or sell stocks at advertised prices on the NYSE and AMEX results in potential delays of between 30 seconds and 2 minutes. In that time, prices may move many times and the price at which the investor sought to trade may no longer be available. Therefore, the trade-through rule, which seeks to give the "best price" to each investor, can actually cause an investor to get an inferior execution.

If the trade-through rule is abolished, investors would have unfettered choice of markets. Competition among execution venues would lead to lower execution costs and superior service to the marketplace. It is a universally accepted principle in the securities market and elsewhere that time equals risk. Securities prices continuously change to reflect evolving market conditions, and prices change at a rapid price. Consequently, each time an investor's order is sent to a slow, manual market, the investor faces a greater risk of prices moving prior to execution than the investor would face on a fast, electronic market.

Citadel believes that eliminating the trade-through rule would be consistent with the SEC's "best execution" requirement. The SEC has long defined "best execution" as the duty to seek the most favorable terms available under the circumstances.[3] This definition focuses on a number of diverse factors including not just price, but also speed, liquidity, certainty and other factors. The evolution of the market towards an appreciation of the value of speed and certainty is clear. Even non-institutional, retail investors are learning the importance of speed in cutting their true cost of execution. This is demonstrated by the recent advertising campaigns of retail brokerage firms focusing on speed of execution to attract new customers.

Abolition of the trade-through rule will benefit <u>all</u> investors because, by rewarding firm quotes, slow markets will be incented to improve and upgrade their trading systems and methods. Manual and hybrid markets will have the flexibility to evolve toward the automation they see fit, but would no longer be afforded the unfair advantages that exist under the current trade-through rule. Indeed, the mere discussion of trade-through reform has already encouraged existing manual markets, like the NYSE and AMEX, to begin planning enhancements to their trading capabilities.[4] Citadel applauds this result and believes the elimination of the trade-through rule would only accelerate these improvements to the benefit of all investors.

<u>Comments on the SEC's Proposed NMS Market Structure</u>

(1) <u>The Extension of the Trade-Through Rule to All NMS Stocks (And Discussion of Extension of Trade-Through Rule to Options Markets)</u>

Citadel does not believe that a compelling case has been made for the extension of the trade-through rule to all NMS stocks. Specifically, Citadel does not believe there is

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[3] Securities Exchange Act Release No. 49325 (Feb. 26, 2005), 69 Fed. Reg. 11126, 11128 (Mar. 9, 2004).
[4] "Highway to Hybrid," Security Industry News (May 3, 1003)(asserting that "by the end of the year, virtually all U.S. equity and options exchange will be electronic or hybrid to respond to competition and regulatory reforms").

any discernable public policy justification for any application of the trade-through rule to electronic markets. In the marketplace for Nasdaq stocks, where there is not a trade-through rule and quotes are generally immediately and electronically accessible, market quality is superior and trade-throughs are not an issue. Market participants have no incentive to ignore a better priced quote that provides certainty through instant execution.

While Citadel is opposed to any trade-through rule, the SEC's proposal is significantly better than the status quo and would eliminate the fundamental flaw of having to wait for responses from manual markets for listed stocks. The SEC has correctly recognized the "serious weakness" in the current trade-through rule – its failure to reflect the "disparate speed of response between manual and automated quotations." [5] The proposed intermarket sweep exemption addresses most of Citadel's concerns about the SEC's initial trade-through proposal and would ensure the efficient execution of large orders.

Citadel's main critique of the SEC's proposal is that the definition of an automated trading center does not make explicit that an automated trading center must protect "away markets" that are also automated.[6] Specifically, an automated trading center should be required to immediately and automatically route orders to other automated trading centers to protect the away markets' quotes and limit orders or to step up to match the better away markets' prices (unless an existing intermarket sweep order already protects away markets). The SEC appears to have contemplated such a requirement in the proposal. Citadel would like to see this requirement spelled out more explicitly.

Citadel strongly supports the rule's extension to the listed options markets. The fundamental philosophical and market structure issues are the same in the equities and options markets. Like the listed equities markets, the quality and effectiveness of the options markets is impaired by a trade-through rule that lacks an exception for manual quotes. Indeed, the problems caused by applying the trade-through rule to manual quotes

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[5] Securities Exchange Act Release No. 50870 (Dec. 16, 2004), 69 Fed. Reg. 77424, 77427 (Dec. 27, 2004) ("Reproposal").

[6] An "away market" is a different market from the market in which an order was originally placed., and comes into play when insufficient shares are available to fill an order. For example, if an order for 30,000 shares is placed on the NYSE, but only 29,000 shares are available, the remaining 1000 shares are routed to an "away market."

are more pronounced in the options markets. Options are derivative in nature and thus must rapidly react to price changes in the underlying securities. Moreover, there are no exceptions to the options market trade-through rule like there are in the equities markets.

(2) <u>The Top-of-Book and Depth-of-Book Alternatives (In Relation to Market Sweep Exemption)</u>

Citadel would support a top-of-book trade-through rule, provided the final rule contains the four key components previously mentioned: (1) an ability to bypass manual markets, (2) an intermarket sweep exemption, (3) a clear definition of automated markets, and (4) its extension to the options markets.

The intermarket sweep exemption as defined by the SEC is crucial to the success of any trade-through rule and should be adopted without modification. The SEC defines an intermarket sweep order as "a limit order that meets the following requirements: (1) the limit order is identified as an intermarket sweep order when routed to a trading center, and (2) simultaneously with the routing of the limit order, one or more additional limit orders are routed to execute against all better-priced protected quotations displayed by other trading centers up to their displayed size."

