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SUSQUEHANNA
INVESTMENT GROUP
AFFILIATE OF SUSQUEHANNA INT'L GROUP, LLP

June 17, 2003

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

Re: SR-CBOE-2003-19 and SR-CBOE-2003-20

Dear Mr. Katz:

This letter is submitted on behalf of the Susquehanna Investment Group ("SIG")[1] for the purpose of commenting on two rule proposals recently submitted to the Securities and Exchange Commission ("Commission") by the Chicago Board Options Exchange ("CBOE" or the "Exchange"). These proposals (SR-CBOE-2003-19 and SR-CBOE-2003-20)[2] re-instate a payment for order flow program that was in effect at the CBOE in a slightly different format until August 2001. We strongly urge the Commission and its staff to abrogate each of these proposals because, as explained below, exchange sponsored payment for order flow ("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. These programs also violate the Securities Exchange Act of 1934, as amended (the "Exchange Act") because they discriminate against certain market participants.

Description of the Proposals

A. SR-CBOE-2003-19. In its filing with the Commission, the CBOE states that beginning June 1, 2003, it will assess a $0.40 per contract fee on certain customer transactions executed on the exchange by CBOE market makers, including those market makers that have "Designated Primary Market Maker" ("DPM") status. The fee applies to customer orders for 200 contracts or less that have been routed to the CBOE by broker-dealers that have agreed to accept payment for

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[1] SIG is a market maker on all of the U.S. options exchanges except The International Securities Exchange ("ISE"). SIG makes a market in more than 2000 options classes and is the "specialist" or "designated primary" market maker in selected classes.
[2] SR-CBOE-2003-19 became immediately effective upon filing pursuant to Section 19(b)(3)(A)(ii) of the Exchange Act and subparagraph (e) of Rule 19b-4 thereunder. SR-CBOE-2003-20 was granted accelerated approval by the Commission.

their order flow (each, an "order routing firm").[3] CBOE DPMs will be solely responsible for negotiating payment for order flow arrangements with order routing firms and may negotiate payment plans that charge less than the $0.40 per contract fee established by the Exchange. In the event that a DPM negotiates a lower amount with an order routing firm, the Exchange will refund the excess revenue to its DPMs and market makers.

B. SR-CBOE-2003-20. This filing establishes a voting procedure that would be available to market makers in trading crowds that have paid for order flow for three consecutive months. Pursuant to this procedure, a market maker could submit a written request to the CBOE to take a vote of eligible market makers to determine whether the majority of market makers in a particular trading crowd want to continue paying for order flow.[4] If a majority of eligible market makers in that crowd vote against participating in the CBOE program, the fee would be cancelled with respect to that trading crowd for the next thirty days or longer unless another vote is requested by an eligible participant in the trading crowd. The rule permits new votes to be taken every thirty days.

RATIONALE FOR ABROGATION

SIG recently filed an application pursuant to Section 36 of the Exchange Act requesting that the Commission 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 PFOF programs.[5] For the reasons set forth in our Section 36 application and the reasons set forth below, we respectfully request that the Commission exercise its authority and abrogate both proposals.

(1) The proposals do not discuss the impact on competition. The CBOE's stated purpose in re-instating an exchange sponsored PFOF program is to make the CBOE more competitive with the ISE, the Pacific Exchange, and the Philadelphia Stock Exchange, each of which has a similar PFOF program.[6] The CBOE rule filings, however, never address what impact its PFOF program will have on competition between members of the CBOE that are subject to the fee and other members of the CBOE and non-member professional traders who are not subject to the fee.

[3] The CBOE describes these firms as firms "that include payment as a factor in their order routing decisions in designated classes of options."
[4] Under the CBOE proposal, a market maker will be eligible to request a vote, and to vote, if the market maker has transacted at least 80% of its market maker contracts and transactions in each of the three immediately preceding calendar months in options classes traded in that crowd's station, and who continues to be present in the trading crowd at the time of the vote.
[5] *See* Letter from Joel Greenberg on behalf of SIG to Jonathan Katz dated June 11, 2003. SIG also requested that the Commission treat the letter as a petition for rulemaking under Rule 192 of the SEC's Rules of Practice to repeal transaction and marketing fees adopted by the CBOE and other option exchanges if Section 36 were determined not to be the proper vehicle for the submission.
[6] *See* 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).

More importantly, the CBOE does not address the impact the program will have on public customers and how, if at all, this kind of competition will benefit the public customers whose transactions form the basis for this fee.

