



Matthew B. Hinerfeld
Direct Dial: 312-395-3167
Direct Fax: 312-267-7628
matthew.hinerfeld@citadelgroup.com

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.

Notification of Potential Cancellation or Adjustment

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,¹ which generally distinguish between the specialists, market makers or floor traders,² 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.³ 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 provision is similar to that found in the rules of the other options exchanges,⁴ 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

¹ 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).

² 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.

³ See BOX Rules, Ch. 5, Sec. 20(d)(i), ISE Rule 720(c)(1), PCX Rule 6.87(g)(3)(A) and PHLX Rule 1092(e)(i).

⁴ See BOX Rules, Ch. 5, Sec. 20(d)(ii), ISE Rule 720(c)(2), PCX Rule 6.87(g)(3)(B) and PHLX Rule 1092(e)(ii).

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 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