Goldman, Sachs & Co. | 85 Broad Street | New York, New York 10004
Tel: 212-902-3372 | Fax: 212-346-2905 | Cell: 917-873-3948
e-mail: marc.spilker@gs.com

Marc Spilker
Managing Director

4

February 4, 2004

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

Re: **Proposed Rule Change by the Philadelphia Stock Exchange, Inc. Relating to Concurrent Representation of Hedging Stock Positions with Option Facilitation Orders in the Trading Crowd; File No. SR-Phlx-2003-75**

Dear Mr. Katz:

Goldman, Sachs & Co. ("GS&Co") respectfully submits the following comments in response to the proposed rule change by the Philadelphia Stock Exchange, Inc. ("Phlx") to adopt new Commentary .04 to Phlx Rule 1064 to allow the concurrent representation of hedging stock positions with options facilitation orders in the trading crowd.[1] Goldman Sachs is a global securities and investment banking firm that provides a wide range of services to customers worldwide. Among other things, GS&Co facilitates customer orders to buy and sell large blocks of stock and options. Affiliates of GS&Co act as options specialists and market makers on the major U.S. options exchanges.

For the reasons described in more detail below, GS&Co believes that the proposed rule change is consistent with the requirements of the Securities Exchange Act of 1934 ("Exchange Act") applicable to the rules of a national securities exchange and, in particular, with Section 6(b)(5) of the Exchange Act.[2] Proposed Commentary .04 to Phlx

---

[1] Securities Exchange Act Release No. 48875 (Dec. 4, 2003) ("Proposing Release"). Combination option and stock positions represented in reliance on proposed Commentary .04 are referred to as "Stock Tied Up Orders."

[2] GS&Co believes that it is appropriate for the introduction of Stock Tied Up Orders to be treated as a substantive rule amendment adopted through the notice and comment procedures of Section 19(b)(2) of the Exchange Act, rather than as a temporary interpretive position and statement of disciplinary intent.

Rule 1064 would help Phlx member organizations manage the market risk associated with their facilitation activities and thus would enable firms to provide their customers with better execution terms. In addition, under the Phlx proposal, options market participants could establish hedging stock positions in a more efficient manner, which would alleviate unnecessary volatility in the stock market. We believe, moreover, that the use of Stock Tied Up Orders would not be unfair or detrimental to stock market participants. Although knowledge of the imminent execution of a large block transaction in a particular stock can be material to that stock's price, traders generally do not consider the *reason* for such a transaction (*e.g.*, that the stock is trading to hedge an options position) independently to be material information. The impact of the stock component of a Stock Tied Up Order is reflected in the price of the stock when the stock trade occurs. Execution of the options component of the Stock Tied Up Order does not have independent stock market impact. Finally, the proposed rule change contains safeguards to ensure that the options trading crowd has a full and fair opportunity to compete for a portion of the Stock Tied Up Order. We urge the Commission to approve the proposed rule change.

I. The Proposed Rule Change is Consistent with the Protection of Investors and the Public Interest

The proposed rule change would increase the willingness of Phlx member organizations to commit capital to facilitate large options orders.[3] In today's securities markets, upstairs firms play an important role as liquidity providers. This is reflected in the development of mechanisms on all of the options exchanges that enable member organizations to facilitate their customers' orders or solicit other contra-side interest.[4] To the extent that Stock Tied Up Orders enable upstairs firms to manage the risk of their facilitation activities more effectively, firms would be able to pass the benefits through to their customers in the form of better prices and/or additional liquidity.

When an upstairs firm quotes a customer a price at which the firm would be willing to facilitate an options order, the firm sets that price based on an estimate of the price at which it could establish a hedging stock position. Phlx Rule 1064(d) currently prohibits a member organization engaged in customer facilitation from entering an order to buy or sell the underlying stock until the terms and conditions of the options order being facilitated are disclosed to the trading crowd. By that time, the price of the

---

3 We anticipate that upstairs firms generally would rely on the proposed rule to facilitate customer options orders that are too large to be immediately executed on the floor.

