

November 20, 2003

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

**Re: File No. SR-Phlx-2003-74**

Dear Mr. Katz:

In the above-referenced rule filing, the Philadelphia Stock Exchange, Inc. ("Phlx") proposes to issue a Regulatory Circular interpreting Phlx Rule 1064(d) (the "anticipatory hedging rule"). The Phlx submitted the filing for immediate effectiveness pursuant to Rule 19b-4(f)(1) under the Securities Exchange Act of 1934 (the "Act"). The International Securities Exchange, Inc. ("ISE") opposes both the substance of this filing and its submission for immediate effectiveness. We urge the Commission either to reject the filing as not properly filed or to abrogate it and, if the Phlx resubmits the proposal for regular-way processing, to institute proceedings to disapprove the proposal.

The filing states that the Phlx proposes to issue a Regulatory Circular:

setting forth its temporary interpretation of existing [Phlx] Rule 1064(d), and stating its intention not to pursue disciplinary action, relating to a practice whereby upstairs [Phlx] members hedge a customer options order together with the underlying security, then forward the customer order and hedging stock position to an on-floor broker with the instructions to represent the customer order together with the hedge position in the underlying security to the options crowd (the "Practice").

The Phlx asserts that this Practice may not involve crossing, facilitation or solicited orders and therefore may not be subject to the rule. Alternatively, the Phlx asserts that the Practice is not inherently harmful or detrimental to customers or their trading crowd.

We strongly disagree with both of these assertions. Moreover, we believe that the Commission should publish this proposal for public comment before considering whether the Phlx should be permitted to change its anticipatory hedging rule to allow the Practice.

## **Procedural Deficiencies**

All of the options exchanges have uniform anticipatory hedging rules that prohibit a member from entering orders to buy or sell the security underlying an options class prior to presenting an options order that is being crossed to the trading crowd. The Phlx discussed its proposed Practice with the other options exchanges at the June and October 2003 meetings of the Options Subgroup of the Intermarket Surveillance Group ("ISG"). At those meetings, all of the options exchanges except the Phlx agreed that the Practice is clearly prohibited by the uniform rules. Notwithstanding the objection of the ISG's Options Subgroup, the Phlx has continued to allow the Practice on its exchange.

Against this background, the Phlx filing states in the "Statutory Basis" section that the proposal furthers the objectives of Section 6(b)(5) in that it is designed to foster cooperation and coordination with persons engaged in regulating transactions in securities. In addition, the filing's "Statement on Burden on Competition" states that the proposed rule change will not "impose any inappropriate burden on competition." Neither of these statements is accurate, as the Phlx's failure to enforce its rule is causing intermarket inequities that result in regulatory forum shopping to the competitive advantage of the Phlx and its members.<sup>1</sup>

The Commission cannot allow the Phlx to substantively amend its anticipatory hedging rule by adopting a "temporary interpretation" that is contrary to the express language of the rule and labeling it a "stated policy, practice or interpretation." The Commission would effectively be allowing the Phlx to turn its failure to enforce its rule into a substantive change in the rule that results in an immediate competitive advantage over the other options exchanges that have enforced their rules as required under the Act. Any such change to the Phlx's anticipatory hedging rule must be filed with the Commission under Rule 19b-4 for full consideration of the substantive issues that are raised.

## **Substantive Issues**

Phlx Rule 1064(d) clearly requires that if a broker-dealer hedges an options position prior to presenting the order to the floor, the broker-dealer must not execute any portion of the order as a cross, facilitation or solicitation. The Phlx's proposed Regulatory Circular, however, does not say this. Rather, it says that it will not take enforcement action against a firm that hedges an option before presenting it to the crowd as long as it offers the hedge to the crowd without limiting a member's ability to facilitate or otherwise cross the order.

We believe that the purpose of this proposal is to further internalization on the Phlx to the competitive advantage of both the exchange and its large members. There is no reason to believe that a broker-dealer would effect a hedge prior to sending an order to an exchange for execution unless it involved a cross, facilitation or solicitation. In fact, we believe that in almost all cases, broker-dealers only undertake a hedge when they are facilitating orders.

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<sup>1</sup> Broker-dealers who execute orders on the other four options exchanges are placed at a competitive disadvantage when they cannot offer the same prices to their customers because they are at greater risk by virtue of their compliance with the anticipatory hedging rules.

The reality is that the Practice has developed because large broker-dealer members have an expectation that they will execute against all or a substantial portion of an options order once it reaches the Phlx floor. Therefore, the broker-dealers seek to lock-in the best possible, risk-free profit from the order as quickly as possible. The fact that the broker-dealers may then “offer the option with the stock” to the trading floor only reflects their expectation that they will be on the other side of all or a substantial portion of the order. Otherwise they would not go to the expense of executing the stock hedge. The assertion that the option may be offered to the trading crowd without the stock is inconsequential. A broker-dealer would be increasing its financial risk to undertake a proprietary stock position if there was any chance that it might be left with the stock without the corresponding option position. We do not believe a broker-dealer would undertake this additional risk unless it was reasonably sure that the crowd would not in fact take the option without the stock.

The Phlx does not even attempt to discuss the substantive issues raised by allowing broker-dealers to trade on order information that is not available to the trading crowd. Rather, it proposes to allow the conduct until it can study whether allowing the Practice is appropriate. In other words, it is seeking a safe-harbor for its members from the uniform rule applied on all of the other exchanges while it tries to find a justification for allowing the Practice on its floor. This turns the Section 19 rule filing process on its head. The Phlx must explain and justify a change to its rules before the change is approved according to the requirements of Section 19 of the Act. In the meantime, the Phlx should enforce the existing industry-wide anticipatory hedging rule by prohibit any firm that hedges a transaction before presenting it to the crowd from facilitating or otherwise crossing the order.

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We urge the Commission either to reject the filing as not properly filed pursuant to Section 19b-4(f)(1) or to abrogate it. Any such substantive change to the Phlx’s anticipatory hedging rule must be considered carefully after a full opportunity for market participants to submit their views. If you have any questions on our comments, please do not hesitate to call.

Sincerely,

Michael J. Simon  
Senior Vice President and Secretary

cc: Annette Nazareth