

# **CSS,LLC**

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December 23, 2003

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

**RE: File No. SR-Phlx-2003-75  
Release No. 34-48875  
Proposed Rule Change by the Philadelphia Stock Exchange, Inc. To Allow  
the Concurrent Representation of Hedging Stock Positions with Option  
Facilitation Orders in the Trading Crowd**

Dear Mr. Katz:

In response to the request of the Securities and Exchange Commission ("Commission"), CSS, LLC ("CSS") submits the following comments regarding the Philadelphia Stock Exchange's ("PHLX") proposed rule change to allow the concurrent representation of hedging stock positions with option facilitation orders in the trading crowd. The Commission is soliciting general comments on the rule change, and has requested specific views regarding whether the rule change is consistent with the Act, the impact of the rule change, and whether the rule change violates prohibitions on frontrunning. For the reasons stated herein, CSS strongly believes that this proposed rule change should be withdrawn by the PHLX or disapproved by the Commission.

## "The Practice"

The PHLX is proposing to adopt commentary .04 to PHLX Rule 1064, Crossing, Facilitation and Solicited Orders, in order to allow upstairs Exchange members and member firms to establish an "anticipatory hedge" for their own account, prior to forwarding a customer option order to an on-floor broker with the instructions to represent the customer option order together with the anticipatory hedge position in the underlying security to the options crowd (the "Practice"). On the whole, CSS believes that allowing this Practice does nothing to benefit a customer's option order execution and impedes the operation of a fair and open market.

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<sup>1</sup> By way of background, CSS is a CBOE member firm and registered broker dealer engaged primarily in proprietary options trading activity from off of the floor.

### Consistency with the Act

In its filing the PHLX states that it "believes that the proposed rule change is consistent with the Act in particular, because it is designed to promote just and equitable principles of trade, ... to remove impediments to and perfect the mechanism of a free and open market, ...and, in general, to protect investors and the public interest, by establishing rules governing Stock Tied Up Orders". However, the PHLX has neglected to present any data or arguments to buttress their contention that there is a bona fide need to change the existing rule. They have not demonstrated that there is any direct customer benefit to changing the rule or that a direct customer disadvantage exists under the current rule. Moreover, they have in no way established that the current practice of prohibiting pre-hedging is an impediment to the mechanism of a free and open market. Neither have they made it clear how allowing anticipatory hedging will promote just and equitable principles of trade particularly when anticipatory hedging is, by design beneficial only to the party doing the pre-hedging. Accordingly, we do not believe the PHLX can argue that the rule change is consistent with the Act.

CSS believes that allowing anticipatory hedging impedes the markets from functioning as independent market mechanisms. It undermines market integrity further diminishing the already tenuous investor confidence levels. The Practice in no way facilitates enhanced order interaction. It neither fosters price competition nor promotes a more efficient or effective market operation. Similarly, investment choices available to investors have in no way been advanced.

### Legalizing Frontrunning

The stated purpose of the proposed rule change is to "bring clarity to the practice of representing hedging stock positions in conjunction with option orders in the trading crowd." This statement suggests that the Practice is currently standard operating procedure at the PHLX and that allowing such activity by its member firms has understandably created uncertainty among other market participants as to its legitimacy. The reason for the uncertainty is because engaging in anticipatory hedging on other option exchanges is considered a violation of just and equitable principles of trade and is more commonly referred to as frontrunning.

Notwithstanding the requirement that the anticipatorily hedged stock be offered to the trading crowd, we feel this Practice is nothing more than legalized frontrunning. Moreover, because of multiple-listing and inter-market linkage, we believe, if approved, the rule will lead to either inconsistent regulatory procedures among exchanges or worse, force other option exchanges to adopt the same unnecessary rule change. In either event, the PHLX will have improperly and unnecessarily impinged upon the regulatory jurisdiction of other Self Regulatory Organizations while demonstrating no valid regulatory purpose for changing this rule.

