CITADEL

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November 28, 2005

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

Re: File Number SR-Amex-2005-060

Dear Mr. Katz:

Citadel Derivatives Group LLC ("Citadel Derivatives")[1] submits this letter in response to the proposed rule amendments by the American Stock Exchange ("AMEX") contained in File Number SR-Amex-2005-060 (the "Proposed Rule Amendments"). In its filing, the AMEX has indicated that it intends to amend its rules applicable to the cancellation and adjustment of equity option and index option transactions, commonly referred to as the AMEX's "Obvious Error rules."[2] We suggest rather a radical revision of the AMEX's Obvious Error rules to promote

[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.

[2] Specifically, AMEX intends to amend AMEX Rule 936 – *Cancellation and Adjustment of Equity Options Transactions*, AMEX Rule 936C – *Cancellation and Adjustment of Index Option Transactions*, AMEX Rule 936 – ANTE – *Cancellation and Adjustment of Equity Options Transactions* and AMEX Rule 936C – ANTE – *Cancellation and Adjustment of Index Option Transactions* as follows:

- The AMEX has proposed to amend the Obvious Error rules to revise the manner in which an obvious price error is determined for both equity and index options.

fundamental fairness for investors and to make the AMEX less of a disruption to the efficient operation of the U.S. options markets.

While we object to certain of the rule changes proposed by the AMEX,[3] our dominant observation is that the proposals ignore more significant problems with the AMEX's Obvious Error Rules and practices. Citadel Derivatives addressed these issues in a comment letter dated March 23, 2005, a copy of which is set forth below as Exhibit A, and therefore we only summarize here certain of the key problems so that we may suggest solutions.

- The AMEX has proposed to clarify the determination of "Fair Market Value" in connection with the index option Obvious Error rules.

- The AMEX has proposed to amend the Obvious Error rules relating to an erroneous quote in the underlying security.

- The AMEX has proposed to amend the Obvious Error rules to permit transactions executed outside of trading hours to be cancelled.

- The AMEX has proposed to amend how obvious errors based on "verifiable disruptions or malfunctions of Exchange systems" as set forth in the Obvious Error rules are adjusted or cancelled.

- The AMEX has proposed to revise the Obvious Error rules to amend the terms that relate to the cancellation of "no bid series."

[3] In particular, we object to the introduction of uncertainty and unpredictability into the determination of what constitutes a numerical obvious error. It is far better to have a rule that all sophisticated market participants can apply themselves, in real time, so that they can know immediately which transactions to expect to be busted. But under the Amex's proposal, the Obvious Error rules will be amended to provide that "[t]he Theoretical Price will not include the last bid price (erroneous sell transaction) or last offer price (erroneous buy transaction) of the competing options exchange that has the most liquidity in that options class in the previous two calendar quarters *if such competing options exchange widens its quote to incorporate the prior erroneous quote of the Exchange*." (emphasis added).

The fundamental problem with this change is that it will generally be impossible to know why another "exchange" (really an individual market maker on another exchange) widened its quote without interrogating the relevant market maker. The AMEX has not indicated how it intends to confirm that any such quotes were widened in response to the AMEX's erroneous quotes, to say nothing of how hundreds of individual market makers will be able to figure that out. While the AMEX proffers an extreme example from which one can infer that the other exchange's widened quote was in reaction to the AMEX's erroneous quote, most instances will not be so extreme and therefore it will not be clear whether the other exchange's quotes were changed in reaction to the AMEX's quote or other factors. This problem may explain why the other options exchanges do not attempt to weed out other exchanges' quotes as proposed by the AMEX.

