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September 30, 2004

VIA E-MAIL

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: File Number SR-Amex 2004-75

Dear Mr. Katz:

Citadel Derivatives Group LLC ("Citadel")[1] is submitting this letter in response to the American Stock Exchange's ("AMEX") proposed rule amendment related to File Number SR-Amex-2004-75 (the "Proposed Rule") relative to the AMEX's proposed amendments to AMEX Rule 154 ("Orders Left with Specialist"). Citadel strongly supports the adoption of the Proposed Rule, but with certain modifications specified below.

The genesis of the Proposed Rule was the recently-announced plan of Susquehanna Investment Group ("Susquehanna"), in its capacity as an ETF specialist on the AMEX and a listed option specialist/designated primary market maker ("DPM") on the AMEX, PHLX and CBOE, to impose certain unlawful, anti-competitive and inappropriate "commissions" or charges on ETF/listed option transactions executed by Susquehanna as principal in its capacity as a specialist and DPM. Citadel opposes Susquehanna's plan, and supports the Proposed Rule (with suggested significant modifications), for the reasons set forth below.

The Privileged Status and Role of DPMs and Specialists

DPMs and specialists play critical, structural, monopolistic (or semi-monopolistic) roles in the securities markets. No one is forced to be a DPM or specialist. Rather, they are coveted positions granted by the exchanges that give the specialists and DPMs a greater percentage of order flow than anyone else in the market place. In exchange for this privilege, DPMs and specialists also assume obligations associated with assuring that orderly markets are made in the securities that they oversee, including that customer (and other) orders are properly handled.

Customers generally have little or no say regarding the exchange to which their orders are routed and (except at the BOX) they and the broker-dealers representing their orders have no say regarding

[1] Citadel is a Primary and Competitive Market Maker on the International Securities Exchange, an e-DPM on the Chicago Board Options Exchange ("CBOE"), a market maker on the Boston Options Exchange ("BOX"), and a member of the Philadelphia Exchange ("PHLX"), the Pacific Exchange and the AMEX.

which specialist or DPM at the exchange interacts with their orders. Rather, orders for particular options or ETFs are routed to an exchange-designated post or bin, where any market maker or specialist at the best price at that post or bin will have the opportunity to trade against it. In each instance, the specialist or DPM is given priority such that if the specialist or DPM is at the best price, it will receive a higher percentage of transactions than other market makers at the post or in the bin.

Generally speaking, exchange specialists and market makers execute orders as principal and earn compensation for their services through the spread (or difference) between the posted prices at which they stand ready to buy and sell; they do not receive compensation through execution or access fees. Thus, the cost of execution is transparent—it is identical to the posted best bid and ask. But by a letter dated August 23, 2004, Susquehanna announced its intention to impose substantial charges in connection with listed option and ETF orders executed by Susquehanna as principal in its monopolistic capacity as a specialist or DPM, and to charge fees for cancelled and expired option and ETF orders. Such charges would not be incorporated into Susquehanna's disseminated quotations and would not be known to the customer until after execution. Therefore, far from being transparent, they would be hidden charges one would learn of only after the fact, transforming best execution into bad execution.

Under Susquehanna's plan it would impose the following charges:

- $1.00 per contract for option order executions;
- $1.00 per one hundred shares for ETF order executions;
- $0.16 per contract for option order cancellations if a firm's cancellations in that option name (regardless of class) for that trading day exceed 15;
- $0.16 per hundred shares for ETF order cancellations if a firm's cancellations in that ETF for that trading day exceed 15; and
- $0.16 per contract (for options) or per one hundred shares (for ETFs) for the expiration/automatic cancellation of unexecuted orders.[2]

Fees such as Susquehanna's Are Unlawful and Bad for Customers

Regardless of the self-serving terminology used by Susquehanna in its proposal, the foregoing charges constitute unlawful access fees that are unjustifiable for a variety of reasons, including those described below. We understand that the status of Susquehanna's proposed fees is uncertain. But analyzing the fees is instructive without regard to what Susquehanna ultimately decides it will charge because they highlight significant problems that can arise with every specialist in the market and shed light on the merits of the proposed rule change.

[2] The maximum monthly charge Susquehanna says it will impose on any firm with respect to ETF (only) order cancellations and expirations (combined) on any single exchange is $75,000. There is no maximum limit with respect to order execution charges or to option order cancellation/expiration charges.

