5

Deutsche Bank Securities

Deutsche Bank Securities Inc.
31 West 52nd Street
New York NY 10019

Tel 212 469 5000

January 30, 2004

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

Re: File No. SR-Phlx-2003-75

Dear Mr. Katz:

Deutsche Bank Securities Inc. ("DBSI") appreciates the opportunity to submit comments to the Securities and Exchange Commission (the "Commission") regarding the proposed rule change (File No. SR-Phlx-2003-75) filed by the Philadelphia Stock Exchange, Inc. ("Phlx") to adopt Commentary .04 to Phlx Rule 1064, "Crossing, Facilitation, and Solicited Orders."[1] In sum, the proposal would effectively allow a Phlx member facilitating a client's listed option order to execute hedging transactions in the cash equities market before the options order was publicly announced on the Phlx floor, thus conferring on the member the right to trade while in possession of private information concerning the client's options order.

DBSI strongly opposes the proposal and believes that it undermines the fairness and integrity that are critically important to the listed option markets in the United States. Furthermore, we believe that the Phlx's rule proposal is not consistent with the Phlx's obligations under Section 6(b)(5) of the Securities Exchange Act of 1934 ("Exchange Act") to, among other things, maintain rules that are "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade . . . and, in general, to protect investors and the public interest."

I. The Proposal Undermines Transparency and Market Integrity

Market participants that transact in options listed on national securities exchanges understand that both upstairs and floor trading activity is highly regulated to ensure the legitimacy of the markets. One of the cornerstones to legitimate markets is the fundamental principle that market participants may not exploit their access to a client's

[1] See Securities Exchange Act Release No. 48875 (Dec. 4, 2003), 68 FR 70072 (Dec. 16, 2003).

non-public information. For example, member firms accepting client orders are prohibited from using their knowledge of such orders to benefit their own interests. Frontrunning, universally acknowledged as improper, is one such practice that involves a member firm promoting its interests ahead of its client's interests by trading first for a proprietary account based on knowledge of a client's stated trading intentions.

Another manner in which knowledge of a client's order may be abused is when a firm, seeking to facilitate a client's listed option order, first transacts in the equity security underlying the listed option before the order is publicly announced to the trading floor. In that instance, the market as a whole is disadvantaged because (i) the member firm has unfairly used its inside knowledge of the listed options order to effect hedging transactions in the cash equities market at prices that are not informed by awareness of the options order (i.e., the cash equities prices may have been different, and quite likely less favorable, had the options order first been publicly represented and announced on the exchange floor); and (ii) members in the options trading crowd were deprived of the opportunity to make informed trading decisions. Although anticipatory hedging activity may benefit the facilitated client by means of a better price being offered by the hedging member firm, other equity and option market participants are disadvantaged by the disparity in information.

We recognize that although market participants generally have equal access to publicly available information, not all market participants possess the same information upon which they base investment decisions. Indeed, when a market participant who possesses public information conducts research, performs analyses, uses statistical models and algorithms, or otherwise carries out diligence to evaluate the merits of a security or transaction, the market participant should be entitled to capitalize on its self-generated information and profit from the investment decision flowing therefrom. When a market participant advances its interests by trading based upon knowledge of a client's undisclosed order, however, that abuse of position cannot lead to a legitimate transaction.

II. The Proposal Contradicts Current Rules and Sound Market Practice

It is our belief that market participants generally understand and accept the paradigm that hedging activities relating to a facilitated listed option order are not permitted to commence until the listed option order has been announced on the exchange floor. So long as all market participants are required to abide by the same rules and standard of conduct, the integrity of the markets is upheld and market participants who are not "in-the-know" are not unfairly disadvantaged.

We find the Phlx's proposal to be troubling because it would afford member firms an opportunity to capitalize on their access to non-disclosed client orders. While we acknowledge that a proposed "Stock Tied Up Order" would be required to be presented to the trading crowd where it could possibly interact with other crowd participants, we believe that the Phlx member assembling such an order through anticipatory hedging transactions would in certain circumstances (i.e., if other crowd participants decline the opportunity to transact with the order) be able to retain and execute the order for its own account and benefit. Therefore, the proposal would undercut the sensible and absolute prohibition against anticipatory hedging, which limitation has been adopted by the other options markets.[2] For example, the Chicago Board Options Exchange ("CBOE"), of which DBSI is a member, maintains CBOE Rule 6.9(e)[3], which prohibits the type of anticipatory hedging activity that would be permitted under the Phlx proposal. In discussing its rule's provisions, the CBOE stated its belief that "these prophylactic requirements are necessary to prevent members and associated persons from using undisclosed information about imminent solicited option transactions to trade the relevant option or any closely-related instrument in advance of persons represented in the relevant options crowd."[4]

We are concerned that if the Phlx proposal is approved, other options markets may be compelled to adopt copycat rules to remain competitive and retain order flow, particularly in this extremely keen business environment.[5] In our view, this "race to the bottom" would encourage reduced transactional transparency and damage a fundamental tenet that promotes fairness in the markets.

We believe that the Commission recognizes and values the importance of self-regulatory organization rules that prohibit the anticipatory hedging activity that the Phlx seeks to accommodate. The Commission recently stated:

> All of the options exchanges have anticipatory hedging rules, which generally prohibit a member that has knowledge of all material terms of a solicited order, an order being facilitated, or orders being crossed, the execution of which is imminent, from buying or selling (1) an option on

---

[2] See Amex Rule 950(d), Commentary .04; CBOE Rule 6.9(e); ISE Rule 400, Supplementary Material .02; and PCX Rule 6.49(b).

