SUSQUEHANNA INTERNATIONAL GROUP, LLP

June 11, 2003

VIA HAND DELIVERY

Mr. Jonathan G. Katz
Office of the Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

Re: Application For Exemptive Relief From Exchange Sponsored Payment for Order Flow Programs

Dear Mr. Katz:

This application is submitted on behalf of the Susquehanna Investment Group ("SIG"),[1] a registered options market maker, pursuant to Section 36 of the Securities Exchange Act of 1934 ("the Exchange Act"), as amended, for the purpose of requesting that the Securities and Exchange Commission ("SEC") grant SIG an exemption from rules adopted by self-regulatory organizations ("exchanges") that require SIG and other similarly situated firms to contribute to exchange sponsored payment for order flow ("PFOF") programs.[2] Exchange mandated PFOF programs harm the options markets as a whole, investors who access those markets, and market makers such as SIG, by introducing artificial costs into the market, decreasing price transparency, and blurring the lines between an exchange's role as the regulator of its members and its role as a "marketer" of the exchange. In addition, such programs violate the Exchange Act because they discriminate against certain market participants. In view of these harms, and because we can discern no overriding benefit to market competition, we hereby request that SIG be exempted from exchange rules that mandate such programs.[3]

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[1] SIG, which was formed in 1987, is a market maker on all of the U.S.-based options exchanges with the exception of The International Securities Exchange ("ISE"). SIG makes a market in over 2000 options classes. In some classes SIG acts as the "specialist" or "designated primary" market maker.

[2] Section 36 of the Exchange Act authorizes the SEC to exempt any person, security or transaction, or any class or classes thereof, from any provision of the Act or rule or regulation thereunder, to the extent such exemption "is necessary or appropriate in the public interest, and is consistent with the protection of investors."

[3] We believe that the SEC has authority under Section 36 of the Exchange Act to grant the relief requested. In the event that Section 36 should be determined not to be the proper vehicle for this submission, we hereby request that the SEC treat this letter as a petition for rulemaking under Rule 192 of the SEC's Rules of Practice to repeal

Background. The payment for order flow phenomenon developed after the proliferation of multiply listed options in 1999. Multiple listing led each exchange to seek out mechanisms to protect its market share and effectively compete for customer orders.[4]

One mechanism adopted by the exchanges beginning in 1999 was the exchanges forcing market makers to pay fees (usually on a per-options contract basis), and the bundling of those fees into PFOF "funds" that could then be used by the exchange or a designated representative to make payments to firms routing their order flow to the exchange. Each exchange adopting such a program publicly admitted that its sole motivation in doing so was to compete with the other exchanges that also had such programs.[5] Exchange mandated PFOF programs were not the result of a desire on the part of the exchanges to provide better service or prices to customers. They were instead the result of an overarching drive by each exchange to capture as much order flow for its market as possible.

Although we know of no publicly available statistics regarding the amount of money collected through these programs, we know that the amount is significant. In any given year, a single exchange can collect millions of dollars through its program. For example, in December 2002, the ISE reported to the SEC that it had ten separate PFOF funds, each authorized to hold $650,000.[6]

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transaction and marketing fees adopted by the ISE, Pacific Exchange, Inc. ("PCX"), Philadelphia Stock Exchange ("PHLX"), and the Chicago Board Options Exchange ("CBOE"). See 17 CFS 201.192 (2002); SR-CBOE-2003-19, Exchange Act Rel. No. 34-47948 (May 30, 2003); SR-PCX-00-30, Exchange Act Rel. No. 43290 (Sept. 13, 2000); SR-PHLX-00-77, Exchange Act Rel. No. 43177 (Aug. 18, 2000); and SR-ISE-00-10, Exchange Act Rel. No. 43833 (Jan. 10, 2000).

[4] In this same period of time, the SEC approved the ISE as a new market to trade options. Prior to the ISE, the options markets had not had a new entrant in 27 years. See Exchange Act Rel. No. 42455 (Feb. 24, 2000), announcing SEC approval of the ISE.