1. The Charges Are Unlawful Absent Rule Making

First, charging an execution fee for orders sent over exchange routing systems and executed by exchange auto-execution systems requires a rule filing by the exchange with the SEC under Section 19(b)(1) of the Securities Exchange Act of 1934, as amended. To permit a specialist to set and impose execution fees would constitute an impermissible end run around the rule-filing requirement and should not be permitted by any exchange.[3]

While the SEC has indicated that in certain circumstances properly disclosed, reasonably tailored order handling fees may be appropriate, the focus of such comments has been in circumstances such as Nasdaq market making where there is no monopolistic control over who makes a market and where the customer and other market participants have meaningful choice regarding which market maker will receive, handle and execute their orders. See, e.g., Order Execution Obligations, Rel. No. 34-37619A (Sept. 6, 1996), text accompanying n. 124. Indeed, the SEC's comments are predicated on the notion that "[t]he level of these fees, of course, would be determined by competitive forces in the marketplace." Id. at n. 126. But those competitive forces do not exist here.

Rather, competition in this situation will not affect the size or existence of the fees, and an option specialist's fee disclosure is essentially meaningless in terms of informed choice. That is due to the monopolistic structure of the options markets and the fact that one will never know until after the fact whether the specialist was involved in the transaction and therefore whether a fee was incurred. There simply is no "But Not Susquehanna" box to check when submitting or routing an option order. Moreover, as discussed further below, Linkage and best execution obligations compel that orders be routed to a particular exchange that appears to be at the NBBO, whether or not hidden fees will apply.

2. The Charges Are Contrary to the Principles Articulated in the SEC's Proposed Regulation NMS

Second, option specialist fees runs counter to the SEC's philosophy underlying proposed Regulation NMS, which is designed to enhance and modernize the regulatory structure of U.S. equity markets to provide for freely accessible, transparent quotes. One of the four substantive proposals incorporated in Regulation NMS is a market access rule that effectively eliminates the ability of electronic communications networks, or ECNs, to charge access fees of the sort contemplated by Susquehanna. As explained by the SEC:

> Guided by little more than the fiduciary duty of best execution, a broker must seek the most favorable terms for a customer's transaction reasonably available under the circumstances. And yet if a customer's order cannot be routed to the market with the

[3] Execution fees/transaction fees imposed by the exchanges but administered/collected by specialists invariably are the subject of rule submissions by the exchanges to the SEC.

> best price, a broker may not be able to fulfill the duty of best execution that it owes to its customer.

(Proposed Rule: Regulation NMS, SEC Release No. 34-49325 at § IV.A.) Option specialist charges would make it virtually impossible for a market participant to determine the most favorable terms available for a customer order and, therefore, render the firm largely incapable of satisfying its best execution obligation. In particular, specialist quotes would have virtually no meaning if each specialist on each exchange in each product were allowed to unilaterally set and charge fees of this nature. For this very reason, according to the SEC:

> ***[M]arket makers must trade at their displayed quotes without imposing access fees.***

> (Id. at § IV.A.3 (emphasis added).)

With the imposition of the proposed specialist charges, broker-dealers will be unable to determine whether a given quote is the real price or if option specialist access fees will apply; consequently, broker-dealers will be unable to determine if the price will be disadvantageous once the order is actually executed. In fact, even if it were known that an option specialist that charged fees was the specialist behind a quote, the broker-dealer still would not know the real price because there would be no way to know how much of a given order would be traded against the specialist versus other members of the trading crowd. Nor would one know if the order would be timely-handled or whether it would be ignored and therefore expire or require cancellation.[4] Therefore, allowing specialists to impose such charges, whether labeled access fees, execution charges, commissions or otherwise, would make it virtually impossible for broker-dealers to determine with any reasonable certainty the extent to which a published quotation is an accurate indication of the actual price and would thereby render the broker-dealer's attempt to satisfy its best execution obligation as no more than guess work. It would also reward them for ignoring orders.

The proposal to charge a "commission" on orders executed in a specialist's option classes also will have a significant adverse impact on a specialist's obligation to route orders to other exchanges through Linkage. A specialist may send an order over Linkage in one of two capacities: as agent (a "P/A" order) or as principal (a "P" order). P/A orders are sent by a specialist when the specialist has received a customer order and the disseminated market at an away exchange is better than the specialist's disseminated market (*i.e.*, when the away exchange is quoting the national best bid or offer, or "NBBO"). Also, a specialist must send a P order to an away exchange if the specialist's disseminated market has created a "locked" or "crossed" market in the NBBO. A specialist may also send a P order over linkage to obtain the best price for a customer. If specialists are permitted to charge fees, however, it will be impossible to determine if a disseminated market

[4] Charging cancellation and expiration fees is particularly egregious because one of the most common reasons for cancellations and expirations – particularly for Linkage orders – is that the market makers who should be promptly executing orders instead ignore them, treating their own quotations as mere invitations to bid rather than honoring them as firm quotes or fading them.

away is truly reflective of the NBBO because an additional access fee may be added to the price. Consequently, the specialist's use of Linkage will be frustrated and the purposes behind the Linkage Plan will be frustrated. As a matter of federal regulatory interpretation, therefore, Susquehanna's proposed fees violate the Linkage Plan and should be prohibited.