Citadel believes the SEC's proposed market sweep exception will be beneficial to all investors. Market efficiency would be improved by avoiding unnecessary message traffic and indefinite message loops. Immediate execution would be facilitated where there is no risk of a trade-through. Market participants would be enabled under the exemption to simultaneously and immediately sweep through multiple price levels in multiple markets.

Citadel believes that a depth-of-book rule would be difficult and costly for many market participants to implement, and might complicate surveillance and compliance with the rule. In addition, the great complexity involved in implementing a depth-of-book solution would no doubt create unintended consequences that we can not now foresee.

(3) <u>Consequences If Any of These Proposals Are Adopted</u>

For the reasons described above, Citadel believes the markets, and therefore all investors, would be better served by abolition of the trade-through rule rather than by incremental reforms such as those proposed by the SEC. Nevertheless, Citadel believes that the SEC's proposal, if adopted, would be an improvement over the model we have now.[7] Under the SEC's proposal, market participants would be free to route orders to manual markets; however, market participants would no longer be required to do so in the listed equity markets, as the current trade-through rule provides. Citadel agrees that "investors are best served when the markets are free to compete and offer an array of execution options."[8] Accordingly, the SEC's proposed modified trade-through system would help achieve the goal of free markets reflected by this important principle. In particular, Citadel commends the exclusion of manual quotations from protection in the SEC's proposed revisions to the trade-through rule. Tangible benefits in the listed equity markets likely to result from the proposed rule include: an increase in market transparency and liquidity; a decrease in effective spreads and execution costs; and a dramatic improvement in execution speed and certainty.

(4) <u>The SEC's Empirical Justifications for the Proposal.</u>

The SEC has correctly recognized the "serious weakness" in the current trade-through rule – its failure to reflect the "disparate speed of response between manual and automated quotations." As the SEC stated, "[b]y requiring order routers to wait for a response in the manual market, the ITS trade-through provisions can cause an order to miss both the best price of a manual quotation and slightly inferior prices at automated markets that would have been immediately accessible."[9] The proposed revised trade-

[7] Securities Exchange Act Release No. 34-50870 (Dec. 16, 2004) "Regulation NMS would include new substantive rules that are designed to modernize and strengthen the design of the US equities markets. First, the 'Trade-Through Rule' would require trading centers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution of trades at prices inferior to protected quotations displayed by other trading centers, subject to an applicable exception.").

[8] John A. Thain, CEO, New York Stock Exchange, Testimony Before Senate Banking Committee – Proposed Regulation NMS (July 21, 2004).

[9] *Id.*

through rule, by excluding manual quotations, would reduce the impact of this fundamental flaw in the current national market system and thus substantially improve the system.

A number of commenters have pointed out flaws in the SEC's analysis in regard to the question of whether to extend the trade-through rule to the Nasdaq market. In particular, these commenters believe that the SEC's analysis overstated the actual number of trade-throughs in Nasdaq stocks, drew the wrong conclusion from the data regarding a supposed lack of liquidity in Nasdaq stocks, and failed to adequately capture the overwhelming superiority in execution quality of Nasdaq stocks. Based on our own experience trading large volumes of both Nasdaq and listed equity securities, we believe strongly that the execution quality of the Nasdaq marketplace is significantly better than that of the listed marketplace.

Conclusion

For the reasons stated, the SEC should abolish the existing trade-through rule altogether or immediately implement the changes to the trade-through rule proposed in Regulation NMS. Either result will promote transparency, competition, highest quality prices, and speed of execution, and ensure that U.S. markets remain the strongest and most efficient markets in the world. Thank you.

Exhibit 1

CITADEL

January 22, 2005

4-496

VIA FEDERAL EXPRESS

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

Re: Petition for Rulemaking to Amend the Options Intermarket Linkage Plan

Dear Mr. Katz:

Citadel Investment Group, L.L.C. ("Citadel")[1] petitions the Securities and Exchange Commission (the "Commission") to address systemic market weaknesses caused by the trade-through provisions of the Options Intermarket Linkage Plan.[2] Specifically, the Commission should limit Linkage Plan trade-through protection only to automated quotes.[3] Eliminating anti-competitive requirements that prevent market participants from consistently obtaining reliable, automated order handling in the options markets will enhance price discovery, create more liquid and deep markets, and significantly benefit all market participants.

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1 Citadel and its affiliates have over 900 employees, with headquarters in Chicago and offices in New York, San Francisco, London and Tokyo. Citadel's affiliate Citadel Derivatives Group LLC is registered with the Commission as a broker-dealer and is a member of the International Securities Exchange, the Chicago Board Options Exchange, the Philadelphia Stock Exchange, the American Stock Exchange, the Pacific Exchange, and the Boston Options Exchange. On average, Citadel's affiliates account for between one and two percent of the daily dollar volume traded on both the New York and Tokyo Stock Exchanges, and more than 10% of daily U.S. listed equity options contract volume.

2 Joint Industry Plan: Order Approving Options Intermarket Linkage Plan Submitted by the American Stock Exchange LLC, Chicago Board Options Exchange, Inc., and International Securities Exchange LLC, Securities Exchange Act Release No. 43086 (July 28, 2000), 65 Fed. Reg. 48023 (Aug. 4, 2000) (the "Linkage Plan" or "Plan").