[5] See, e.g., SR-PCX-2001-37, Exchange Act Rel. No. 44830 (Sept. 21, 2001), notice of a rule change by the PCX relating to a change in its PFOF program; SR-ISE-00-10, Exchange Act Rel. No. 43833 (Jan. 10, 2000), notice of a rule change by the ISE relating to its PFOF program; comment letter from the CBOE, dated November 21, 2000, regarding the ISE's proposed PFOF program; see also SR-CBOE-2003-19, supra note 3, wherein the CBOE informs the SEC that it is re-activating its PFOF program as of June 1, 2003.

[6] See SR-ISE-2002-26, Exchange Act Rel. No. 46976 (Dec. 9, 2002) wherein the ISE informed the SEC that it was lowering the cap on each of its PFOF funds from $650,000

The issues that arise from PFOF have not gone unrecognized by the SEC and its staff. The SEC and staff have been concerned for a number of years with the effect of payment for order flow on the options markets. This concern is reflected in findings made in a December 2000 report by the SEC's Office of Compliance Inspections and Examinations and the Office of Economic Analysis[7], numerous comments of its former chairmen,[8] and many SEC releases discussing PFOF programs.[9] Numerous market participants and commentators have objected to PFOF programs, and the SEC has been asked to ban the practice.[10] To date, however, such programs continue to be sanctioned by the SEC.[11]

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to $550,000 because it had collected more money than the program had paid out to order flow providers.

[7] See Office of Compliance Inspections and Examinations and Office of Economic Analysis, United States Securities and Exchange Commission, "Payment for Order Flow and Internalization in the Options Markets" (December 2000) (hereafter, the "Payment For Order Flow Study").

[8] See, e.g., former SEC Chairman Arthur Levitt's October 21, 2000 speech to the Securities Traders Association and his November 4, 1999 speech to the Securities Industry Association; see also "Options Traders in U.S. Jointly Denounce Payment for Order Flow," 35 Wall Street Letter 11, 2003 WL 12387733 (Mar. 17, 2003) (referencing a letter from SEC Chairman Harvey Pitt to all exchanges requesting that they stop PFOF).

[9] See, e.g., SR-ISE-00-24, Exchange Act Rel. No. 43688 (Dec. 7, 2000), a proposed rule change by the ISE relating to a PFOF program.

[10] See, e.g., letter from Michael L. Meyer on behalf of the CBOE to Annette Nazareth, Director, Division of Market Regulation, SEC, dated Jan. 7, 2000, in which the CBOE requests that the SEC impose a temporary moratorium on PFOF in the options markets until the practice has been sufficiently studied.

[11] See, e.g., SEC orders for ISE and PCX PFOF programs, supra note 3. Exchange mandated PFOF programs must be filed with the SEC pursuant to Section 19(b) of the Exchange Act. These rule filings are typically filed in a manner that permits them to become immediately effective upon filing. In order to abrogate such a program, SEC staff must act to do so within 60 days of the filing's receipt by the SEC. Because the programs become immediately effective upon filing, members of the public and the market participants to whom such programs apply have no opportunity to apprise the SEC of their views prior to the implementation of these programs. To date, the SEC has not acted to abrogate any exchange's PFOF program.

Rationale in Support of the Petition

For the following reasons, we respectfully request that the relief applied for be granted.

Effect on Competition. The Exchange Act requires the SEC to conclude that each exchange's rules are, among other things, designed to promote just and equitable principles of trade, remove impediments to a "free and open" market, and protect investors and the public interest.[12] The Exchange Act also prohibits exchange rules from imposing "any burden on competition not necessary or appropriate" under the Act.[13] We strongly believe that exchange sponsored PFOF programs are inconsistent with these tenets.

As noted above, the rationale put forth by exchanges that have adopted PFOF programs is that such programs are necessary in order to compete with other markets. To date, however, no evidence has been produced that supports a finding that exchange sponsored PFOF programs have had a positive impact on market competition, and no evidence has been produced that shows that public customers have benefited. What is known is that the adoption of a PFOF program by one exchange inevitably leads to the adoption of a similar program by other exchanges.[14] We also know that such programs do not pay for themselves; market makers that are forced to participate in such programs will either adjust the prices they charge to the public to reflect the cost of such programs, or absorb the cost themselves. When faced with this choice, it is unrealistic to expect market professionals to absorb all of these costs indefinitely. Rather, market makers may ultimately widen their spreads, resulting in higher costs for public customers.