3. The Charges Would Violate the Firm Quote Rule

Specialist charges also would violate the clear mandate of the SEC's Firm Quote Rule, which requires "responsible brokers and dealers" (as defined), to execute orders "*at a price at least as favorable to such buyer or seller as the bid price or offer price comprising such responsible broker's or dealer's published bid or published offer … in any amount up to its published quotation size*." (SEC Rule 11Ac1-1(c)(2) (emphasis added).) Simply put, this provision requires specialists to honor their published quotations, at least where customer orders are at issue, and certainly prohibits them from charging anyone more than their published quotations. As explained by the SEC, the Rule "prohibits non-ECN broker-dealers from charging an access fee in addition to their posted quotation." (Proposed Rule: Regulation NMS, SEC Release No. 34-49325 at § IV.A.3(i).) By charging a fee over and above its published quotation, a specialist clearly will be violating the explicit directive of the Firm Quote Rule.

The Firm Quote Rule does allow the "responsible broker or dealer" to charge a commission. However, a commission is a fee chargeable by a market participant executing a customer order on an *agency* basis. That is, for example, if a customer reaches out to a particular broker and asks that broker to handle an order for the customer, then a commission may be charged. But in that circumstance, the customer has free choice as to who it will use as its broker and is not a captive of a monopolist. In that regard, see the discussion of the SEC's Order Execution Obligations Release, Rel. No. 34-37619A, above. An option specialist may argue that it acts as an agent in its role as a specialist or DPM because it not only executes against orders but has certain order handling obligations, such as routing orders through Linkage where another exchange is at the NBBO. But its obligations associated with the privilege of being an exchange-appointed monopolist and the involuntary nature of a customer's relationship with the DPM distinguish these circumstances from true agency relationships in which commissions might be charged. That is, those in which a broker-dealer and its customer feely and voluntarily associate with each other and in which they may freely bargain with each other over execution costs. In addition, although Susquehanna styles its charges as "commissions," in fact they apply to transactions executed by Susquehanna as principal in its capacity as specialist or DPM, and as such are not commissions, but are access fees that are disallowed under the Firm Quote Rule.

4. Specialist Charges Likely Will Not Be Uniform

Finally, when an exchange charges a fee, it must be applied uniformly and is subject to SEC oversight and approval. Conversely, a specialist charging an access fee will have the ability and the incentive to collect the fees and then rebate them, on a discretionary and discriminatory basis, to certain preferred order flow providers. In other words, a specialist will be able to use the fee, and its ability to waive or rebate the fee in whole or in part to certain customers or with respect to certain transactions, as a means to discourage certain types of orders or certain market participants. Among other problems, this makes the market less transparent and less accessible because the same "quote" may cost one market participant more than another market participant who is able to obtain a rebate or other fee concession from a specialist acting in its exchange-sanctioned monopolist role.

The Proposed Rule

As noted above, we have reviewed the Proposed Rule and, while we are generally supportive of it as combating many of the evils of fees such as those proposed by Susquehanna, we believes that certain changes would enhance its effectiveness and prevent the imposition by specialists of anti-competitive and potentially discriminatory commissions or fees on orders that they are responsible for handling in their privileged capacity as exchange-appointed specialists. These proposed changes are as follows:

- A prohibition on any commission from being charged for orders executed automatically by exchange systems (even if executed several minutes after receipt), because such executions require no effort by the specialist and because automatic execution systems are exchange, not specialist facilities (and any fee would therefore constitute an exchange fee requiring Section 19(b) approval);

- A prohibition on any commission from being charged for linkage orders, given that these orders are required to be routed to the specialist at the receiving exchange; and

- A prohibition on any commission from being charged simply because the order is from "a competing market maker," because (unlike the other exceptions in the rule in which commissions may be charged) the commission in this case is based solely on the *status* of the sender rather than the manual effort involved in handling the order, and is clearly anti-competitive.

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For the foregoing reasons Citadel strongly encourages the approval of the Proposed Rule, with the above referenced modifications, and intends to encourage the other options exchanges to promptly propose similar rules.

Please do not hesitate to contact me at (312) 395-3167 if you have any questions or comments.

Sincerely,

/s/Matthew Hinerfeld

Matthew Hinerfeld
Managing Director and
Deputy General Counsel