3 Specifically, pursuant to Rule 192 of the SEC Rules of Practice, 17 CFR 201.192, Citadel petitions the Commission to institute a rulemaking proceeding to amend the Plan's trade-through rule to synchronize it with the trade-through rule set forth in proposed Regulation NMS. See Securities Exchange Act Release No. 50870 (Dec. 16, 2004), 69 Fed. Reg. 77424 (Dec. 27, 2004) ("Reproposal"). The Commission has the authority to amend the Plan under Section 11A(a)(3)(B) of the Securities and Exchange Act of 1934 ("Exchange Act") and Rule 11Aa3-2 thereunder. Correspondingly, Citadel petitions the Commission to order the American Stock Exchange ("AMEX"), the Boston Stock Exchange ("BOX"), the Chicago Board Options Exchange ("CBOE"), the International Securities Exchange ("ISE"), the Pacific Exchange ("PCX"), and the Philadelphia Stock Exchange ("PHLX") and any other future Plan participants (collectively, "Plan Participants") to amend their respective rules to conform to these Plan amendments. The Commission has authority to issue an order requiring the SROs to conform their rules to the proposed Plan amendments under Section 19(c) of the Exchange Act. Alternatively, the Commission could extend Regulation NMS to the options markets.

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I. Executive Summary

The existing trade-through rule governing the listed equity markets fails to recognize the distinction between manual and automated quotations. The Commission and market participants have concluded this failure to distinguish between types of quotes substantially impairs the quality and effectiveness of the national market system for equities. As a result, the Commission has proposed Regulation NMS, which seeks to address the inherent limitations of the current trade-through rule as it relates to manual equity markets.

The arguments in favor of revising and updating the trade-through rule in the options markets are even more compelling than in the equities markets. Although the trade-through rule causes similar problems in both markets, the effects are amplified in the options markets. First, because options are derivatives, there is a greater need for automated order handling in the options markets to enable rapid reaction to price movements in underlying equities. Second, the absence of "upstairs" trading of listed options prevents brokers from insulating their customers from the delays and uncertainty of manual order handling. Citadel thus urges the Commission to recognize this regulatory gap in the options markets and to address the issue with all due speed.

Specifically, the Commission should limit trade-through protection in the options markets to automated quotations, leaving manual quotations unprotected. The Commission should do so by revising the trade-through provisions of the Options Linkage Plan in a manner consistent with proposed Regulation NMS, and order the Plan Participants to revise their rules accordingly.[4]

In addition to this long-term solution, the Commission should implement interim measures to immediately improve the operation of the options markets. First, the Commission should prohibit the options exchanges from discriminating against broker-dealer orders (including away market maker orders) with respect to access to the exchanges' automatic execution systems and should afford broker-dealer orders the same firm quote protection as customer orders. Second, the Commission should adopt a uniform obvious error rule that is objective, fair, and prevents exchange discrimination against orders routed from other exchanges. Third, the Commission should allow any firm that routes a linkage order to bring an arbitration claim against the receiving exchange for the exchange's failure to handle the order as required by

[4] Citadel continues to believe that the market structure issues related to the trade-through rule would be best addressed—in both the equities markets and the options markets—through the elimination of the existing trade-through rules altogether. Nevertheless, as we explained in Citadel's original comment letter regarding proposed Regulation NMS, and as Citadel will reiterate in our comment letter on the reproposal of Regulation NMS (which will be submitted to the Commission shortly), an appropriately crafted trade-through rule that limits trade-through protection to automated markets' automated quotes, would be a major improvement over current market structure. See Letter from Kenneth Griffin, President and CEO, Citadel, to Jonathan G. Katz, Secretary, Commission (July 9, 2004) ("2004 Comment Letter").

the Options Linkage Plan. Among other important benefits, these interim measures would almost entirely eliminate locked and crossed markets.

II. Trade-Through Rule Reform is Essential for the Option Markets

The Commission, Citadel, and many other market participants agree that the current application of trade-through protection to both automated and manual quotations impedes the efficient operation of the national market system.[5] The delays inherent in manual markets, through slow order handling, phantom quotes, or otherwise, impede consistent receipt of quality execution or any execution at all. Yet, the existing trade-through rules in both the equities and options markets effectively require market participants to attempt to access manual quotes, without recognizing the harm caused by this mandated uncertainty.

To address this issue in the equities markets, the Commission proposed Regulation NMS, which would revise the equities trade-through rule to permit market participants to trade through manual quotations.[6] Citadel strongly endorses this approach and recognizes the substantial and immediate benefits this would bring to the equities markets. The options markets need such a change even more. Therefore, the Commission should quickly modernize the options trade-through rule in a similar manner.

A. The Need for Trade-Through Reform is Even More Compelling in the Options Markets

The trade-through rule affects the options markets more profoundly than the equities markets for a number of reasons. First and foremost, execution time lags are even more likely to harm investors trading listed options. Because options are derivatively priced, it is critical that investors have the capability to react nearly instantaneously to price movements in the underlying securities. For example, due to the slowness and unreliability of manual market executions, options market makers are less willing to provide liquidity because they must factor in options execution time lags when considering how much liquidity to provide and at what price level. In addition, delayed or uncertain executions negatively impact hedging and arbitrage strategies involving listed options and the underlying equities or other related instruments. The effectiveness of hedging and arbitrage strategies is degraded the longer it takes to execute one leg of the hedge or arbitrage. As the Commission previously has recognized, these strategies contribute to the depth and liquidity of *both* the equity and options markets and facilitate efficient price discovery.

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5 See Original NMS Proposal at 11133-11134 and n.45 (noting that this point has been raised in various forums, including congressional hearings, trade publications and conversations with regulators); Section 1 of 2004 Comment Letter.