Exchange sponsored PFOF programs also put exchange market makers at a competitive disadvantage to traders who are not members of an exchange. Market makers on the floor of an exchange must compete with market professionals who are not members of an exchange and are thus not required to pay these fees. To date, exchange market makers have absorbed a substantial portion of the PFOF fees imposed by the exchanges. As stated above, no market maker can absorb these costs indefinitely. In our experience, the economic burden of these fees has contributed, and will likely continue to

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[12] Section 6(b)(5) of the Exchange Act.

[13] Section 6(b)(8) of the Exchange Act.

[14] As of the date of this petition, only one exchange (the American Stock Exchange) has resisted the pressure to adopt a PFOF program. As noted previously, in May 2003, the CBOE joined the ISE, PCX and the PHLX in adopting a PFOF program. See note 5, supra.

contribute, to a reduction in the number of market makers competing on all of the options exchanges, thus further reducing the liquidity available to customers.

PFOF programs also burden competition by negatively impacting other methods by which market makers could seek to attract order flow. When market makers' costs are increased by PFOF program fees, public customers are deprived of benefits (including improvements in products, technology, customer service and communications) that could occur if market makers were free to decide how best to channel their revenues. PFOF fees that must be paid to an exchange inhibit the ability of exchange market makers to develop new competitive initiatives that could benefit customers.

Thus, while PFOF programs may indeed accomplish their intended goal of attracting order flow providers to exchanges that sponsor these programs, the end result of this "competition among the exchanges" is that customers have less liquidity, pay more for purchasing or selling an option contract than they would in the absence of such programs, and are deprived of new competitive initiatives that may have been developed.

In all other circumstances in recent memory, the SEC has strived to increase competition *so that it would lower customer costs and enhance liquidity.* In the context of these programs, however, the exact opposite result is being achieved. That customers should actually be harmed can not have been the Congress' intent when it adopted and amended the Exchange Act.[15]

Conflict of Interest. Exchange sponsored PFOF programs raise alarming conflict of interest issues for exchanges, who, on the one hand, facilitate payment for order flow to order flow providers – one of the practices most criticized by the SEC -- and, on the other hand, have been tasked by the SEC with ensuring that these order flow providers seek and provide best execution. The SEC and its staff have been unflinching in their public admonishments that all broker-dealers owe a duty of best execution to their customers. How can an exchange hold itself out to the investing public as its protector at the same time that it mandates PFOF programs -- programs that the SEC perceives as creating a conflict of interest?

The public perception that is created by exchange sponsored PFOF programs should not be ignored. These programs have the potential to erode investor confidence by making it appear that brokers route customers orders based upon a desire for PFOF

[15] To the contrary, the Exchange Act requires that the rules of each exchange not impose any burden on competition that is "not necessary or appropriate in furtherance of the purposes of the Act." See Section 6(b)(8) of the Exchange Act.

fees and not the best interests of their clients.[16] This erosion of confidence can significantly impact the ability of the options markets to function as a hedging vehicle for equity market investments and can tarnish the public's perception of the markets as a whole. Historically, the U.S. options markets have had a positive impact on equity investment by providing a means by which investors (both small and large) could lay off risk.[17] In view of recent efforts by the SEC, Congress, the Federal Reserve Board and others to *increase* investor confidence in U.S. markets, it seems counter-intuitive that exchange sponsored programs that erode investor confidence should be sanctioned by the SEC.

Disparate Impact on Certain Market Competitors. In practice, exchange sponsored PFOF programs discriminate against high volume liquidity providers such as SIG. These programs typically assess fees on a per contract basis. As a result, market makers that historically have been willing to trade a large number of contracts at a specified price, and/or make markets in a large number of options classes, pay disproportionately higher fees.[18] However, as the SEC knows, large orders entail greater risk, and are typically not the type of orders market makers want to pay for through PFOF programs. Nonetheless, when a market maker like SIG facilitates a single large customer order, the fee the market maker must pay because of exchange sponsored PFOF programs is used to buy small lot order flow for the exchange. The net effect of this payment structure is to discourage firms that have historically provided significant liquidity to the options market from continuing to do so.