<u>The AMEX Rules Are Biased Against Other Market Participants</u>

First, the AMEX's bust-verses-adjust rules are biased in favor of AMEX market makers and against all other market participants. Under the AMEX rules, when AMEX finds that an obvious error has occurred – whether due to a true, numerical (and numerically verifiable) obvious error or due to a so-called "verifiable disruption or malfunction" of AMEX's computer systems – transactions between AMEX market makers will be adjusted unless both parties agree to bust them. In contrast, transactions between AMEX market makers and other market participants are busted unless both parties agree to an adjustment. But adjustment should be the rule and guarantee for other market participants, not the exception. As one would expect, AMEX market makers rarely agree to adjustments when doing so would be against their economic interest. Thus, it is disingenuous to hold out the illusory possibility of voluntary adjustments as a meaningful remedy.

Busting trades leaves counterparties with naked "hedges" they have put on in reliance on having entered into transactions on the AMEX, only to discover belatedly that their hedges are all they have, leaving them exposed to market swings. Indeed, Citadel Derivatives has several arbitrations pending against AMEX market makers in which we are seeking to recover several hundred thousand dollars of damages arising out of just such instances. The AMEX busted numerous trades in Taser International options that *were not numerical obvious errors* long after Citadel Derivatives had hedged its trades with purchases of common stock. When the AMEX options transactions were busted (due to alleged, but un-flagged, AMEX computer problems), Citadel Derivatives was left with naked stock positions that had already lost hundreds of thousands of dollars due to a quickly moving market.

There is no good reason why the AMEX should be permitted to treat its own market makers better than it treats other market participants. All market participants should be permitted to insist on an adjustment rather than a bust in circumstances in which trades between AMEX market makers would be adjusted rather than busted.

<u>The AMEX Forces The Rest Of The Market To Bear The Costs Of Its Defective Computer Systems</u>

Second, the AMEX's rules and practices regarding busting trades that occur during the existence of an alleged "verifiable disruption or malfunction" in its computer or communication systems force the rest of the market to bear the costs of the AMEX's defective computer systems. These rules and practices also enable AMEX market makers to profit by using the shield of alleged systems errors as a sword, letting them pick and choose what trades to honor.

The AMEX is not alone in having a rule that permits trades to be busted due to alleged computer system errors. The Chicago Board Options Exchange, for example, has such a rule (in contrast to the International Securities Exchange, which permits busting only for numerical obvious errors). But the AMEX stands out as far and away the most frequent offender for busting trades based upon alleged internal computer problems.

The high frequency of AMEX's busting of trades due to alleged problems with its computer systems makes a mockery of the Intermaket Linkage Plan. Under the Linkage rules, other market makers are forced to send orders to the AMEX when the AMEX is displaying the best price. But all too frequently either AMEX market makers do not honor their quotes in the first place or, when they do, they get the trades busted due to alleged problems with AMEX's computer systems, even in circumstances in which AMEX is *not* displaying a flag indicating that its quotes are not firm. That is exactly what happened to Citadel Derivatives in connection with the Taser transactions referenced above. This is the "damned if you do, damned if you don't" problem: If you do send an order to the AMEX, you can never be sure if it will be filled and, if filled, you can never be sure it will stand. Indeed, if the market moves in your direction after the trade, there is an even greater chance that the AMEX will end up busting it. On the other hand, if you ignore the AMEX's quotes, you are exposed to regulatory sanction for having traded through a better (even if phantom) price on the AMEX.

<u>The Time For Radical Change – The Cost of Accidents</u>

These AMEX computer problems have persisted for quite some time without meaningful change, even with the introduction of the AMEX's ANTE trading platform. The AMEX has little incentive to improve its computer systems: Assuming these so-called systems errors actually exist, they are cost-free to the AMEX and its market makers. Whenever a system problem occurs that results in unfavorable trades for AMEX market makers, the AMEX just busts the resulting trades at the request of the affected AMEX market makers. Thus, the only people hurt by the AMEX's defective computer systems are external to the AMEX – that is, all market participants other than AMEX market makers. Indeed, some AMEX market makers appear to use the AMEX's alleged computer problems as a profit tool, accepting those trades that turn out to be profitable and only seeking to bust trades that turn out to be unprofitable given market movements in the minutes after the trades occur.

