April 23, 2004

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

RE: Concept Release on Competitive Developments in the Options Markets [Release No. 34-49175; File No. S7-07-04]

Dear Mr. Katz:

This letter is submitted on behalf of Susquehanna Investment Group ("SIG") in response to the request by the Securities and Exchange Commission (the "SEC" or "Commission") for comments to the above-referenced Concept Release (the "Release"). The Release focuses on competition in the options markets, and more specifically, on the effects that certain developments in the options markets have had on price competition, namely payment for order flow, internalization, specialist and facilitating firm guarantees, decimalization and inter-market linkage. The Commission also requests comments regarding whether certain changes (*e.g.*, penny quoting) would be beneficial to the options markets. We commend the Commission's efforts in these areas and provide the following insights.

Payment for Order Flow, Internalization and Specialist/Facilitating Firm Guarantees

We have repeatedly expressed our concerns with exchange sponsored payment for order flow plans and refer the Commission to our application for exemptive relief that is referenced in the Release.[1] As more fully explained in our application, exchange sponsored plans harm investors, market makers and the markets as a whole. These plans introduce artificial costs into the market, decrease price transparency and blur the lines between an exchange's role as the regulator of its members and its role as a "marketer" of itself. We also believe such programs violate the Exchange Act because they discriminate against certain market participants.

In the Release, the Commission has asked questions that highlight the major issues involved with any payment for order flow or internalization initiative. These questions recognize that any proposal related to these matters must create a level playing

[1] See Letter to Jonathan G. Katz, Secretary, SEC, from Joel Greenberg, Chief Legal Officer, Susquehanna International Group, LLP, re: Application for Exemptive Relief from Exchange Sponsored Payment for Order Flow Programs (June 11, 2003), Petition for Rulemaking File No. 4-474.

field for all market participants. Accordingly, it would be inherently unfair if either payment for order flow or internalization were permitted to exist without the other. In either case, a class of market participants would be disadvantaged to the ultimate detriment of public customers. For example, if all payment for order flow arrangements were prohibited, facilitating firms would have a large competitive advantage over other option brokerage firms that do not have internalization capabilities and instead rely upon payment for order flow to reduce their costs to customers. Moreover, if market makers are hampered in their ability to attract order flow, internalizing firms could potentially dictate their own terms and participation levels when facilitating order flow to the detriment of both intra- and inter-market competition. Ultimately, such competitive advantage would reduce liquidity and competition to the detriment of the public.

The Commission also recognizes that payment for order flow can take many forms and that it will be very difficult, if not impossible, to prevent all arrangements and understandings where order flow is directed to a market participant in exchange for some consideration or other benefit. Thus, it would be unfair to arbitrarily prohibit one method of payment for order flow while other arrangements continue unabated. With respect to payment for order flow and internalization initiatives generally, we believe market forces and safeguards instituted by the exchanges effectively prevent specialists or order flow providers from exerting too much market power.

However, the Commission's approach to exchange sponsored payment for order flow programs should be revisited. These plans are antithetical to a free and competitive marketplace. In the Release, the Commission extols the virtues of intra-market competition between market makers.[2] However, exchange sponsored payment for order flow plans require these natural market making competitors to join forces and pool their funds to attract order flow. Not only do the plans create a common purpose for these competitors, but they inhibit the ability of any one of these competitors from competing based on price or from using the funds it is forced to pay to find its own unique competitive advantage. While the Commission emphasizes price competition and acknowledges that this form of competition is impacted by payment for order flow, the Commission should not ignore the unique negative impact on innovation created by exchange sponsored payment for order flow plans.[3] In this regard, the elimination of

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[2] The Release recognizes that one concern with payment for order flow is that it raises the costs for market makers and that this cost must be passed on to the public in the form of wider spreads. Although we agree that the uniform fees imposed on market makers under exchange sponsored payment for order flow plans result in wider spreads, this same result does not follow from non-exchange sponsored payment for order flow. If every market maker was unencumbered by "marketing" fees assessed by the exchanges, both the intra- and inter-market competition extolled by the Commission would be enhanced.

[3] At a minimum, exchange sponsored payment for order flow programs should not be treated as merely "fee" filings that are immediately effective. Although Section 19(b)(4) and Rule 19b-4(f) permit fee filings to be effective upon filing, these provisions were not designed for controversial proposals, such as exchange sponsored payment for order flow fees, that raise significant issues regarding their burden on competition and potential harm to the public.

exchange sponsored payment for order flow will not disadvantage an exchange that has many market makers competing aggressively. To the contrary, these market makers will have every incentive to compete more aggressively on price or to develop innovative methods to compete. Moreover, they will be able to do so without the burden of their exchange's mandatory "marketing" fee. Thus, the intra-market competition from these aggressive market makers should combine with the increased competition caused by inter-market linkage and trade-through prohibitions to negate any theoretical adverse effects from payment for order flow.

Penny Quoting

Although we agree with the Commission that decimalization may have been a contributing factor to the elimination of payment for order flow in the equities markets, the adverse effects of penny quoting on the options markets will far outweigh any marginal benefits. In the Release, the Commission acknowledges that penny quoting would cause system challenges and flickering quote problems. However, the Release does not recognize the severity of these issues. Moreover, penny quoting will severely curtail liquidity in the options markets as specialists and market makers will find it difficult, if not impossible, to continue to make two sided markets in size when forced to update their markets with the frequency that would be required if penny quotes were permitted. Given these detriments and the fact that payment for order flow in the options market is diminishing[4], we urge the Commission not to adopt penny quoting in the options markets.

