



SUSQUEHANNA
INVESTMENT GROUP

AFFILIATE OF SUSQUEHANNA INT'L GROUP, LLP

August 16, 2005

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

Re: SR-PHLX-2005-44

Dear Mr. Katz:

This letter is submitted on behalf of Susquehanna Investment Group ('SIG')¹ for the purpose of commenting on the above-referenced rule proposal recently submitted to the Securities and Exchange Commission (Commission) by the Philadelphia Stock Exchange, Inc. (Phlx' or the 'Exchange'). This proposal² amends the Exchange's equity options payment for order flow programs by, among other things, making Directed ROTs³ ('DROTs') ineligible to request reimbursement for payment for order flow paid by them to induce order flow providers to direct equity option order flow to the Phlx even though competing specialists are eligible to receive such reimbursements. We strongly urge the Commission and its staff to abrogate this proposal because (1) the program eliminates competition between specialists and ROTs for order flow to the detriment of the investing public; (2) the program violates the Exchange Act of 1934, as amended (the 'Exchange Act'), because it unfairly discriminates against DROTs in favor of specialists; and (3) the filing is not of a type that should be effective upon filing

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-PHLX-2005-44 became immediately effective upon filing pursuant to Section 19(b)(3)(A)(ii) of the Exchange Act and subparagraph (f) of Rule 19b-4 thereunder.

³ A "DROT" is an Exchange registered options trader who receives customer orders to buy or sell options that have been specifically directed to the trader ('Directed Orders').

Recently, the Phlx amended its payment for order flow program to support its initiative to allow Directed Orders to be sent to DROTs.⁴ Under the Exchange's initial proposal (the "Initial Proposal")⁵, specialists and ROTs participating in any Directed Order were assessed a payment for order flow fee for any contracts allocated to them when they were not a Directed Participant for that transaction. Specialists and DROTs were then able to request reimbursement for the expenses they incurred in attracting order flow to the Exchange from the funds collected from all ROTs. In adopting the Initial Proposal, the Exchange stated that the program was intended to permit specialists and DROTs to compete for order flow. By eliminating the DROTs ability to collect revenues directly attributable to the order flow it attracts, the Phlx has severely reduced (if not eliminated) the DROTs ability to compete for this order flow. To illustrate, assume an order flow provider has a 100 contract order. Under the current proposal, the Phlx specialist is able to collect \$0.60/contract from all ROTs participating in the transaction to supplement the payment it is willing to make to the order flow provider to direct that order to the Phlx. If the specialist is willing to pay \$0.60/contract for the portion of this transaction it effects, the order flow firm will receive \$0.60 contract for its entire order, or a total of \$60 for this order (*i.e.*, \$0.60/contract from the specialist and \$0.60/contract from the other participating ROTs). Even if a DROT were willing to pay substantially more than the specialist for this order, it would be very difficult for the DROT to compete with the specialist. For example, if the DROT were willing to pay twice as much as the specialist (*i.e.*, \$1.20/contract) for the portion of the transaction with which it interacts, the DROT will not be able to compete with the specialist. This is because the DROT only will be able to interact with up to 40% of the 100 contract order and thus will only be willing to pay \$48 for this order (100 contracts x 40% x 1.20/contract). The specialist on the other hand will pay \$60 for this order (\$0.60/contact x 100 contracts) as it is able to use the funds collected from the ROTs to supplement its payment. If the DROT were able to use the funds collected from the ROTs participating in the transaction, the order flow provider could have received \$84 for this order (\$1.20 x 40 contracts plus \$0.60 x 60 contracts). The public clearly loses from this loss of competition. As has been widely reported, retail option commissions continue to decline and retail customer offerings continue to expand. The revenues that order flow providers receive as a result of payment for order flow are large contributors to the ability of order flow providers to reduce commissions and make technological advancements for the benefit of their customers.

While the Commission, for the reasons set forth above, should abrogate the rule filing to further the public interest and protect investors, abrogation of the rule is also appropriate because the Exchange's proposed payment for order flow program unfairly discriminates against DROTs in favor of specialists. As the Commission recognized in its Concept Release on Competitive

⁴ Phlx Rule 1080(1).

⁵ See SR-PHLX-2005-37. The SEC abrogated this proposed rule, see Securities Exchange Act Release No. 51984 (July 7, 2005).

Developments in the Options Markets [Release No. 34-49175; File No. S7-07-04], any proposals related to payment for order flow should create a level playing field for all market participants so they can all compete to the ultimate benefit of public customers. Moreover, the rule change violates the Exchange's duties to establish an equitable allocation of dues and other charges and to avoid unfair discrimination among dealers and promote just and equitable principles of trade under Sections 6(b)(4) and (5) of the Exchange Act.

Under the proposed plan, the Phlx imposes a payment for order flow fee on all ROTs that are not Directed Participants for the portion of a Directed Order in which they participate. However, the DROT is not able to use these funds to help pay the cost of the order to which the fee relates. Instead, the specialist is able to use funds collected on transactions directed to the Exchange from the efforts of a DROT to supplement the specialist's efforts to attract other order flow. The rule, thus, allows the specialist to divert fees generated by transactions in which it played a secondary role to enhance its competitive position in attracting other order flow for which it will get a larger participation rate. It is hard to imagine how these fees can be characterized any other way but unjust, inequitable and discriminatory.

If this did not place the DROT at enough of a competitive disadvantage, the plan also requires that the DROT disclose its payment for order flow strategy to the specialist in order to share in the payment for order flow fees collected by the Exchange. Under the proposed plan, only the specialist can make payments to order flow providers. In order for the specialist to pay an order flow provider for order flow attracted by a DROT, the DROT will have to disclose to the specialist the amount payable, and presumably the calculation, for each payment to be made to an order flow provider. DROT's view this information to be sensitive, competitive information and are certainly going to be reluctant to share this information. Thus, a DROT will be in a catch-22 situation whereby they either have to disclose competitively sensitive information or forego any chance to share in Exchange collected payment for order flow fees.

Given the deficiencies in the Phlx' payment for order flow program, it is not surprising that the filing does not contain any discussion on the proposal's impact on competition. Instead the Phlx filing simply and summarily concludes that the program is "designed to enable the Exchange to compete with other markets in attracting customer order flow" and will "serve to enhance the competitiveness of the Phlx and its members." However, the Phlx filing never addresses what impact its payment for order flow program will have on competition between members of the Phlx, particularly between specialists and DROT's. More importantly, the Phlx 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.

Finally, this is not the type of rule filing that should be effective upon filing. The Exchange designated the proposed rule as a fee change pursuant to Section 19(b)(3)(A)(ii) of the Act and Rule 19b-4(f)(2) thereunder. Although the Exchange's program does involve a fee and the proposal does increase the fee payable pursuant to the program, the rule filing involves much

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more than the mere changing of a fee. Instead the proposal involves a wholesale rewriting of the Exchange's payment for order flow program, including an elaborate mechanism for the allocation of collected fees. The complexity of the proposal is evidenced both by its length, and more strikingly, by the Commission's recent abrogation of the Phlx's first attempt to revamp its payment for order program.⁶

For the reasons set forth above, we respectfully request that the Commission exercise its authority and abrogate the Phlx proposal. If you have any questions with respect to our comments, please contact the undersigned at (610) 617-2600.

Sincerely,

/s/ Todd L. Silverberg

Todd L. Silverberg
General Counsel

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

⁶ See Securities Exchange Act Release No. (July 7, 2005).