The AMEX's rules permitting it to bust trades that are not numerical obvious errors should be abolished. This would force the AMEX to internalize the costs of its defective computer systems. The AMEX and its membership can then sort out whether each individual market maker should have to bear the costs of the "error" trades to which it is a party or whether AMEX itself, as an entity owned by its members, should have to bear the costs. Either way, the hue and cry of AMEX market makers clamoring for AMEX immediately to fix its computer systems would be heard for miles around and a problem that has persisted for years will disappear in a matter of months.

AMEX market makers may find such a proposal unfair. But they must recognize that *someone* has to pay the price for AMEX's defective computer systems. Currently that someone is other market participants who must send orders to the AMEX. On the basis of relative fault alone, most people would agree that AMEX and its market makers are more at fault than are other market participants for the AMEX having defective computer systems. But even a pure economic assessment of the circumstances results in the overwhelming conclusion that the AMEX and its market makers are in the best position to reduce the damage caused by the

AMEX's defective computer systems at the least cost and therefore they should be forced to internalize those costs.

In his seminal book, The Cost of Accidents : A Legal and Economic Analysis (1970), Professor (now Judge) Guido Calabresi raised the notion of assigning liability for accidents not to the party who is somehow blameworthy but simply to the party who is in the best position to reduce the overall cost of accidents plus the cost of avoiding accidents. Thus, for example, if an accident causes $10 in damage and it would have cost Party A $5 in to avoid it whereas it would have cost Party B $8 and Party C $11 to avoid it, then Party A should bear the cost, resulting in a $5 savings to society.

Here, the AMEX is Party A – only the AMEX can fix its own computer systems. If the AMEX has to internalize the costs of its defective computer systems, then the AMEX will quickly assess whether the cost of fixing its computer systems is greater than the cost of becoming a party to the unprofitable trades that result from defects in its computer systems and will act accordingly. Either way, the rest of the market will be freed from constant AMEX trade busts, busts that make AMEX the weak link in the Intermaket Linkage Plan and increase the costs of trading for everyone.

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

EXHIBIT A

CITADEL

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March 23, 2005

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

Re: File Number SR-Amex-2005-11

Dear Mr. Katz:

Citadel Derivatives Group LLC ("Citadel") is submitting this letter in response to File Number SR-Amex-205-11, pursuant to which the American Stock Exchange ("AMEX") proposes to adopt new rules to provide for the cancellation and adjustment of options transactions resulting from obvious errors (the "Proposed Rules"). While Citadel supports the adoption of more uniform and objective rules by the AMEX, there are several aspects of the Proposed Rules that are detrimental to customers and the functioning of a fair and orderly market.

As noted in Citadel's Petition for Rulemaking to Amend the Options Intermarket Linkage Plan, dated January 22, 2005, firms that are not specialists or registered options traders ("ROTs") on the AMEX have historically been subjected to arbitrary standards for canceling trades. These cancellations typically take place long after the original execution and often are based on vague and subjective rationales for the action taken. We are pleased to note that there have been recent substantial constructive changes in such behavior. But long term solutions to such behavior must be based, in part, on well constructed rules that place the interests of public investors ahead of the interests of market makers on the exchange. While the Proposed Rule attempts to address certain of these concerns, most notably by imposing more objective standards to be observed in canceling and adjusting trades, it fall short in a number of respects.

<u>Notification of Potential Cancellation or Adjustment</u>

The Proposed Rules gives an AMEX member or person associated with a member 15 minutes notify an exchange official after an execution that may be subject to cancellation or adjustment. This period is far too long and is in stark contrast to all but one of the other options exchanges,[4] which generally distinguish between the specialists, market makers or floor traders,[5] on the one hand, and order sending firms on the other hand. In those circumstances, specialists, market makers and floor traders must provide notification of a possible cancellation or adjustment within *five* minutes of the execution, while order sending firms are given twenty minutes (or fifteen minutes in the case of the PHLX) from the execution to notify the appropriate exchange official.[6] This distinction presumably exists because the specialist, market maker or floor trader is in the best position to know, and know very quickly, if there is a potential problem with a trade. The rules of these exchanges (as well as the Proposed Rules) do provide for extensions of time in unusual circumstances, which should give the specialist, market maker or floor trader adequate protection if they are unable to meet the time frame due to circumstances outside their control, such as a large influx of orders, a fast market or other situations that would limit their ability to provide timely notification.