6 See Proposed Rule 611 of the Reproposal.

Second, on manual exchanges, compliance with the basic requirements of the Options Linkage Plan has been lax and enforcement of those requirements has been inconsistent, at best. The AMEX and its market makers and specialists consistently fail to provide the requisite firm quotes and to execute or respond to orders within required time periods, even after facing a Commission enforcement action concerning similar issues. In fact, AMEX conduct and conduct on the AMEX has undermined the options markets to such an extent that Citadel filed with the Commission a Petition for Sanctions Against the American Stock Exchange ("Petition for Sanctions") to ensure that the Commission was more fully informed about the nature and extent of the AMEX's misconduct.[7]

Third, unlike the listed equities markets, the options markets have no safety valve, such as "upstairs" trading, to address the problems caused by the current trade-through rule. In listed equities markets, broker-dealers use upstairs trading extensively to insulate customers from manual market execution delays and uncertainty, by providing customers with immediate "upstairs" execution. For example, as a result of upstairs trading, retail brokerage customers can immediately buy or sell many National Market System stocks at the National Best Bid or Offer ("NBBO"), in amounts even greater than is quoted at the NBBO. In listed options markets, however, a broker-dealer is prohibited from filling a customer order in this manner. As a result, customers bear the full brunt of listed option execution delays, uncertainty, and unfilled orders.[8]

B. The Options Markets Are Technologically Capable of the Proposed Reforms

The options markets have matured significantly in recent years. The tremendous success of the all-electronic ISE, the launch of the all-electronic BOX, and the roll-out of hybrid trading on the CBOE and PCX belie any notion that the options markets are not ready for an increased level of automation and a corresponding regulatory structure.[9] Moreover, if our proposed

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7 A copy of the Petition for Sanctions, including the First Supplement to the Petition for Sanctions Against the American Stock Exchange filed Jan. 21, 2005 ("First Supplement"), is attached as Appendix B.

8 Listed option contracts may be traded only on a national securities exchange that is an Options Clearing Corporation ("OCC") participant. See Article VI, Section 1 of the OCC By-Laws.

9 Citadel strongly supports the development of innovative new trading technologies and increased automation of the handling of orders on the floor-based exchanges. However, the benefits of such an expansion in automated execution capabilities will be significantly undermined if Plan Participants can disengage their automated execution systems or operate these systems in any manner other than the normal manner set forth in the Plan Participant's rules. The Commission should continue to be vigilant in monitoring and enforcing the floor-based exchanges' compliance with the requirements of Section IV.B.h.(i)(bb) of the Commission's September 11, 2000 Order Instituting Public Administrative Proceedings Pursuant to Section 19(h)(1) of the Act, see Securities Exchange Act Release No. 43268 (Sept. 11, 2000), Administrative Proceeding File No. 310282, and the rules that the exchanges adopted to satisfy those requirements, see AMEX Rule 933(f), PCX Rule 6.87(h) and Phlx Rule 1080(c) and (e).

reforms are adopted, any markets that conclude that they are not up to the challenge of modernization would be free to preserve their existing framework. As under Regulation NMS, markets would not be required to automate. Manual markets would, however, have to decide whether to automate, knowing that the trade-through rule would no longer prohibit market participants from avoiding interaction with manual markets.

C. These Reforms Would Further Inter-Market Consistency

The time has come for trade-through rule modernization in the listed options markets. The public policy and philosophical questions are fundamentally the same as those considered in the Commission's Regulation NMS deliberations. Applying a similar trade-through rule framework to the options and equities markets would continue the recent trend toward, and the Commission's strong desire for, regulatory consistency across markets.

In recent years, the Commission has attempted to update options market structure in a manner similar to that of the equities markets. For example, the options markets now have an intermarket linkage, a firm quote rule, a consolidated NBBO, and the inclusion of size in displayed quotes.[10] In a similar vein, the SEC recently cited equality of regulation across markets as a primary reason for its adoption of Regulation SHO[11] and its proposal of Regulation NMS.[12]

III. Improving the Trade-Through Provisions of the Options Linkage Plan

To address the market structure deficiencies described above, the Commission should repeal the existing trade-through provisions of the Options Linkage Plan and replace them with a trade-through rule similar to proposed Rule 611 of Regulation NMS. We recommend that these proposed Plan amendments take the form set forth in Appendix A.

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10 When the Commission adopted these regulations for the equities markets, it did not apply the initiatives to the options markets because the trading of standardized options was relatively new and needed time and opportunity to develop. See, e.g., Securities Exchange Act Release No. 43086 (July 28, 2000), 65 Fed. Reg. 48023 (Aug. 4, 2000).

11 Securities Exchange Act Release No. 48709 (Oct. 29, 2003), 68 Fed. Reg. 62972 (Nov. 6, 2003); Securities Exchange Act Release No. 50103 (July 28, 2004), 69 Fed. Reg. 48008 (Aug. 6, 2004). The uniform bid test is on hold until the end of the Pilot Program. See Securities Exchange Act Release No. 50104 (July 28, 2004), 69 Fed. Reg. 48032 (Aug. 6, 2004).

12 Original NMS Proposal at 11128-29.

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A. Overview

Citadel's proposed trade-through rule would take a substantially different approach than the trade-through provisions currently contained in the Options Linkage Plan.[13] Because the Plan's trade-through provisions were drafted at a time when most listed options trading took place on floor-based exchanges, the existing provisions fail to distinguish between manual and automated quotations and their disparate speeds and reliability of response. In addition, rather than prohibiting trade-throughs, the current provisions only state that Participants "should avoid" trade-throughs and provide an after-the-fact complaint procedure for aggrieved markets. Our proposed trade-through rule would address both of these structural deficiencies.

1. Protect Only Automated Quotations

First and foremost, our proposed trade-through rule would only protect automated quotations. An automated quotation would be defined as one that, among other things, is displayed and immediately accessible through automatic execution. Thus, our proposed trade-through rule would not require Participants attempt to access any manual quotations, which generally entail a slow and uncertain response.