Allowing this Practice to occur will impede the price discovery and price improvement processes to the detriment of the customer. The PHLX states in its proposal that it will impose several "requirements" that member organization must satisfy when representing Stock Tied Up Orders in the crowd. They claim that the purpose of these requirements is to ensure that the hedging stock position represented to the crowd would be a good faith effort to provide crowd participants with the same opportunity as the member

organization introducing the Stock Tied Up Order to compete for the option order. What they fail to note is that because the hedging stock order has already been executed, the opportunity for price improvement on the customer's option order has been significantly reduced, if not eliminated. Moreover, should the stock hedging activity be of sufficient enough size to impact the price of the underlying security, the ensuing option prices would be affected accordingly. Offering the hedge stock to the trading crowd will do nothing to ameliorate the negative impact of the stock trade on the price of the option. We believe that exposing orders to the marketplace and allowing competition for such orders from various unrelated market participants is the foundation of price discovery and improvement and is therefore necessary to promote a free and open market.

CSS would like to note one material aspect of this rule change that was not addressed in the filing. That aspect is the applicability of the rule to market participants other than the member firm introducing the customer option order to the floor. All options exchanges have rules concerning crossing, facilitation and solicited orders. These rules arose because it is common practice for a firm receiving a large customer option order to solicit participation on the order from upstairs, prior to sending the order to the trading floor for execution (thereby creating the opportunity for frontrunning and hence the need for such a rule). Thereafter, to the extent that a solicited party participates on the solicited transaction, the introducing firm receives remuneration from the solicited party.

In the event that the introducing member firm is not interested in facilitating its customer's order, but finds an interested counter party through the upstairs solicitation process, it would seem that the solicited counter party should be allowed to engage in an anticipatory hedging prior to arriving at the trading crowd to facilitate the order so long as the solicited party offers their stock to the trading crowd and complies with the other requirements of the proposed rule change. It should be noted that we do not believe this is a prudent interpretation, but we envision this activity as the next step in the evolution of this rule change.

#### Impact from the Rule Change

The Commission has asked what the impact would be of allowing PHLX members to pre-hedge large option orders while avoiding pressures on the market from the underlying securities that can result from the reporting of such large option transactions to the tape. While it may be true that there are instances when the "tail can wag the dog", it is more likely that the pre-hedging activity in the stock will be detrimental to the eventual execution price of the customer order. In particular, if the customer's option order is of sufficient size to impact the stock price, any corresponding stock pre-hedging activity will most certainly negatively impact the ensuing option prices.

In its filing the PHLX is attempting to advance the seemingly altruistic notion that allowing anticipatory hedging by the introducing member firm is protecting the on-floor crowd participants since the option transaction is offered with a tailor-made hedge. Consequently, the introducing firm *may* not ultimately be buying or selling the stock for its own account, but could be seen as assembling the hedge position for the accounts of the members in the trading crowd who are given the opportunity to take the hedge position along with the customer's option position. They argue that the fact that the parties to such a trade end up fully hedged *may* even contribute to the best execution of the order. This is a theory in a vacuum.

As noted in the filing, the price of an option is not completely dependent on supply and demand, or on the price of the underlying security. Market participants also price options based on basic measures of risk and they also must consider their existing positions (in any number of option strikes in the class and in the underlying security) when determining what portion of a trade they are willing to compete for. As a result, the only time the acquisition of a pre-hedge position would likely be attractive to other market participants is when such market participants have no existing positions to factor into their pricing decisions. This is not a realistic expectation.

Correspondingly, allowing a PHLX member to lay-off its own risk through pre-hedging activity in order to avoid pressures on the stock price that can be caused by reporting large option trades to the tape undermines the stock specialists. Again, if a customer's option order is of sufficient size to impact the stock's price following its execution, the stock specialist has been put into the position of pricing a stock transaction without knowing all the material terms of the order. Consequently, pre-hedging does not promote a free and open market.

We believe the PHLX's interest in adopting this rule change is inherently anti-competitive because it appears they are attempting to lure large customer option orders away from their competitors. The decision to execute on PHLX will, however, not be made by the customer on account of better pricing, it will be made by the introducing firm because the firm will be allowed to engage in activity on the PHLX that is currently prohibited on other options exchanges. Nonetheless, the PHLX's order flow surge will be short-lived as the other option exchanges will be forced to relax their solicitation and facilitation rules accordingly in order to remain competitive. We believe that in the multiple-listing markets, in particular, it is imperative that coordinated and consistent regulations are applied and enforced across exchanges.

CSS believes that the Commission should give serious consideration to the negative impact of the PHLX's proposed rule change on price discovery/improvement, market competition, inter-market regulation, and the mechanism of a free and open market before taking action to approve such a rule change. We appreciate the opportunity to express our views on the PHLX's rule change proposal.

Sincerely,



Michael J. Carusillo  
Manager Member