Citadel believes that it is inappropriate to provide a 15 minute window to specialists, market makers and floor traders. Given their informational advantages, they will be well aware of a possible problem as soon as the execution takes place. It is imperative that they provide notification in as short a time as is reasonably practicable to limit the exposure of the other party to the transaction. They should not be given a lengthy free option to decide whether to accept the trade. That is particularly true where (as under the Proposed Rules) they are able to cancel trades rather than having them adjusted. Given that four of the other options exchanges have determined that five minutes is a sufficient amount of time for such notification, the AMEX should be held to a similar standard.

Cancellation of Transactions

In the context of an obvious pricing error, the Proposed Rules provide for an adjustment to the execution price of a transaction where both parties to the transaction are AMEX specialists or ROTs. However, where one party to the transaction is not an AMEX specialist or ROT, the transaction must be cancelled, unless both parties agree to adjust the price. Although this

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[4] The Chicago Board Options Exchange imposes notification requirements that are similar to those contained in the Proposed Rule. See CBOE Rules 6.25(b)(1) and 24.16(b)(1).

[5] For purposes of this letter, the term "specialist" refers to any member of an exchange who is registered with such exchange as a Designated Primary Market Maker, Lead Market Maker, Primary Market Maker, specialist or in a similar capacity; and a "market maker" refers to any member of an exchange who is registered with such exchange as a Competitive Market Maker, market maker, remote market maker or in a similar capacity.

[6] See BOX Rules, Ch. 5, Sec. 20(d)(i), ISE Rule 720(c)(1), PCX Rule 6.87(g)(3)(A) and PHLX Rule1092(e)(i).

provision is similar to that found in the rules of the other options exchanges,[7] it creates an inequity in the market that significantly disadvantages customers. The application of this provision will cause customers to be exposed to market risk, and such customers will likely not be aware of that exposure for a period of time. At the same time, the trades of other market participants may be adjusted in accordance with an objective pre-established set of rules. These market participants will know exactly where they stand if there is a pricing error. Customers, on the other hand, will be told at some later point in time that their trades have been cancelled. This provision protects AMEX specialists and ROTs at the expense of customers.

We note that this disparity between customers, on the one hand, and AMEX specialists and ROTs, on the other hand, is even more pronounced as a result of the requirements under the Intermarket Options Linkage Plan. If the AMEX is displaying the best market, albeit in error, a market maker on another exchange may have no alternative but to send a principal acting as agent order to the AMEX to avoid a trade-through. In such a context, it would violate the very purposes of the Intermarket Options Linkage Plan for the AMEX to be permitted to cancel the trade rather than giving the ultimate customer the option of adjusting the trade to the actual NBBO, turning customer protection into customer punishment.

While an argument could be made that retail customers might prefer to have a trade cancelled rather than adjusted, this would certainly not be the case for most institutional investors. At a minimum, trades between an AMEX specialist or ROT and such professional customers should be subject to adjustment rather than cancellation. Moreover, within reasonable time limits, even retail customers should be given the option of whether they would like to adjust or cancel a trade. That would shift the risks of error transactions to where they belong – to the AMEX specialists and ROTs (who are, after all, owners of the AMEX) rather than to the investing public.

