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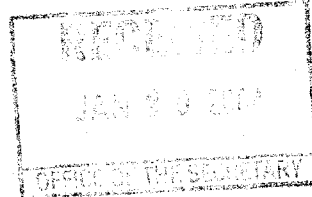
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January 14, 2004

By FEDEX and Fax to (202) 942-9651

Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549



Re: SR-PHLX 2003-75

Dear Mr. Katz:

The Chicago Board Options Exchange appreciates the opportunity to comment upon PHLX Rule filing SR-PHLX-2003-75.

The CBOE urges the SEC to disapprove PHLX 2003-75 because it would legitimize unfairly advantaged anticipatory hedging and thereby greatly disadvantage public customers throughout the marketplace.

The PHLX proposal appears intended to provide a sort of regulated alternative to such hedging. However, the proposal is fundamentally flawed in ways that make this "cure" as bad as the disease.

Under PHLX 2003-75, a PHLX member organization that received a customer's options order could decide to buy or sell a stock position prior to exposing the options order to the trading crowd¹, provided that the member creates a written record that it is engaging in a "Stock Tied Up Order" ("STU order") prior to buying or selling any shares of the underlying stock in the hedging stock position, and provided further that the hedging stock position satisfies specified criteria. The hedging stock position would need to :

- (i) Be comprised of the same underlying stock as the option order;

¹ Throughout this comment letter, the term "trading crowd" refers to the group of registered options traders or market-makers, led by a specialist (at PHLX) or designated primary market-maker ("DPM") (at CBOE), all of whom provide price improvement and liquidity to customer orders by continuously offering two-sided markets in the particular options classes and series.

- (ii) Be announced concurrently with the option order in the crowd;
- (iii) Be offered to the crowd in its entirety;
- (iv) Be offered at the stock execution price received by the member organization introducing the order, to any option crowd participant who has established parity or priority for the related options;

In addition, the hedging stock position must not

- “exceed the options order on a delta basis,” and
- be “transacted promptly upon receipt of the option order and, if brought to [PHLX], [be] brought without undue delay to the crowd.”

Finally, the proposal promises that “crowd participants may participate in the option transaction without participating in the hedging stock position.”

This Proposal Harms Public Customers

The Exchange urges the Commission to disapprove 2003-75 because this proposed STU order procedure will provide regulatory approval to unfairly advantaged anticipatory hedging. As noted above, the STU proposal permits the member organization receiving an options order (that may or may not originally include stock) to decide to categorize that order as a STU order, and then unfairly use the non-public knowledge of that order to trade stock before presenting the options transaction to the options trading crowd.

This would be no different than the CBOE permitting its trading floor DPMs to

- (1) receive customer orders; then
- (2) simply hold them, unannounced, while the DPM first traded stock to hedge against the order; and
- (3) only then announce the order as a package in the trading crowd.

The SEC would be correct to reject any such proposal as hopelessly violative of a DPM’s agency and due diligence obligations under CBOE rules and the Securities Exchange Act of 1934 (the “Act”) to provide their customers with prompt execution at the best possible price.² Yet this, in essence, is exactly what the PHLX is asking permission to let its member firms do under the STU proposal. The harm to public customers will be extensive.

Notice that the proposed rule gives the member firm, not the customer, the authority to categorize an order as “STU.” Thus, even if the customer’s original order never involved stock and could immediately be executed against other public customer orders with

² Section 6(b)(5) of the Act requires that the rules of PHLX and other SROs “remove impediments to and perfect the mechanism of a free and open market and...protect investors and the public interest.”

priority in the crowd, the STU procedure permits the firm to decide to hold up the options order while they first execute a stock hedge against their anticipated facilitation of the option order. The delay involved in waiting for this hedge, even if brief, could easily cost the customer price improvement resulting from immediate exposure and execution. Worse yet, and particularly with larger options orders, the firm's hedge order could itself significantly move the stock price to the disadvantage of the options customer.