It should go without saying that the costs born by individual market makers who must pay an additional $0.40 for each contract they trade can not be underwritten by CBOE market makers indefinitely. Ultimately market makers may have to widen their spreads in order to re-coup the cost of the fee. The CBOE program seems to impose this cost only on those orders for which CBOE market makers are required to pay a fee. However, to the extent market makers pass all or any part of these costs to the public in the form of wider spreads, all public orders will suffer as market makers on the floor must post their bids and offers without knowing who is the party on the other side of the trade.

Customers will also experience the impact of the fee in other negative ways. First, because every market maker in a crowd will be hit with increased costs, there is the very real likelihood that the number of market makers in a class will decrease as individual market maker firms reduce the number of options classes in which they are willing to post a quote. Fewer market makers hurt the competitive position of the exchange and mean that customers have less liquidity, a phenomenon that by itself tends to increase customer costs. Second, customers will lose out on the opportunity to benefit from innovations (such as improvements in products, technology and customer service) that market makers may be willing to fund were it not for the increased cost they will bear as a result of the CBOE program.[7]

(2) <u>The proposals are anti-competitive, thus violating the Exchange Act</u>. The Exchange Act prohibits any exchange from adopting rules that impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act,[8] and requires exchange rules to promote just and equitable principles of trade,[9] and remove impediments to a free and open market.[10] For the reasons stated above regarding the likely impact of the CBOE proposals on public customers, we believe that the proposals violate these provisions of the Act.

We also believe that the CBOE PFOF program fee is anti-competitive for several other reasons. First, the proposal is likely to discriminate against large liquidity providers such as SIG because the fee is assessed on a per-contract basis, without regard to the benefits the Exchange and the other market makers in the crowd realize by having large liquidity providers on the CBOE floor. The fact that large liquidity providers will in all likelihood become the principal source of revenue for the PFOF program is likely to have a negative impact on the willingness of such firms to continue to provide the same depth to the market that they have in the past.

Second, the CBOE PFOF fee places an unfair burden on CBOE market makers when compared to professional traders who are not members of the Exchange. Non-member traders will not be

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[7] While the comments contained in this letter are specific to the two CBOE filings discussed herein, it should be noted that SIG objects to all exchange sponsored PFOF programs.
[8] *See* Section 6(b)(8) of the Act.
[9] *See* Section 6(b)(5) of the Act.
[10] *See id.*

required to pay these fees, yet they will be permitted to access the liquidity provided by CBOE market makers.

Third, we believe that the fee can lead to discrimination among market makers on the floor by making it possible for a group of market makers to apportion the fee among the market makers in a crowd in a discriminatory manner. While it is too soon to know if this is a real possibility, we do know that on other exchanges, PFOF fees appear to have been assessed in an arbitrary, and perhaps discriminatory, manner.[11]

(3) <u>The proposals call in to question the ability of the Exchange to properly regulate its members</u>. As the Commission knows, the Exchange Act makes clear that every exchange must have fair procedures for disciplining its members and must indeed impose discipline when member conduct so warrants.[12] What is striking about the CBOE proposals, and about all exchange sponsored PFOF programs, is that by their very nature such programs create a conflict of interest between an exchange's role as the regulator of a marketplace, and its role as a "marketer" of its exchange. For this reason alone, the rule proposals should be abrogated.

<u>Conclusion</u>

For all of the above-stated reasons and the reasons in our letter dated June 11, 2003, we respectfully request that the Commission abrogate the CBOE PFOF rules.

If any questions should arise with respect to our comments, please contact the undersigned at (610) 617-2600.

Sincerely,

/s/ Todd L. Silverberg

Todd L. Silverberg

cc: Annette Nazareth, Director, Division of Market Regulation
Robert L.D. Colby, Deputy Director, Division of Market Regulation
Elizabeth King, Associate Director, Division of Market Regulation

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[11] For example, in 2002 SIG requested that a per-contract PFOF fee of $0.50 be assessed pursuant to the PFOF program sponsored by the PCX. SIG had initially elected not to participate in the PCX PFOF program but later decided to do so as a result of competitive pressure from other exchanges that sponsor similar programs. When SIG requested that a charge of $0.50 be assessed in the classes for which SIG acted as Lead Market Maker ("LMM"), its request was denied, even though the PCX committee in charge of the PFOF program approved charges of at least $0.50 for almost all other LMM operations on the PCX. SIG was told that it could collect a fee of $0.25 for contract, which made it one of only 13 classes (out of a total of 160) for which the marketing charge approved by the exchange was less than $0.50 per contract.

[12] *See* Section 6(b)(7) of the Exchange Act.