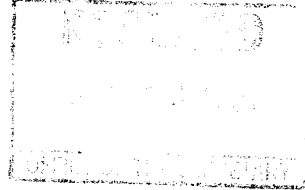


#2

January 12, 2004

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



RE: Release No. 34-48875 / SR-Phlx-2003-75  
Tied-Up Stock Proposal

Dear Mr. Katz:

I am writing on behalf of Susquehanna International Group, LLP and its affiliates (“SIG”) in support of the proposed rule change by the Philadelphia Stock Exchange (“Phlx” or “the Exchange”) to adopt a Tied-Up Stock exception to the anticipatory hedge prohibition. The “Tied-Up Stock” proposal should be approved for the Phlx and should be encouraged for adoption at other options exchanges as well.

### **Background**

The stock-before-options anticipatory hedge scenario has been the subject of much debate over the years, and much disagreement – even among options exchanges. While certain options exchanges adopted applicable rules many years ago, one exchange (the AMEX) only adopted its prohibition a few years ago. The primary stock markets have never adopted such rules, and it is still permissible to trade futures as an anticipatory hedge to stock facilitations. The reason this issue has continued to be debated over the years is because pre-hedging would have such a favorable benefit to customers. Thus, the topic has been viewed by many as an issue in need of a solution that would secure the ability to pre-hedge in a way that would also encourage and enable heightened competition among upstairs facilitators and floor traders.

The Phlx proposal, in fact, is beneficial to both facilitators and customers. It will safeguard the ability of floor traders to price improve options orders while at the same time bring efficiencies to the hedging process. The added efficiencies will encourage more competition from floor traders. In addition, by having the same access to the stock hedge, the floor traders will be able to compete with each other and the upstairs firms on a more level playing field.

### **The Unknown Hedge Risk**

The Phlx's Tied-Up Stock proposal is a way to increase competition by floor members for block option trades in a manner that also reduces the cost of "unknown hedge risk."

Unknown hedge risk occurs when the broker-dealer facilitator voices an order in the crowd subject to facilitation and the options market makers attempt to compete on filling the order without knowledge as to how much hedging stock is needed and available, and at what price. This risk arises while the option block is in auction and can continue until such time where the participant(s) to the options block have been established and necessary hedges effected.

Assessing the extent of available hedging stock is a critical and challenging step when competing for an options block. The challenge is that, although wishing to reduce risk by effecting the hedging stock as soon as possible, the competitors (whether upstairs firm or the floor traders) often do not immediately know for sure the extent to which their efforts to compete have been successful. It sometimes requires a few seconds or even minutes for the auction to be completed. Because their options pricing is predicated on the stock price, market makers can make tighter markets if they have a reliable estimate on the cost of their hedging needs. The recurring concern is if the underlying stock prices change before they have a chance to execute their hedge, which causes their option quotes to no longer be accurate. In addition, when they are unsure as to their hedging needs, it creates risk. The larger and more complicated the trade; the longer the quoting period on the floor can be and the greater the risk.

This "unknown hedge risk" cost of execution would be largely eliminated with a pre-establish stock hedge "tied" to the options order. Competing facilitators (both upstairs firms and floor traders) would be better able to provide quicker and better prices to customers under this proposal because the stock hedge would already be effected and there would be no or little worry of "missing the market."

### **Overhedging and Underhedging**

When competing facilitators are forced to make premature educated guesses on how much stock hedging is needed and what the cost of the hedges will be, it often results in over-hedging and under-hedging. The associated time delay in the execution of the option can also lead to lost opportunities for the initiating customer. The cost of uneven and imperfect hedges manifests itself in higher premium prices customers pay for options blocks. As such, the protections afforded by the anticipatory hedge prohibitions have come at a price to the customer.

Under the Phlx proposal, overhedging concerns would be greatly eliminated because the hedges would be available on a pro rata delta base in direct relation to the number of options contracts executed by the competitor. The proposal would also diminish underhedging to the extent of shares that are tied-up and available for distribution to participants in the options trade.

### **Efficiency**

The stock-before-options anticipatory hedge prohibition was designed to ensure that upstairs firms do not exhaust available hedging stock and thereby deprive the floor traders the opportunity to compete on filling customers at improved prices. While this has been a reasonable policy over the years, it has been far from perfect. The Tied-Up Stock proposal represents an important efficiency that has been missing from the options market since the inception of facilitation crosses. It represents an attractive opportunity to secure a combination of improved and more expeditiously made options prices to customer orders. It would improve best execution of customer orders while also reducing "hedge" risk to the facilitator, which is a rare combination of favorable outcomes that should make the proposal attractive to customers, upstairs block desks and floor traders alike.

This proposal provides an opportunity for floor traders to compete for block participation more effectively, and it does so without re-raising the conflict that was at the core of the anticipatory hedge debates. That is, the broker-dealer facilitator would be able to secure the appropriate hedge but not at the expense of the floor trader. Hedging stock could be secured with less price impact than what currently occurs, which will allow options market makers to quote the options block more competitively than before. The more attractive pricing will be particularly appreciated in those cases where the tied-up stock procedure replaces the instances marked by excess flurries of stock orders sent from multiple sources (i.e., facilitators and would-be facilitators) in a short period of time as potential hedges.

### **Leveling the Playing Field**

The present proposal will level the playing field between block desks and floor traders in cases where they compete on filling block-sized options orders as both will be provided an equal opportunity to compete with the same access to an evenly priced stock hedge. When multiple sources send stock orders in near proximity, it not only impacts the stock more than necessary it also leaves the competitors with uneven hedges. If overhedging occurs because of these uncertainties, it may add to the price of the options to the customer order. This disjointed process is not only inefficient to block desks and floor

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traders, but is costly to the customer. The tied-up stock proposal lessens each of these concerns for all parties involved in a very even-handed manner.

### **The Growth of the "Facilitation Order"**

As a final point, the problems with the current method for handling a facilitation order grows with the rise in number of instances where upstairs desks show a willingness to facilitate options block orders. As the proclivity for upstairs facilitation trading grows, the problems with this process become more pronounced. For this reason, the Phlx filing is timely.

Thank you for this opportunity to respond.

Sincerely,



Gerald D. O'Connell  
Compliance Director

cc: Commissioner William H. Donaldson  
Commissioner Paul S. Atkins  
Commissioner Roel C. Campos  
Commissioner Cynthia A. Glassman  
Commissioner Harvey J. Goldschmid  
Ms. Annette L. Nazareth, Director, Division of Market Regulation  
Mr. Robert L.D. Colby, Deputy Director, Division of Market Regulation  
Ms. Elizabeth King, Associate Director, Division of Market Regulation