For instance, a customer might send her firm an order to buy 2,000 February 40 calls at the limit price of 2, so long as the stock is trading at no less than \$40 per share. For purposes of this example, assume that the stock is then offered at 40. Assume further the options have a delta of 50³ and there are traders in the option crowd willing to sell the March 40 calls at 2. Notwithstanding this clear opportunity for a quick fill, the firm might nevertheless wish to sell those calls itself (or find another customer to sell the calls, which is more likely, since the firm can also bill brokerage to that second customer), so long as the firm can cover the delta risk of selling the calls with stock. In this case, the delta risk of selling 2,000 50 delta option calls would be covered by buying 100,000 shares of stock.⁴ The STU procedure would allow the firm to delay the customer order to buy the calls while the firm tried to fill the order to buy 100,000 shares. However, the buy order of 100,000 shares could easily use up all the stock shares being offered at 40. If the stock moved up only 20 cents as a result, the 50 delta option calls would likely move up in price at least ten cents themselves.⁵ Quite possibly, the customer would receive nothing done on the order, even though it could have been filled if promptly sent to the options trading crowd as a plain order to buy calls.

In addition, the STU procedure effectively denies customer orders any chance for public price improvement in the market. Quite the contrary, the price for a STU order will be determined "upstairs" in a non-competitive environment by the firm holding the order, along with whichever few (if any) other market participants that organization chooses to solicit to take the other side. Only after the price is determined upstairs and the stock is traded will the options trading crowd be presented with the order as a *fait accompli* that

³ The term "delta" refers to the amount by which the option price is expected to change for a one dollar change in the stock price. For example, a one dollar change in the price of the stock will change the price of a "50 delta option" by .50 of a dollar, or fifty cents.

Note that options traders also use deltas as a shorthand to express an option position's approximate risk/reward potential in terms of an equivalent amount of stock. In this case, for example, owning 2,000 calls with a 50 delta is roughly equivalent to being long 100,000 shares of the stock, calculated as follows:

each option contract represents the right to purchase 100 shares of stock so 2,000 (contracts) X 100 (shares per contract) X .50 (50 deltas) = 100,000.

⁴ See the delta calculation in note 3 above.

⁵ As explained in footnote 3, a 20 cent increase in stock price would cause a 10 cent increase in the price of a 50 delta option.

the crowd members can trade, or ignore, but not change. Nothing in SR-PHLX-2003-75 expressly provides any opportunity for the crowd to offer price improvement in the face of a STU order. This is to be expected under the logic of the STU proposal, which aims to help firms facilitate customer orders, rather than ensure that those customers receive the best possible price. However, even if PHLX were to interpret its priority rules to give the crowd a theoretical opportunity to offer price improvement, the STU procedure makes price improvement by the crowd most unlikely to occur as a practical matter, since the STU procedure will always allow the firm to have already 'traded ahead' the same shares of stock that the crowd market makers might otherwise have used to hedge an offer of a better price on the options.

In the example just noted, assuming that the firm buys the 100,000 shares at 40 under the STU procedure, by the time the options trading crowd sees the order to pay \$2 for the calls, the stock would be offered \$.20 higher than where the firm purchased it. Since the crowd needs to pay more than 40 for the stock to hedge against any sale of the calls, it is unlikely they could even match, much less improve, the firm's offer to facilitate a sale of the calls at 2. The crowd might have been able to sell the calls to the customer for less than 2, however, if they could have bought the stock offered at 40.

All the above demonstrates a clear potential conflict of interest the STU procedure creates between the firm's interests as an agent to get the best price for their customer's order and the firm's own proprietary interests in facilitating such orders and hedging such facilitations.

In practice, the STU proposal's non-competitive, upstairs pricing, stripped of any effective opportunity for price improvement, cannot possibly result in a better-executed order for the customer. This is made plain by a glaring omission in the STU procedure: namely, that the firm representing the order would never be required to guarantee their options customer a fill, even after the firm has completed the hedging stock transaction. The lack of such a guarantee enables the firm to transfer risk to its customer, particularly since, as noted earlier, the firm's very execution of a hedging STU stock order could well move the options market away from the customer's desired price level. In fact, a STU procedure without a fill guarantee for the customer could enable an unscrupulous firm to 'lean' on its own customer's options orders while trading in and out of the tied up stock, scalping stock profits for itself without ever being obligated to satisfy its options customers.