More specifically, our proposed trade-through rule would protect only "protected bids or protected offers" (subject to the exceptions discussed in Section B). Protected bids and offers would consist of the best automated quotations, displayed by an automated Participant.

An automated quotation would be defined as a quotation displayed by a Participant that: (1) permits an incoming order to be marked as immediate-or-cancel; (2) immediately and automatically executes an order marked as immediate-or-cancel against the displayed quotation up to its full size; (3) immediately and automatically cancels any unexecuted portion of an order marked as immediate-or-cancel without routing the order elsewhere; (4) immediately and automatically transmits a response to the sender of an order marked as immediate-or-cancel indicating the action taken with respect to such order; and (5) immediately and automatically displays information that updates the displayed quotation to reflect any change to its material terms. Consequently, a quotation would not qualify as automated if there is any human intervention on the part of the receiving market or an opportunity for intentional delay in response.

An automated Participant would be defined as a Participant that (1) has implemented such systems and rules as are necessary to render it capable of displaying automated quotations; (2) identifies as manual quotations all quotations that are not automated quotations; (3) immediately identifies its quotations as manual quotations whenever it has reason to believe that

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13 See Section 8(c) of the Options Linkage Plan.

it is not capable of displaying automated quotations; (4) immediately and automatically routes orders to other automated Participants to protect better automated quotations displayed by other automated Participants, or steps up to match the better automated quotations displayed by other automated Participants;[14] and (5) has adopted reasonable standards limiting changes in the automated or manual status of its quotations, including specifically defined circumstances that promote fair and efficient access to its automated quotations and are consistent with the maintenance of fair and orderly markets.

2. Make the Rule Easier to Enforce

In addition, Citadel's proposed trade-through rule would incorporate an approach to trade-throughs that is stricter and more comprehensive than the current Plan provisions. First, our proposal would require Participants to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent trade-throughs, or, if relying on one of the proposed rule's exceptions, that are reasonably designed to assure compliance with the exception. To assure compliance, such policies and procedures would need to incorporate objective standards that are coded into a Participant's automated systems. Moreover, a Participant would be required to regularly surveil to ascertain the effectiveness of its policies and procedures and to take prompt action to remedy deficiencies. In this way, our proposed trade-through rule would eliminate the inadequate and loose standard for enforcement currently applied through the Plan.

B. Exceptions to Trade-Through Liability

Any trade-through rule must be implemented in a manner that is efficient and workable. To achieve this goal, Citadel's proposed trade-through rule would include certain exceptions that are intended to address potential practical difficulties, including flickering quotes and system malfunctions.[15] These exceptions generally would limit the application of Citadel's proposed trade-through rule to quotations that are truly accessible.

1. Flickering Quotations

The first of these exceptions involves flickering quotations. A Participant's best displayed quotation often can change multiple times in a single second. These rapid price changes can create the impression that a quotation was traded through, when in fact the trade was

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[14] This automated routing or step up requirement is an addition to the language of proposed Regulation NMS. As will be discussed in greater detail in Citadel's forthcoming comment letter about Regulation NMS, Citadel believes that this requirement is an important additional characteristic of automated markets.

[15] See Proposed Sections 8(c)(iii) of the Options Linkage Plan. In addition, the proposed trade-through rule would provide exceptions for openings and reopenings and crossed markets.

effected nearly simultaneously with the display of the quotation. To address this problem of flickering quotations, the Commission should allow a one-second "window" prior to a transaction for Participants to evaluate the quotations at another Participant.[16] Participants would be entitled to trade at any price equal to or better than the least aggressive best bid or best offer, as applicable, displayed by the other Participant during that one-second window.

2. Self-Help Exception

In addition, Citadel's proposed trade-through rule would provide an exception for the quotations of Participants experiencing a material delay in providing a response to incoming orders due to a failure, material delay, or systems or equipment malfunction.[17] This exception addresses concerns that Participants should not be dependent on the willingness and capacity of other markets and market makers to meet, and the Commission's and markets' ability to enforce, these automation requirements. Our proposed trade-through rule, therefore, would provide a "self-help" remedy that would allow Participants to bypass the quotations of a Participant that fails to meet the immediate response requirement. This would address some of the significant problems with the current trade-through rule, as discussed above.

IV. Stopgap Measures

Despite the tremendous recent growth and improvements in the options markets, these markets are reaching only a fraction of their potential. One of the principal constraints preventing the options markets from reaching their true potential is the Options Linkage Plan's trade-through rule. Citadel recognizes, however, that even with the Commission's most diligent efforts to move quickly, options market trade-through rule modernization will take time to adopt and implement. Therefore, the Commission should implement the following incremental steps, which could be quickly achieved and would provide immediate and necessary improvements.

A. Prohibit Discrimination Among Orders

Options market makers are prevented from providing greater liquidity to the extent that manual markets and manual market makers intentionally delay handling market maker orders or decline to honor posted quotes. For example, certain exchanges continue to place restrictions on access to their automatic execution ("auto-ex") systems for broker-dealer orders, especially market maker orders. Moreover, current rules offer very limited firm quote protection to broker-dealer orders. By manually handling market maker orders, and failing to honor quotes, floor-based market makers have the ability unilaterally to expropriate free options from electronic market makers—that is, an option to execute orders based on market movements that occur

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16 See Proposed Section 8(c)(iii)(F) of the Options Linkage Plan.

