



BOSTON  
STOCK EXCHANGE

June 8, 2007

Via Electronic Mail  
and Federal Express

Nancy M. Morris  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549

***Re: File No. SR-BSE-2006-56***

Dear Ms. Morris:

The Boston Stock Exchange, Inc. (“BSE” or “Exchange”) respectfully submits this response to a comment letter received by the U.S. Securities and Exchange Commission (“Commission”) regarding the BSE proposal (“Proposal”) to amend the Rules of the Boston Options Exchange (“BOX”)<sup>1</sup> to add a new order functionality called an Automatic Auction Order (“AAO”) in order to make it easier for all Customers, including non-professional customers, to participate in Improvement Auctions (*e.g.*, BOX’s Price Improvement Period (“PIP”)).<sup>2</sup> Together with Partial Amendment No. 2,<sup>3</sup> these proposals create a mechanism that will make it easier for Public Customers to participate in Improvement Auctions.

In response to the original rule filing the Exchange received one comment in opposition to the proposal.<sup>4</sup> The commenter expressed concerns that: (1) the AAO could become a non-

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<sup>1</sup> Capitalized terms not otherwise defined herein shall have the meanings prescribed under the BOX Rules.

<sup>2</sup> See Securities Exchange Act Release No. 55233 (February 2, 2007), 72 FR 6626 (February 12, 2007) (SR-BSE-2006-56).

<sup>3</sup> See Partial Amendment No. 2 (submitted June 8, 2007) (SR-BSE-2006-56).

<sup>4</sup> See Letter from Michael J. Simon, Secretary, International Securities Exchange to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission re: File No. SR-BSE-2006-56, dated March 5, 2007 (“ISE Comment Letter”).

transparent internalization mechanism for firms, with no exposure to the BOX marketplace; (2) since the AAO is not broadcast to BOX Participants it does not provide additional price improvement opportunity; (3) the AAO's time priority will discourage other BOX Participants from competing aggressively for PIP orders; (4) Participants can adjust the AAO price without other Participants knowing about its interest while maintaining price priority; and (5) that there should be no other 'penny pricing' initiative during the Penny Pilot.<sup>5</sup> The BSE disagrees with the core concerns expressed by the commenter opposing the original proposal for the reasons outlined below.

### ***Internalization Mechanism***

The BSE does not believe that AAO will create a non-transparent internalization mechanism for Options Participants. Nevertheless, at least for the initial stage of this functionality, the BSE believes that it is appropriate to amend its proposal to limit the use of the AAO to Public Customers only, which will be allocated trades in the Improvement Auction accordingly. As such, any internalization concerns are unwarranted for this proposal. If the BSE expands the use of AAO to non-Public Customers, then it will address any internalization concerns at that time.

### ***Price Improvement Opportunity***

The BSE does not agree that the AAO is inconsistent with the Commission's approval of PIP and fails to provide additional price improvement opportunities. The AAO is very similar to the Customer PIP Order ("CPO") that was approved by the Commission in the original PIP approval.<sup>6</sup> The main difference being that the submission of the AAO Improvement Order is done by the BOX trading system rather than the Order Flow Provider ("OFP"). In approving the PIP, the Commission stated that it "believes that permitting Public Customer Orders to participate in the PIP through the use of CPOs is an adequate means of Public Customer access to the PIP." The BSE believes that AAO provides even greater access and more opportunities for price improvement than the CPO because an OFP is not required to submit a CPO Improvement Order to the PIP, while the BOX Trading Host will always automatically submit eligible AAO Improvement Orders to the Improvement Auction. The BSE notes that the CPO also contains a price that would provide additional price improvement that is not broadcast to Participants. It is the CPO's PIP Reference Price, which may not ever be submitted to a PIP as the OFP manages the price level of the Improvement Order. Nonetheless, the Commission recognized the added value of the CPO to the PIP process and should also for the AAO.