In the previous example, even if the firm were not able to buy the 2,000 call options at 2, the firm might be able to sell its 100,000 shares it purchased at 40 for \$40.20 per share, thereby making a profit of \$20,000 for itself while getting 'nothing done' for its options buying customer.

Further, the STU order, because of its size and priority, may unfairly trade ahead of smaller customer option orders already booked, thereby disadvantaging still other public customers beyond those involved in the given order.

All of the foregoing simply makes clear that the STU proposal, with its anticompetitive upstairs pricing and unfairly advantaged anticipatory hedging, will only help the member organization trying to facilitate orders, and the PHLX, trying to lure their order flow, at the expense of the customers placing the orders and the rest of the investing public.

In addition, the regulatory requirements set forth in PHLX 2003-75 for STU orders will not effectively counteract the harm threatened by STU orders to public customers and the public options marketplace.

Crowd Participation Right Limited and Ineffective

As noted earlier, although the STU proposal would seem to promise the options trading crowd the opportunity to participate in the STU transaction “in its entirety,” the crowd would not be given any opportunity to perform their most important function: to offer price improvement to the customer.

Firm's Time Advantage Not Effectively Limited

Although PHLX 2003-75 apparently tries to reduce the firm's time advantage by requiring the firm to enter the stock hedge “promptly” and “if brought to the [PHLX],” bring the order “without undue delay to the crowd,” these “requirements” are unenforceably vague.

Unclear Whether Trading Crowd Can Take the Entirety of Only the Options

It also strains credibility to suggest, as PHLX 2003-75 does, that the crowd will be permitted to “participate in the option transaction without participating in the hedging stock position” in its entirety, since that would leave the firm that has already traded the stock with substantial unhedged market exposure.

In the previous example, if the firm were to let the options trading crowd trade all the options without trading the stock, the firm would be left with a naked, unhedged exposure of being 100,000 shares long in the market.

Perhaps the ability to participate in only the options side of the STU transaction is not a right to participate in the “entirety” of only the options side of the order, but that point is unclear from the filing, and should be further clarified by PHLX.

The STU Procedure Will Conflict with Linkage

PHLX should also be required to explain how it would reconcile the STU proposal with the operation of the intermarket Linkage. SR-PHLX-2003-75 makes no provision for what would happen if a firm trades stock under the STU procedure, and then brings a STU options order to the PHLX option trading crowd, but finds a better price for the options under the NBBO at another options exchange. This emphasizes again that PHLX's STU proposal does not promote the best execution of customers' options orders.

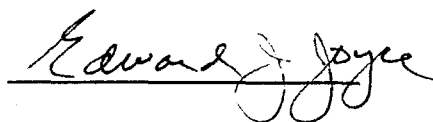
Delta Limitation on Stock Position Unenforceably Vague

Perhaps sensing the dangers inherent in its proposal to authorize unfairly advantaged anticipatory hedging, PHLX 2003-75 establishes a requirement that the hedging stock position must "not exceed the options order on a delta basis." However (as the Commission appears to indicate in its own notice of this proposal), there is not nearly enough specificity in this requirement to offer any real protection to public customers and the options marketplace. The delta of an option order, which as described in note 3 above, expresses the amount that an option's value changes with a one dollar change in the value of its underlying security, is itself a constantly changing value that is based on a variety of factors. Some of these factors are objective, like the price of the underlying stock. However, others components of delta have a strong subjective element (such as estimates of the stock's volatility.) These factors need to be specified with a precision that is wholly lacking from SR-PHLX-2003-75.

For all the foregoing reasons, the Exchange urges the Commission not to approve this proposal. The Commission should be encouraging SROs and their members to provide greater transparency, greater price improvement, and greater due diligence for public customer orders. Legitimizing trading ahead at the PHLX through unfairly advantaged anticipatory hedging will do exactly the opposite on every point.

If you would like to discuss this letter, or have any related questions or comments, please call Joanne Moffic-Silver at (312) 786-7462 or the undersigned at (312) 786-7310.

Sincerely,



Edward J. Joyce
President and Chief Operating Officer

CC: Annette Nazareth
Robert Colby
Elizabeth King