Verifiable Disruptions or Malfunctions of Exchange Systems

The Proposed Rules provide that a transaction may be cancelled or adjusted in the event of a "verifiable disruption or malfunction of exchange systems." In particular, if a quote or order trades in excess of its disseminated size as a result of a disruption or malfunction of an AMEX automated quotation, dissemination, execution or communication system, trades in excess of the disseminated size will be cancelled. In addition, if a member is prevented from updating or canceling a quote or order as a result of a disruption or malfunction of such systems and such disruption or malfunction is documented, any resulting trade will be cancelled or adjusted if it qualifies under the provisions for obvious pricing errors.

We believe that AMEX members should not be permitted to cancel trades resulting from systems disruptions or malfunctions unless and until the AMEX has declared an unusual market

[7] See BOX Rules, Ch. 5, Sec. 20(d)(ii), ISE Rule 720(c)(2), PCX Rule 6.87(g)(3)(B) and PHLX Rule1092(e)(ii).

condition pursuant to AMEX Rules 115 or 958A(d). This puts the accountability for systems failures squarely where it should be—with the party responsible for building and maintaining such systems and ensuring that such systems work in a manner that protects customers and the integrity of the market. If AMEX systems are malfunctioning, it is incumbent upon the AMEX to take appropriate action that will protect customers and the market. That action should not include shielding its members from potentially unprofitable trades.

We also have concerns specifically with the provisions relating to a member's inability to update or cancel a quote or order. As with the obvious error rule on which it relies, this provision disadvantages customers in favor of members by requiring that customer trades be cancelled rather than adjusted. The Proposed Rule specifically provides that adjustments will be made to trades resulting from quotes or orders that, but for a systems problem, would have been updated or cancelled only if they qualify for adjustment. That will never be the case for customer orders as the Proposed Rules are currently drafted. Customer trades never qualify for adjustment and always must be cancelled. Once again, the Proposed Rules unfairly place the burden of trading losses on customers, rather than the specialist or ROT. The specialist or ROT has the ability to "wipe the slate clean," while the customer loses the benefit of a legitimate transaction in the market. At a minimum, customers should be accorded the same rights as members—the opportunity to have a trade adjusted in accordance with pre-determined objective standards. This enables both parties to a transaction to know in advance how problems will be handled and does not disadvantage either party.

A further concern with these provisions relates to the documentation and verification of system disruptions and malfunctions. The Proposed Rules require documentation from the AMEX "reflecting that the member sought to update or cancel the quote/order." Such documentation will be deemed sufficient if "the automated quotation system was programmed to update or cancel a quote based upon specific changes in the underlying, those changes occurred and due to the disruption or malfunction the quote was not updated or cancelled." This standard is self-serving and vague and provides no independent verification that an actual system problem occurred. Rather, all that is required is that a member assert that the system was supposed to do something and it failed to do that. Such an approach again shifts the burden of system problems to the parties in the least likely position to be able to either fix the problem or ensure that the problem will not recur. The Proposed Rules must require that there be actual documentation that can be independently verified showing a systems problem. Such documentation also must be made available to the other party to the trade upon request. Anything short of actual and verifiable documentation provides an opportunity for a specialist or ROT to use the Proposed Rules as a means to avoid unprofitable trades.

Uniformity of Rules

Citadel supports the AMEX in its attempt to add a certain amount of objectivity to an area that has historically been fraught with subjective policies that have harmed customers. However, we believe that the options markets and customers would be best served by a uniform rule across all options exchanges. Such a rule could be patterned on the Proposed Rules, but modified to take into account the concerns identified above.

Customers should not be subjected to different standards for adjustments and cancellations depending upon where they send their orders. Furthermore, this is not the type of rule where there are factors unique to the different exchanges that justify variations in exchange rules. Rather, this is an area where customers should be treated fairly and objectively at all times, without regard to where the order is routed. That can only happen if a uniform rule is imposed on the exchanges.

In conclusion, we do not believe that the Proposed Rules should be approved in their current form. At a minimum, we believe that the Proposed Rules should be modified to more appropriately allocate risk and responsibility for errors among customers and AMEX specialists and ROTs. In addition, we believe that a uniform rule regarding obvious errors for options transactions should be adopted by all options exchanges. 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