4 *See* Phlx Rule 1064(b) and (c); *see also* American Stock Exchange Rule 950(d), Chicago Board Options Exchange Rules 6.9 and 6.74, and International Securities Exchange Rule 716.

underlying stock may have moved significantly (especially if the crowd's hedging activity results in additional volatility, as discussed in more detail in Section II below). These price fluctuations, in turn, may increase the costs of establishing the hedging stock position and/or may cause the options position to be imperfectly hedged. Upstairs firms currently factor these risks into the prices they give their customers. This results in less attractive pricing for customers compared to the pricing they would be quoted if these risks could be better controlled.

Proposed Commentary .04 to Rule 1064 would allow a Phlx member organization that is facilitating a customer options order to execute its hedging stock order more quickly and thus would reduce the uncertainty surrounding the stock price. Because the upstairs firm would be exposed to less market risk, the firm would be able to provide the customer with more competitive execution terms (*i.e.*, better prices and/or more volume).[5] The benefits of the firm's ability to hedge promptly thus would be passed through to the customer.[6] As a result, we believe that the proposed rule change would improve the quality of executions received by customers.

II. The Proposed Rule Change Would Alleviate Unnecessary Volatility in the Market for the Underlying Stock

The proposed rule change also would help alleviate volatility in the stock market that may occur in connection with the hedging of large options facilitation transactions. Under current Phlx rules, if the trading crowd takes part of the transaction, the upstairs firm doing the facilitation and the floor traders frequently will attempt to lay off risk by sending separate orders to the stock market at or around the same time. This sudden

---

5 We note that the price of the underlying stock is a factor in options valuation, whether or not pre-hedging is permitted. We believe that the net results for customers would be better if Phlx member organizations could use Stock Tied Up Orders. The greater the uncertainty about future changes in the stock price, the larger the risk premium or discount incorporated into the pricing of the options trade.

6 This would be the case even if the upstairs firm does not interact with all of the customer options order. As discussed in more detail in Section III below, the options component of a Stock Tied Up Order generally would be represented in the trading crowd in the same manner as any options facilitation order. Proposed Commentary .04(b) would specify that the floor broker must announce the stock and options components concurrently and must offer the entire hedging stock position to the crowd *at the stock execution price received by the upstairs firm*. Because the floor traders could avail themselves of the same downside protection as the upstairs firm doing the facilitation, the trading crowd should be as, if not more, willing to provide price improvement to a Stock Tied Up Order than any other facilitation order.

increase in buying or selling interest may result in volatility in the price of the underlying stock.

Stock Tied Up Orders would represent a more efficient means of establishing hedging stock positions. Under the Phlx proposal, a member organization that has received a customer options order would be able to "work" the hedging stock order.[7] By definition, an order that is handled in this way should have less market impact than would separate orders for multiple options market participants executed at or around the same time. Accordingly, the proposed rule change should promote more orderly trading in the underlying stock.

Moreover, we believe that the proposed rule change would not be unfair or detrimental to stock market participants. The Proposing Release solicited comments on "the impact ... of allowing Phlx members to hedge large options orders while avoiding pressures on the market for the underlying securities that can result from the reporting of such options transactions to the tape" and specifically asked whether "the proposed rule change would violate prohibitions on front running." Frontrunning generally refers to the practice of trading a security to take advantage of material, non-public information regarding an imminent block transaction in the same or a related security.[8]

In our view, execution of the options component of a Stock Tied Up Order generally would not have a material impact on the price of the stock component, regardless of the timing or the sequence of the two transactions. Under these circumstances, the information that would be material to a stock trader (including the stock exchange specialist) is the terms of the stock trade, not the fact that it is intended as

---

7 Proposed Commentary .04(d) would require that the hedging stock order be transacted "promptly" upon receipt of the option order. In the Proposing Release, the Phlx indicated that a member organization could establish a hedging stock position "over a brief period of time, rather than by way of a block-sized market order that could be of high-impact to the stock price" if doing so "would best serve the interest of the customer."