As noted above, exchange mandated PFOF programs also discriminate against exchange market makers because they allow off-floor participants to engage in exchange transactions without bearing the costs of exchange sponsored PFOF programs. Off-floor traders generally do not take on the same risks as on-floor liquidity providers and thus do not contribute to the overall fairness and efficiency of any market to the same degree as on-floor liquidity providers. Off-floor traders are a competitive reality, however, for all

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[16] The SEC has acknowledged the affect PFOF has on investor confidence. See SEC News Digest, "Commission to Study Effect of Payment for Order Flow and Internalization in the Options Markets" (July 19, 2000).

[17] See, e.g., "The Striking Price" by Kopin Tan, Barron's Online, Dec. 30, 2002, noting that in 2002 option market volume was approximately 22% of New York Stock Exchange volume.

[18] It should also be noted that market makers are charged for order flow even when the particular order flow provider on the other side of the transaction does not accept such payments. Because market makers do not know the source of any particular order, each market maker must assume that it will be assessed a charge for every order and factor such cost into its quotes. As a result, customers of order flow providers who do not accept PFOF payments are subsidizing payments made to other order flow providers.

exchange market makers and not requiring their participation in these programs creates an unfair and uneven playing field.

Exchange PFOF plans also allow market participants, under the cover of an exchange and SEC approved plan, to discriminate between market makers. For example, when the PCX reinstated its PFOF plan, it granted a committee that included market makers the right to approve PFOF charges for each option class. At first, SIG did not request that any PFOF charges be assessed in the option classes for which it acted as Lead Market Maker ("LMM"). In response, however, to competitive pressure from other exchanges that have PFOF plans, SIG requested in August 2002 that a fee of $0.50 per contract be charged in the option classes for which it acted as LMM. Although the committee approved charges of at least $0.50 per contract for almost all other LLM operations[19], the committee would only permit a $0.25 per contract charge for the options for which SIG acted as LMM. This determination was made without any explanation and demonstrates how an exchange sponsored program can be administered in an arbitrary, and arguably discriminatory, manner.

Moreover, exchange sponsored PFOF programs force firms that have historically been adamantly opposed to any type of PFOF to now participate in the practice. For example, some of the largest, most well-known Wall Street firms refuse to accept payment for order flow and have publicly declared their opposition to payment for order flow. These same firms are now required to pay thousands of dollars for option contracts when they act as market makers. We can assume that these firms do not appreciate being forced to act in a manner contrary to their publicly stated views.

Large liquidity providers, such as SIG, are not the only market participants opposed to exchange mandated PFOF plans. Smaller liquidity providers also feel that exchange plans are unfair and anticompetitive.[20] These market makers raise some of the same issues discussed above and also complain that they have little or no input regarding the amount of payments to be made or to whom such payments are to be made. They correctly point out that there are no other exchange programs where an exchange imposes a fee and tells a member to spend the proceeds as the member sees fit. Thus, it seems

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[19] Approved fees ranged from $0.25 per contract to $1.00 per contract. Of the over 160 issues for which SIG did not act as LLM and for which the committee approved a marketing charge, there were only thirteen (13) issues for which the marketing charge was less than $0.50 per contract.

[20] See e.g., letter from Merrill G. Davidoff to Jonathan G. Katz, Secretary, SEC, re: SR-PHLX-00-01, Exchange Act Rel. No. 43100 (Nov. 9, 2000); letter from Edward Frank to SEC Chairman Arthur Levitt re: Comments on SR-ISE-00-10 (Sept. 22, 2000); letter from Marjorie McGee to SEC Chairman Levitt re: File No. SR-ISE-00-10 (Sept. 29, 2000).

that both large and small liquidity providers believe that exchange mandated PFOF programs are patently unfair.

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Conclusion. We have witnessed firsthand the consequences that arise from exchange PFOF programs and know of no reason why they should continue to be sanctioned by the SEC. We firmly believe that these programs are antithetical to the tenets of the Exchange Act, and that all market makers, and all markets, deserve the opportunity to compete on the basis of providing *real* benefits to customers. Exchange PFOF programs are simply not consistent with the development of these opportunities.

For the reasons set forth above, SIG respectfully requests that the SEC grant the relief requested herein. If any questions should arise with respect to this application, please contact the undersigned at (610) 617-2600.

Sincerely,

/s/

Joel Greenberg
Chief Legal Officer

cc: Chairman William H. Donaldson
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid
Annette Nazareth, Director, Division of Market Regulation
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