17 See Proposed Section 8(c)(iii)(A) of the Options Linkage Plan.

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while a floor-based market maker sits on an order. The Commission should quickly address this issue by prohibiting options exchanges from discriminating with respect to their auto-ex systems and by affording broker-dealer orders the same firm quote protection as customer orders. These basic steps would go a long way towards eliminating the chronic problem of locked and crossed markets created by the existing framework as a result of phantom quotes and execution delays.

1. Equal Access to Auto-Ex Systems

Citadel urges the Commission to amend the options exchanges' rules regarding access to their auto-ex systems to the extent that those rules discriminate between customer orders and broker-dealer orders. Despite recent strides in this area, certain exchanges still restrict their auto-ex functionality for orders for the accounts of broker-dealers generally or for the accounts of market makers in particular.[18] Depending on the exchange and the options class, broker-dealer orders may be guaranteed an execution for fewer contracts than customer orders,[19] may not be able to interact automatically with limit orders on the limit order book,[20] or may not be eligible for automatic step-up or price improvement features.[21] There policies may result in more orders being "kicked out" to the floor for manual handling. Market maker orders may be subject to additional limitations, such as speed bumps prohibiting the entry of multiple orders with a particular time period (*e.g.*, 15 seconds).[22] There is no reason why these disparities should continue to exist.

By way of background, several years ago, the options exchanges made changes to their auto-ex systems to allow for automatic execution of larger numbers of contracts for customer trades.[23] The exchanges made these changes in response to an evolving options market structure,

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18 Historically, these rules have stated that broker-dealer orders are not eligible for automatic execution, unless the exchange's floor procedure committee or similar body determines on a class-by-class basis to allow such orders to be executed automatically. See e.g., AMEX Rule 933; CBOE Rule 6.8.

19 See, e.g., AMEX Rule 933-ANTE (c)(1).

20 See, e.g., CBOE Rule 6.8 Interpretation .01(b)(1) (for those classes on RAES that have not been designated by the appropriate floor procedure committee as eligible to participate in a pilot program allowing broker-dealer orders to automatically execute against the book).

21 See, e.g., AMEX Rule 933- ANTE (c)(2).

22 See, e.g., CBOE Rule 6.13(b)(i)(c)(iii)

23 See Exchange Act Release No. 49175 (Feb. 3, 2004), 69 Fed. Reg. 6124-01 (Feb. 9, 2004). For example, when CBOE began allowing automated executions of up to 500 contracts in QQQ options, AMEX immediately matched its proposal and the ISE soon announced that it would guarantee a size up to 2,000 contracts in the two near-term expiration months, and up to 1,000 for all other expirations. Amex soon matched ISE's advance; and Phlx and PCX followed suit shortly thereafter.

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advances in technology, and increased competition among the markets. Around the same time, the exchanges began to allow broker-dealer orders (other than market maker orders) to be executed through their auto-ex systems, albeit in a limited fashion.[24] These changes were met with approval by the Commission. Specifically, the Commission noted that increased access to auto-ex systems would "improve the efficiency with which orders for the accounts of broker-dealers are executed" and "by providing prompt execution for broker-dealer orders, [which] also may help attract broker-dealer options orders to the Exchange, and thus help improve the depth and liquidity of the Exchange's options market."[25]

It has been four years since the exchanges began permitting broker-dealer orders to be executed through their auto-ex systems, subject to a number of significant limitations. The options markets are now sufficiently mature and technologically advanced to allow all broker-dealers—including away market makers, whether they are routing orders through the linkage or directly to another exchange—to have equal access to the exchanges' auto-ex systems. Therefore, it is now time to remove the remaining impediments to such unfettered access. This change would have immediate practical benefits, ranging from a reduction of locked and crossed markets to the creation of a more precise order handling audit trail.

2. Equal Protection Under the Firm Quote Rule

Citadel also petitions the Commission to amend the provisions of the Commission's firm quote rule governing transactions in listed options.[26] In particular, the Commission should amend Rule 11Ac1-1(d) under the Exchange Act to require that size be displayed with all disseminated listed options quotes and that displayed quotes be firm for all orders. Although the rule requires that listed options quotes be firm for customer orders, the rule does not require that quotes be firm for broker-dealer orders for more than one contract.[27] This makes it impossible for a broker-dealer (including an away market maker) to determine whether a quote is firm or

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[24] See Securities Exchange Act Release No. 46598 (Oct. 3, 2002), 67 Fed. Reg. 63478 (Oct. 10, 2002); Securities Exchange Act Release No. 45758 (April 15, 2002), 67 Fed. Reg. 19610 (April 22, 2002); Securities Exchange Act Release No. 46479 (Sept. 10, 2002), 67 Fed. Reg. 58654 (Sept. 17, 2002); Securities Exchange Act Release No. 45032 (Nov. 6, 2001), 66 Fed. Reg. 57145 (Nov. 14, 2001).

[25] Securities Exchange Act Release No. 46479 (Sept. 10, 2002), 67 Fed. Reg. 58654 (Sept. 17, 2002). In approving a similar PCX proposal, the Commission found that the use of auto-ex systems by broker-dealers was consistent with the Exchange Act in that it was designed to promote just and equitable principles of trade, to remove impediments and to perfect the mechanism of a free and open market and a national market system, and in general, to protect investors and the public interest." See Exchange Act Release No. 45032 (Nov. 6, 2001), 66 Fed. Reg. 57145 (Nov. 14, 2001).

[26] Exchange Act Rule 11Ac1-1(d), 17 CFR 240.11Ac1-1(d).

[27] Id. The Linkage Plan further requires that quotes be firm for up to 10 contracts with respect to broker-dealer linkage orders.

ephemeral, or to obtain reliable executions, because the displayed size may not be firm for its orders. This harms the market as a whole by diminishing transparency and liquidity.