In addition, since the AAO penny interest is not broadcast to Participants, yet its potential improvement is always present, it will incent competitors to put forth their best price in order to potentially better the AAO Maximum Improvement Price and increase their likelihood of allocation. The AAO also increases the size available at the best Improvement Order price. If the best Improvement Order is not for the full quantity of the PIP Order, the AAO will execute at the best price for up to its full quantity, thereby providing additional price improvement, *i.e.*, a

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<sup>5</sup> *Id.*

<sup>6</sup> See Securities Exchange Act Release No. 49068 (January 13, 2004), 69 FR 2775 (January 20, 2004) (File No. SR-BSE-2002-15).

better price, for the contracts in excess of the quantity of the best Improvement Order. Currently, those contracts would execute at the next best price level.

### ***Time Priority***

The BSE does not agree that the AAO's time priority will discourage aggressive competition for PIP Orders by Participants. The AAO provides Public Customers with an easier way to participate in Improvement Auctions, but will not discourage Participants from competing for PIP Orders. A Market Maker's order will yield to the AAO due only to time priority, since the time stamp of the AAO is the time of the submission of the limit order and the time stamp of the Market Maker's order is the time of the submission of the Improvement Order. Market Makers will be competing with Public Customers, however; as stated above, this competition with Public Customers will increase aggressive price competition within the Improvement Auction as it will incent competitors to put forth their best price in order to potentially better the AAO. Further, this not much different than the current PIP as there is always a chance that a Participant can join in at the end of an auction and other Participants would not have time to react.

### ***Price Adjustment***

The BSE does not agree that permitting a Participant to adjust their AAO Maximum Improvement Price without disclosing such interest to other Participants provides too great of an advantage for AAOs that it eliminates competition in the PIP. As stated above, since the AAO penny interest is not broadcast to Participants, yet its potential improvement is always present, it will incent competitors to put forth their best price in order to potentially better the AAO Maximum Improvement Price and increase their likelihood of allocation. Further, the criticism that the "member that utilizes an AAO can monitor the PIP auction and adjust the penny price of the AAO to assure that the AAO matches the best price established by other market participants"<sup>2</sup> misunderstands the utility of the AAO. The AAO functionality is being proposed in order to make it easier for more non-professional customers to participate in an Improvement Auction because they lack the ability to monitor and adjust prices fast enough to be competitive and may not have access to a broker that utilizes the CPO function. With AAO functionality they don't need to be able to monitor the PIP. The Trading Host will automatically match the best price established in the auction up to the AAO Maximum Improvement Price. Therefore, AAO actually increases competition in the PIP because it allows more new entrants. Additionally, since Public Customer Orders already have priority status in Improvement Auctions pursuant to customer priority rules, AAO will only incrementally increase the priority available to them.

### ***Penny Pilot Results***

The BSE sees no reason not to implement another 'penny pricing' initiative such as the AAO during the Penny Pilot. The AAO and the Penny Pilot can run simultaneously providing Public Customers greater access to penny pricing with minimal impact to the results of the Penny

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<sup>2</sup> See ISE Comment Letter at 3.

Pilot. BOX was the first options exchange to introduce penny pricing with the PIP and is continuing its path of innovation with the AAO.

We also wish to point out that AAOs may only be entered for those series that are limited to trading in standard increments greater than one cent (non-penny series). Some of those classes may be included in the current Penny Pilot, however, we believe this will have minimal impact on the results of the pilot. While flattered by the notion that the AAO and BOX's Improvement Auctions will be so successful as to distort the statistically results on the Penny Pilot from the whole options markets, we doubt this would result from the introduction of the AAO functionality or impact the Staff's decisions regarding the Penny Pilot.

**Conclusion**

The BSE believes that AAOs will increase the number of Improvement Orders that will be available to participate in an Improvement Auction and thus create a greater possibility for better execution prices on all orders placed on BOX, without harm to customers or the markets as a whole. The BSE appreciates the opportunity to respond to comments on the Proposal.

Please contact me if you have any questions regarding this response or would like to further discuss these matters.

Sincerely,

A handwritten signature in cursive script that reads "William Meehan". The signature is written in black ink and is positioned below the word "Sincerely,".

William Meehan  
General Counsel

cc: Elizabeth King