Penny quoting was relatively easy to implement in the equities markets as each equity security is one-dimensional. Each option class, however, has a multitude of strikes and expirations, each with its own set of quotes. If the options markets were to convert to penny increment pricing, the multitude of rapidly changing quotes would indeed cause the system capacity and flickering quote problems cited in the Release. For every movement in a stock price, there potentially could be hundreds of option price changes. Equally important, it would inevitably cause an exponential increase in the number of locked and crossed markets.

Exchange systems will not permit options specialists and market makers to update the multitude of quotes quickly enough to keep their prices current in penny increments. Such delays will result in many mispricings, including locked and crossed markets, and will thus subject options specialists and market makers to an inordinate amount of risk from the off-floor traders that will use electronic systems to seize upon these mispricings. To reduce this risk, market makers will necessarily reduce the size of their quoted markets in fear that they will be "picked-off". Consequently, the options markets will suffer from a loss of transparency in that the true size of the market will not be

[4] For example, the ISE recently eliminated its payment for order flow program and many of the market maker crowds on the Chicago Board Options Exchange have rejected the imposition of marketing fees.

disseminated. This loss of transparency will likewise result in a loss of efficiency as market participants will not know the depth of the market, or the full liquidity available at prices close to (but not at) the quoted markets. Moreover, these concerns would cost the investing public the greater liquidity that would have been otherwise available at the best displayed prices.

We also are not convinced that penny quoting in the options markets will result in the tighter markets achieved in the equities markets. Market makers will not only be discouraged from making tight markets as a result of the risks discussed above, but they will also be dissuaded by the risk of unintentionally trading against other crowd participants who may have systems that, at times, update quotes more rapidly than their systems. To avoid unintended trades with other crowd participants, market makers will either maintain wider quotes, reduce their size, or both.

Depriving public investors of liquidity at displayed prices will serve to convert listed options from a valuable hedging tool to more of a speculative day-trading tool. Options are currently a valuable hedging tool because of the leverage they provide. However, if quote sizes diminish, so will option market participants leverage opportunities. In the case of stock trading, penny quoting robbed the market of some ability to match institutional investors with block sized liquidity providers but, at the same time, provided price improvement to many small lot traders (as the "penny-improved" bids and offers are most often small lots themselves). In options, however, the loss of liquidity at an accurate price point would be more profoundly felt than it was in stocks. Smaller sized penny quotes will deprive the market of leverage by reducing liquidity at single price points. It took many years for specialist volume guarantees to reach "10-up", and then "20-up", and now higher levels in many cases. With penny quoting, these levels will begin to decline and the gains we have seen over the years will, to a large degree, be scaled back.

The systems capacity and flickering quote problems that will result from penny increments also should not be minimized. A move to penny quoting in the options markets would cause significant disruption to the consistent and reliable dissemination of option markets. The impact would be felt by all participants in the market, each suffering in their own way. The Exchanges are already challenged to significantly increase the capacity of the messaging interfaces through which quote contributors submit their quotes. This is the result of efforts to extend quoting capabilities to more liquidity providers. Quoting options in pennies could only exacerbate this problem. Moreover, although OPRA as a market utility has increased its capacity to over 40,000 quote updates per second (providing some cushion over the current peak load of approx. 20,000 quotes/second), it is likely that this cushion would not last long if the market moves to penny quoting, thus jeopardizing the market data distribution infrastructure. Market data vendors will also be impacted and forced to resolve the conflict between providing high quality service at a cost that the market will bear. While processing quote volumes at the magnitude and rate that will result from decimalization is possible with existing

technologies, it is not possible to do inexpensively. Either the cost to the investment community of receiving market data will become unreasonable compared to its value, or the ability of vendors to provide a reasonable level of service at a sustainable price level will be impossible, or both.

Moreover, penny increments will spur the further development of sophisticated automatic quoting systems that are so sensitive to input changes that price discovery will become ephemeral, something only machines will be able to consume. Quotes will move so rapidly that visual displays will be unusable. The result will be either a time sampling of the quote data, rather than a reliable display, or the need for more expensive and sophisticated display applications and equipment to process a completely dynamic data stream. It could become impossible for customers and brokers to determine what price they might actually receive at any moment because all they will see is a flickering screen which will update faster than their eyes or minds can process.

Charging for quote capacity is not a solution. To the contrary, if market makers and other liquidity providers had to pay for the capacity that they use, they would quote less efficiently. Because option markets are by nature noisy (quote changes in the underlying security causing numerous option market changes), an explicit charge for the capacity to maintain quotes would be a disincentive to maintain tightly priced markets. Because the quote to trade ratio in the options markets is extraordinarily high (compared with equities) and the chances of trading on any targeted published market is so low, a liquidity provider would be reluctant to pay to display quotes when the likelihood of a trade occurring is so limited. This would encourage wider quotes that change less frequently, a result that is clearly damaging to the quality of the market. Moreover, as one of the goals of decimalization would be to reduce costs (whether as a disincentive to payment for order flow or to permit reduced spreads), it seems antithetical to this goal to impose an additional quote capacity usage cost on liquidity providers.

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We appreciate this opportunity to provide our comments and urge the Commission to abrogate exchange sponsored payment for order flow programs and to proceed very cautiously before introducing decimalization to the options markets.

Sincerely,

Todd Silverberg

Todd Silverberg
General Counsel