Firm quotes have provided tremendous benefits to investors in both the equities and options markets. The existence of a uniform quote requirement in the equities markets has lead to tighter spreads, aggressive price discovery, and true market transparency. Uniform firm quotes have also been extremely well received on the ISE and are one of the primary reasons recognized by observers for the ISE's resounding success. One of the most common arguments against requiring firm quotes in options markets for all market participants has historically been that "professional traders" will put market makers out of business if market makers are required to execute professional orders at quoted prices. The ISE's experience proves, however, that a universally applied firm quote rule can be successfully applied to the options markets.

B. Adopt a Uniform Obvious Error Rule

Today, not only do options market participants have to endure and attempt to access manual market phantom quotes, they have to endure phantom executions. Options orders frequently are busted by certain manual exchanges hours after execution (and sometimes even the next trading day) based on vague or non-existent standards, and the decisions to bust are made by people with an incentive to favor the "home team." These delayed busts are particularly harmful because they often retroactively expose market participants to the full market risks represented by their suddenly and unexpectedly naked hedges. This type of manual market misconduct is discussed in greater detail in the Petition for Sanctions.[28]

To remedy this type of misconduct, promote market integrity, and ensure a consistent approach across the exchanges, the Commission should adopt a uniform options obvious error rule that is objective, fair, and prevents discrimination against orders routed from other exchanges. Citadel proposes an "obvious error" standard for busts, similar to the standard successfully employed by certain exchanges.[29]

Under Citadel's proposal, Plan Participants would be permitted to bust a transaction or adjust the execution price of a transaction *only* if it is a result of an "obvious error." An "obvious error" would be deemed to have occurred *only* when the execution price of a transaction meets a

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28 See pp. 12-17 and Exhibits D, G, H, I, J, K, L of the Petition for Sanctions and Section I of the First Supplement.

29 See ISE Rule 720; BOX Rules Ch. 5, Sec. 20, PCX Rule 6.87(g); Phlx Rule 1092. Correspondingly, Citadel petitions the Commission to revoke any existing exchange rule that is inconsistent with this objective standard.

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pre-determined objective price standard.[30] A determination of whether an "obvious error" has occurred would have to be made pursuant to specific procedures and time limits set forth in the rule. Under our proposal, if a market maker believes that it has participated in a transaction that was the result of an obvious error, it must notify the Exchange's market control center or similar body within five (5) minutes of execution. If an order entry firm believes that it has experienced an obvious error, it must report to market control within twenty (20) minutes of the execution. Market control would not grant relief unless notification is made within the prescribed time period. If market control determines that a transaction was the result of an "obvious error," the trade would be adjusted to the next best bid or offer at the time of the trade, unless the *both* parties agree otherwise. The parties may request a review of market control's decision by an obvious error panel, which *must* render a decision on the same day as the transaction, or the next day if the request is made after 3:30 p.m. Eastern Time.[31]

C. Allow Arbitration Claims for Exchange Mishandling of Linkage Orders

As detailed in Citadel's Petition for Sanctions, failures to comply with the Options Linkage Plan are common occurrences. Options market makers who route linkage orders (which is often effectively *required* by the current trade-through rule) have little recourse for such violations. Currently, the Plan provides no method for settling disputes that arise between Plan Participants and market participants who use the linkage. This failure to provide a forum for market participants to air grievances *in a neutral forum* and hold Plan Participants accountable is especially troubling because the Commission affords Plan Participants tremendous power and leeway in implementing and enforcing the Plan. As a result, market participants currently are limited to contacting the Commission about violations and asking the Commission to consider addressing violations through rulemaking or an enforcement action against the relevant Plan Participant. Such an approach, even if it is eventually successful, does not remedy any issues with regard to particular trades.

To address these inequities, the Commission should allow any firm that routes a linkage order to bring an arbitration claim against the receiving exchange for failing to handle the order as required by the Linkage Plan. Such an approach would not only address the particular wrong,

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30 The execution price must be higher or lower than a pre-determined Theoretical Price for the series by a specified amount. For example, under ISE Rule 720, if the Theoretical Price for a series is below $2.00, and the execution price is at least $.25 higher or lower than $2.00, an obvious error is deemed to have occurred. Similarly, if the Theoretical Price for a series is $20.00, and the execution price is at least $1.00 higher or lower than $20.00, an obvious error is deemed to have occurred.

31 All determinations made by the Exchange, market control or the obvious error panel shall be rendered without prejudice as to the rights of the parties to the transaction to submit a dispute to arbitration. See e.g., ISE Rule 720.04. See also, section IV(C) below regarding arbitration of Option Linkage Plan disputes.

but would help to encourage the Plan Participants' compliance with the Options Linkage Plan on an ongoing basis.

V. Conclusion

The Commission has broad authority to address the serious problems facing the options markets as a result of an obsolete Options Intermarket Linkage Plan. The Commission has decided to address similar problems in the equities markets. It is now time to bring parity to the two markets by applying these same solutions to the options markets. Citadel urges the Commission to take swift action to remedy these problems by amending the Options Linkage Plan to permit trade-throughs of manual quotes and to order Plan Participants to amend their rules accordingly. A failure to address these serious issues will have significant negative ramifications for investors and our national market system.

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We appreciate the opportunity the Commission provides to participate in the critically important debate regarding options market structure. If we can answer any questions or provide further insights, Citadel would be delighted to discuss these issues further.

Sincerely,

Adam Cooper /jcn

Adam Cooper/jcn
Senior Managing Director and
General Counsel

cc: Chairman William H. Donaldson
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid
Annette L. Nazareth, Director, Division of Market Regulation
Robert L.D. Colby, Deputy Director, Division of Market Regulation
Elizabeth K. King, Associate Director, Division of Market Regulation

Enclosures

4-496

Appendix A

Deletions are [bracketed], and additions are **underlined and in bold**.