8 The major stock and options exchanges take the position that a member organization's use of such information to trade for its own benefit and to the detriment of the public and other exchange members is inconsistent with just and equitable principles of trade. As we have argued in a prior comment letter, we do not believe that a transaction (or series of transactions) effected by a member organization in a principal capacity should constitute frontrunning *if* the transaction is incidental to facilitation of a customer order *and* is intended to provide better execution terms for the customer *or* to liquidate or otherwise offset the risk of a position assumed through customer facilitation. *See* letter from Scott Prince, Managing Director, GS&Co, to Jonathan G. Katz, Secretary, SEC, dated March 3, 2003 (File No. SR-Amex-2001-85).

a hedge to an options facilitation order. Accordingly, we do not believe that a Phlx member organization that establishes a hedging stock position in accordance with Commentary .04 to Rule 1064 would be *taking advantage of material, non-public information* as contemplated by the prohibitions on frontrunning or otherwise engaging in manipulative conduct.

III. The Proposed Rule Change Would Not Undermine the Integrity of the Options Market

The proposed rule change contains safeguards to ensure that Stock Tied Up Orders are exposed to the order interaction process on the Phlx floor in accordance with auction market principles. As with any options facilitation order, a floor broker handling a Stock Tied Up Order would be required to request a market from the trading crowd, announce the options component to the crowd and then make a bid or offer between the quote.[9] Existing Phlx rules require, and would continue to require, that crowd participants be given a reasonable opportunity to trade with the Stock Tied Up Order before the floor broker may cross all or any remaining part of such order with the upstairs firm's proprietary order.[10] If there are multiple bids or offers at a particular price level, the same rules of priority, parity and precedence would apply to execution of a Stock Tied Up Order as to the execution of any other options facilitation order.

Most notably, under proposed Commentary .04(d) to Rule 1064, the trading crowd would be able to choose whether to participate in both the stock and options components of the Stock Tied Up Order or only in the options transaction. In addition, proposed Commentary .04(b)(iii) would require that the upstairs firm make the underlying stock available at the price at which the upstairs firm established its position, even if the market for the stock has moved. These provisions, together with the other Phlx rules noted above, should enable the options trading crowd to make informed decisions about the risks of the options transaction and should provide floor traders with a meaningful opportunity to compete with upstairs firms for a portion of Stock Tied Up Orders.[11]

---

9 *See* Phlx Rule 1064(b)(ii).

10 *See* Phlx Rule 1064(b)(iii).

11 In evaluating the impact of the proposed rule change on the options markets, it is important to note that the rules governing anticipatory hedging originally were adopted, in large part, to protect options exchange specialists and market makers. *See, e.g.*, Securities Exchange Act Release No. 34959 (Nov. 9, 1994) (File No. SR-CBOE-94-15) ("The CBOE has stated that the purpose of these measures is to prevent members and associated persons from using undisclosed information about imminent solicited option transaction to trade the relevant option or any closely-related instrument in advance of

IV. Conclusion

For the reasons set forth above, we believe that the proposed rule change is consistent with the requirements of the 1934 Act applicable to the rules of a national securities exchange and in particular with Section 6(b)(5) of the 1934 Act and that the proposed rule change promotes the goals set forth in Section 3(f) of the 1934 Act. We therefore urge the Commission to approve the proposed rule change. We would be pleased to discuss this letter. If you have any questions or would like to arrange a meeting, please contact Susan E. Sidd at (212) 357-5441, Patricia Levy at (312) 697-2784 or me at (212) 902-3372.

Very truly yours,

GOLDMAN, SACHS & CO.

By: ______________________
Marc Spilker
Managing Director

cc: Annette Nazareth, Esq.
Robert L.D. Colby, Esq.
Elizabeth K. King, Esq.
Securities and Exchange Commission
450 Fifth Street
Washington, D.C. 20549

---

persons represented in the relevant options crowd"). The Phlx proposal represents an alternative way to level the playing field between floor and upstairs traders.