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Mr. Jonathan G. Katz
Secretary
United States Securities
and Exchange Commission
100 F Street, NE
Washington, DC 20549-9303

Re: File Number SR-Phlx-2005-42

Dear Mr. Katz:

Citadel Derivatives Group LLC (“Citadel Derivatives”)¹ submits this letter in response to the proposed rule amendments by the Philadelphia Stock Exchange (“Phlx”) contained in File Number SR-Phlx-2005-42 (the “Proposed Rule Amendments”). In its filing, the Phlx has indicated that it intends to amend its rules applicable to the review of Floor Official rulings regarding the nullification and adjustment of trades. We applaud the proposal to introduce a fully independent and professional appellate official into the dispute resolution process. But we do not support the automatic imposition of \$250 fines for unsuccessful but non-frivolous appeals or the elimination of the right of appeal to the Phlx’s Board of Governors. Accordingly, we believe that the Commission should not approve the Proposed Rule Amendments as submitted.

The Introduction Of A Neutral, Professional, Referee Is A Positive Development That All Floor-Based Exchanges Should Follow

The Phlx proposes to establish a neutral Referee who would be an Exchange employee or independent contractor who would, among other things, hear appeals from Floor Official rulings regarding the nullification or adjustment of trades. In our experience, the processes for adjudicating disputed trades on floor-based exchanges are sorely in need of an overhaul. The processes in place at most exchanges are strongly biased in favor of exchange insiders (often known as “locals”) and against customers, market makers from other exchanges, and even

¹ Citadel Derivatives is one of the most active listed options market makers in the United States. Citadel Derivatives is an affiliate of Citadel Investment Group, L.L.C. which, with its affiliates, operates one of the world’s largest alternative investment firms. On an average day, Citadel affiliates account for approximately 3% of the daily volume on the NYSE and Nasdaq. Citadel Derivatives is also a substantial shareholder in the Phlx.

against the floor-based exchanges' own electronic market makers. This bias begins with dispute rules that are more favorable to market makers on the exchange in question than to customers or market makers on other exchanges.² Further, while there are some well qualified officials, decisions are often made by Floor Officials and then appellate review officials who (1) have little or no training in fact finding or expertise in the applicable rules; (2) are inherently biased to protect locals because they are locals themselves; and (3) often have long-standing friendships and other close associations with the local market maker who is a party to the dispute.

In light of these problems, the Phlx's proposal to introduce a neutral Referee into the review process is a welcome one. Whether it will be successful will depend, in part, on the abilities of the people chosen as Referees, whether they are truly neutral, and the thoroughness of their training. But the underlying goal is laudable – more fair and professional reviews that result not only in better substantive decisions but also more fundamentally equitable treatment for those that are not exchange insiders. In addition, while it would be preferable to have neutral decision makers conduct the initial adjudication of trade disputes (not just the appellate review of trade disputes), the introduction of truly independent and thorough appellate Referees may also inspire Floor Officials to conduct more thorough, objective and fair initial adjudications. We urge the other floor-based exchanges to follow this model.

The Imposition of \$250 Fines for Unsuccessful But Non-Frivolous Appeals Is Not Warranted and Will Harm the Exchange's Credibility

The proposal to impose \$250 fines for unsuccessful but non-frivolous appeals is a bad idea for two reasons. First, it is fundamentally unfair. As noted above, at the Phlx and other floor-based exchanges, the initial decisions regarding trade disputes are made by Floor Officials who are not independent, well trained, professional adjudicatory officials. In addition, outsiders to an exchange generally have no ability to see into an exchange and make their own assessment of whether some exchange-specific error has occurred that might be found to justify a bust. Because of those factors, it would be fundamentally unfair to penalize people for taking non-frivolous appeals from Floor Officials' rulings.

Second, the existence of a rule that imposes \$250 fines for non-frivolous but unsuccessful appeals will harm the credibility of the Phlx with customers and market makers on other exchanges. Given the factors outlined above, the rule would be a clear signal to exchange outsiders that the deck is stacked against them.

² For example, on both the Chicago Board Options Exchange ("CBOE") and the AMEX, the rules permit market makers on the Exchange to get the Exchange to bust trades done with outsiders (customers and market makers from other exchanges) but if those very same trades had been done with another market maker from that Exchange they could not be busted absent the agreement of both parties to the trade. CBOE Rule 6.25; AMEX Rule 936(a). The comparable Phlx rule does not contain such an explicit asymmetry, but it permits trades to be busted absent mutual agreement of the parties, thereby permitting Phlx market makers to obtain busts even when adjustments would be more equitable to blameless counterparties. Phlx Rule 1092(c).

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The Right Of Appeal to the Phlx's Board of Governors Should Be Retained

We also think it unwise to eliminate the right of appeal to the Phlx's Board of Governors. It is true that the importance of the Board's role in the review of any specific ruling may be diminished by an independent Referee providing appellate review. But that will ultimately depend upon the independence, knowledge and judgment of the people who are chosen to be Referees over time – there can be no guarantee that they will always meet the high standards the Phlx will hope to achieve. Thus, the ability to appeal to the Board of Governors remains an important safeguard and an incentive for the Referee to rule fairly. Moreover, the ability to appeal to the highest authority at the Exchange emphasizes the seriousness with which the Exchange takes trade disputes – a matter of significance for customers and market makers on other exchanges to maintain confidence in the exchange. In addition, the opportunity to review provides the Board with a unique window into the nature of the trading problems occurring on the Exchange and therefore better equips the Board to address potentially systemic problems early on. The significance of this check and balance should not be underestimated.

For the foregoing reasons, we urge the Commission to reject Proposed Rule Amendments as presently drafted and we urge the Phlx to resubmit a more limited proposal that establishes an independent Referee but does not impose fines for non-frivolous unsuccessful appeals or eliminate the Board of Governors from the appeals process.

Thank you for your consideration.

Sincerely,

Matthew Hinerfeld
Managing Director and
Deputy General Counsel
Citadel Investment Group, L.L.C.
On behalf of Citadel Derivatives Group LLC