* * * * *

Plan for the Purpose of Creating and Operating an Intermarket Option Linkage

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Section 2 - Definitions

1) - No change.

2) "Automated Quotation" means a quotation displayed by a Participant that:

(a) Permits an incoming order to be marked as immediate-or-cancel;

(b) Immediately and automatically executes an order marked as immediate-or-cancel against the displayed quotation up to its full size;

(c) Immediately and automatically cancels any unexecuted portion of an order marked as immediate-or-cancel without routing the order elsewhere;

(d) Immediately and automatically transmits a response to the sender of an order marked as immediate-or-cancel indicating the action taken with respect to such order; and

(e) Immediately and automatically displays information that updates the displayed quotation to reflect any change to its material terms.

3) "Automated Participant" means a Participant that:

(a) Has implemented such systems and rules as are necessary to render it capable of displaying quotations that meet the requirements for an Automated Quotations set forth in paragraph 2 of this Section.

(b) Identifies all quotations other than Automated Quotations as Manual Quotations.

(c) Immediately identifies its quotations as Manual Quotations whenever it has reason to believe that it is not capable of displaying Automated Quotations

(d) Has adopted reasonable standards limiting when its quotations change from Automated Quotations to Manual Quotations, and vice versa, to specifically defined circumstances that promote fair and efficient access to its Automated Quotations and are consistent with the maintenance of fair and orderly markets; and

(e) Immediately and automatically routes orders to other Automated Participants to protect better Automated Quotations displayed by the other Automated Participants; or steps up to match the better Automated Quotations displayed by other Automated Participants.

[2) - 13)] - **4) - 15)** - No change

[14) - 17)] - **16) - 19)** - No change.

20) "Manual Quotation" means any quotation other than an Automated Quotation.

[18) - 25)] - **21) - 28)** - No change.

29) "Protected Bid or Protected Offer" means a quotation in an options series of an Eligible Option Class that:

(a) Is displayed by an Automated Participant;

(b) Is disseminated pursuant to an effective national market system plan ; and

(c) Is an Automated Quotation that is the best bid or best offer of a Participant.

30) "Protected Quotation" means a Protected Bid or Offer.

[26) - 28)] - **31) - 33)** - No change

[29)] **34)** "Trade-Through" means a transaction in an options series **of an Eligible Option Class during regular trading hours, either as principal or agent, at a price that is lower than a protected bid or higher than a protected offer** [at a price inferior to the NBBO].

[30)] - **35)** - No change.

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Section 8 - Participants' Implementation Obligations

(a) - (b) - No change

(c) Order Protection

The Participants agree that[, absent reasonable justification and during normal market hours,] members in their markets should not effect Trade-Throughs. Accordingly, the Participants agree to approve and submit to the SEC for its consideration uniform rules governing Trade-Throughs that contain the following provisions:

(i) [Trade-Throughs.]

[(A)] General Provision. **A Participant shall establish, maintain and enforce written policies and procedures that are reasonably designed to prevent Trade-Throughs of Protected Quotations in any options series of an Eligible Option Class that do not fall within an exception set forth in paragraph (iii) below and, if relying on such an exception, that are reasonably designed to assure compliance with the terms of the exception.** [When purchasing or selling, either as principal or agent, any options series of an Eligible Option Class, or when sending a Linkage Order, members of a Participant should avoid initiating a Trade-Through unless one or more of the provisions of paragraph (iii) are applicable.]

(ii) [(B] Surveillance. **A Participant shall regularly surveil to ascertain the effectiveness of the policies and procedures required by paragraph (i) above and shall take prompt action to remedy deficiencies in such policies and procedures.**[Each Participant shall establish procedures to conduct surveillance of their markets to identify trades executed at prices inferior to the NBBO and shall maintain records identifying Trade-Throughs and the actions taken by such Participant in response to Trade-Throughs.]

[(C) Disciplinary Action. The uniform rules shall provide that it will be a violation of a Participant's rules for a member to engage in a pattern or practice of trading through bids and offers that are entitled to be satisfied pursuant to paragraph (ii)(B) below (whether or not Satisfaction Orders with respect to such Trade-Throughs are received from members of other Participants whose bids or offers were traded through ("aggrieved parties") unless one or more of the provisions of paragraph (iii) below are applicable, provided however, that a Block Trade executed at a price inferior to the NBBO shall not be considered a Trade-Through for the purpose of this paragraph if the member initiating the trade satisfied all aggrieved parties pursuant to paragraph (ii)(B) below following the execution of the Block Trade.]

(iii) Exceptions.

(A) The transaction that constituted the Trade-Through was effected when the Participant displaying the Protected Quotation that was traded-through was experiencing a failure, material delay, or malfunction of its systems or equipment when the Trade-Through occurred.

(B) The transaction that constituted the Trade-Through was a single-priced, opening, reopening, or closing transaction by the Participant .

(C) The transaction that constituted the Trade-Through was executed at a time when a Protected Bid was priced higher than a Protected Offer in that options series.

(E) The Participant displaying the Protected Quotation that was traded through had displayed, within one second prior to execution of the transaction that constituted the Trade-Through, a best bid or best offer, as applicable, for the option series with a price that was equal or inferior to the price of the Trade-Through transaction.

(ii) Satisfaction of Trade-Throughs - deleted.

(iii) Exceptions to Trade-Through Liability - deleted

(iv) Responsibilities and Rights Following Receipt of Satisfaction Orders - deleted