[3] See CBOE Rule 6.9(e), Trading Based on Knowledge of Imminent Undisclosed Solicited Transaction, which states in pertinent part:

> It will be considered conduct inconsistent with just and equitable principles of trade and a violation of Rule 4.1 for any member or person associated with a member, who has knowledge of all material terms and conditions of an original order and a solicited order, including a facilitation order, that matches the original order's limit, the execution of which are imminent, to enter, based on such knowledge, an order to buy or sell an option of the same class as an option that is the subject of the original order, or an order to buy or sell the security underlying such class, or an order to buy or sell any related instrument until either (i) all the terms and conditions of the original order and any changes in the terms and conditions of the original order of which that member or associated person has knowledge are disclosed to the trading crowd or (ii) the solicited trade can no longer reasonably be considered imminent in view of the passage of time since the solicitation.

[4] See CBOE Weekly Regulatory Bulletin (June 8, 1994).

[5] We note that the Commission recently approved the Boston Stock Exchange's proposal to operate the Boston Options Exchange facility, which will be the sixth US exchange market for trading listed options and the second all-electronic exchange market for trading listed options. See Securities Exchange Act Release Nos. 49065, 49066, 49067, 49068 (Jan. 13, 2004).

> the same underlying security as the option that is the subject of the order, (2) the underlying security itself, or (3) any related instrument until either the terms of the order are disclosed to the trading crowd or the options order can no longer be considered imminent in view of the passage of time since the order was received. The Commission believes that the options exchanges' anticipatory hedging rules prevent the misuse of non-public information and afford trading crowds a full and fair opportunity to make informed trading decisions. In addition, the Commission believes that anticipatory hedging could threaten the integrity of the auction market or disadvantage other market participants. [footnotes omitted][6]

III. The Procedural Underpinnings of the Proposal are Questionable

We believe that the manner in which the Phlx proposal was presented to the Commission and the Phlx membership further calls into question the merits of the proposal. The Phlx took the unusual step of issuing a "Memorandum" (Regulatory Circular 1729-03, November 14, 2003) contemporaneous with the filing of the rule change to explain its actions to Phlx members and to effectively provide no-action relief to members engaging in the activity specified in the proposal. The Memorandum was filed with the Commission, and the Phlx sought to have the Memorandum considered "non-controversial" so that it could become immediately effective upon filing. The Commission properly rejected the request.

In a second Memorandum issued shortly thereafter (Regulatory Circular 1780-03, November 21, 2003), the Phlx withdrew the earlier Memorandum in response to the Commission's opposition, and the Phlx cautioned members that the Commission's action

---

[6] See Securities Exchange Act Release No. 49068 (Jan. 13, 2004). These views of the Commission further reinforce the following comments, which were made by the Commission with respect to an ISE proposal regarding the facilitation of client orders:

> The Commission notes that the ISE rule against anticipatory hedging, is similar to longstanding rules of this kind on all the other options exchanges, and was adopted by the Exchange at the Commission staff's urging after a market participant raised the concern that the ISE's rules, too, should contain such a provision. See generally Amex Rule 950(d), Commentary .04; CBOE Rule 6.9(e); Philadelphia Stock Exchange Rule 1064(d); and PCX Rule 6.49(b). These rules against anticipatory hedging generally state that it may be considered conduct inconsistent with just and equitable principles of trade for any member or associated person who has knowledge of all material terms and conditions of orders being crossed, an order being facilitated, or an order and a solicited order -- the execution of which are imminent -- to enter an order to buy or sell an option for the same underlying security or a related instrument until the terms of the order of which the member or associated person has knowledge have been disclosed to the trading crowd or the trade can no longer be considered imminent. These provisions were originally developed in the context of similar rules designed to prevent frontrunning of block transactions, and were conceived to preclude a member or associated person from using undisclosed information about an imminent cross, facilitation, or solicitation transactions in one option from trading a relevant option or other related instrument in advance of persons represented in the relevant option crowd.

Securities Exchange Act Release No. 46514, note 72 (Sept. 18, 2002), 67 FR 60267 (Sept. 25, 2002).

"has the effect of not permitting the Exchange to continue its temporary 'no action' position."

The Phlx's brief attempt to provide no-action relief to firms engaging in activity consistent with the proposal looks to be an attempt to circumvent Sections 19(b)(1) and (2) of the Exchange Act, which require public notice and a comment period before the Commission is permitted to consider approving a proposed rule change that does not qualify for immediate effectiveness under Section 19(b)(3)(A) of the Exchange Act. In addition, by initially agreeing to withhold enforcement action regarding a practice that was not permitted under existing Phlx rules, and one that does not lend itself to being characterized as a minor or incremental extension of existing permitted practices, the Phlx did not uphold its charge under Section 19(g)(1)(A) of the Exchange Act to enforce Phlx members' compliance with existing Phlx rules.

IV. Conclusion: Commission Approval Should be Withheld

Given the affirmative obligation imposed on the Commission by Section 19(b)(2) of the Exchange Act (i.e., before the Commission approves a proposed rule change, the Commission must find "that such proposed rule change is consistent with the requirements of [the Exchange Act] and the rules and regulations thereunder"), we urge the Commission to withhold approval of the Phlx's proposed rule change. We believe the Phlx proposal would undermine transactional transparency, harm market participants through inequitable informational advantages, and damage the integrity of the securities markets, all of which are outcomes inconsistent with the Exchange Act's provisions.

We appreciate the opportunity to present our views regarding the Phlx's proposed rule change. If the Commission or the Division of Market Regulation staff wishes to discuss these issues further, please do not hesitate to contact me at (212) 250-7938 or Michael Loftus at (212) 250-5018.

Very truly yours,

Matthew Carrara
Managing Director
Head of Equity Derivatives, North America

cc: 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
Mr. David Shillman, Associate Director, Division of Market Regulation
Ms. Deborah Flynn, Assistant Director, Division of Market Regulation