

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-50814; File No. SR-BSE-2004-52)

December 7, 2004

Self-Regulatory Organizations; Boston Stock Exchange, Inc.; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto Relating to Market Maker Quote Obligations Under the Rules of the Boston Options Exchange Facility

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on November 24, 2004, the Boston Stock Exchange, Inc. (“BSE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. On December 3, 2004, the BSE filed an Amendment No. 1 to the proposed rule change.<sup>3</sup> The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The Exchange proposes to adopt a rule under the rules of the Boston Options Exchange Facility (“BOX”) to provide BOX Market Makers protection from the unreasonable risk associated with communication failures and systemic errors. The text of the proposed rule change, as amended, is below. Proposed new language is in *italics*.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> In Amendment No. 1, the BSE made technical, non-substantive changes to the rule text.

**Chapter VI.**

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**Sec. 12 Standard Market Maker Protection Mechanism****(a) Trade Counter**

The Trading Host will maintain a "trade counter" for each Market Maker on each class to which the Market Maker is appointed. This trade counter will be incremented by one every time the Market Maker executes a trade of at least 10 contracts on any series in the appointed class. Whenever the Trading Host receives from the Market Maker a message to update or refresh any of his quotes on any of the options series in the same class, the trade counter at the Trading Host for that class will be reset to zero.

**(b) Standard Market Maker Protection Mechanism**

The Trading Host will implement the Standard Market Maker Protection Mechanism on an appointed class whenever the following conditions are met:

- i. the trade counter has reached "n" executions against the quotes of the Market Maker in the Market Maker's appointed class; and
- ii. the Trading Host has not received from the Market Maker a message to update or refresh any of his quotes on any of the options series in the same class before the "n" executions have occurred.

When the above conditions are met, the Trading Host will automatically cancel all quotes posted by the Market Maker on that class by generating a "bulk cancel" message.

**(c) The bulk cancel message will have the same time priority as any other quote or order message received by BOX. Any orders or quotes that matched with the Market Maker's quote and were received by the Trading Host prior to the receipt of the bulk cancel message**

will be automatically executed. Orders or quotes received by the Trading Host after receipt of the bulk cancel message will not be executed against the Market Maker. At any time the Market Maker may update or refresh any of its quotes for any of the options series in the same class and reset the trade counter to zero.

- (d) The Board shall determine the appropriate trade counter threshold of "n" executions required in paragraph (b) above to implement the Standard Market Maker Protection Mechanism. In no case will the threshold be lower than five.

### **Sec. 13 Advanced Market Maker Protection Mechanism**

- (a) The Advanced Market Maker Protection Mechanism is enabled (or disabled ) for an options class when a Market Maker sends an Advanced Market Maker Protection enabling (or disabling ) message to the Trading Host. Unless enabled, the Advanced Market Maker Protection Mechanism is disabled for all options classes.
- (b) When the Advanced Market Maker Protection Mechanism is enabled for a Market Maker's appointed options class, any "bulk quote" message sent by the Market Maker on that class is automatically rejected as soon as one of the following activating events occurs:
- i. The Market Maker's Standard Market Maker Protection Mechanism is triggered for that class, pursuant to Section 12; or
  - ii. The Market Maker activates the Panic Quote function for that class pursuant to Section 14.
- (c) Once the Advanced Market Maker Protection Mechanism has been activated for an options class, any bulk quote messages sent by the Market Maker on that class will continue to be rejected until the Market Maker sends an Advanced Market Maker Protection enabling or disabling message to the Trading Host.

(d) For purposes of this Section 13, a “bulk quote” message is a single message from a Market Maker that simultaneously updates all of the Market Maker’s quotes in multiple series in a class at the same time.

**Sec. 14. Panic Quote**

A Market Maker may simultaneously cancel all its quotes in an assigned class by sending a Panic Quote message to the Trading Host through the Panic Quote channel, or otherwise requesting BOX operations staff to manually generate the Panic Quote message to the Trading Host in order to cancel all of the Market Maker’s quotes in that class.

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II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it had received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The purpose of the proposed rule change is to provide all BOX Market Makers protection from the unreasonable risk of multiple nearly simultaneous executions caused by communication failures or systemic errors. Like auto-quote systems used on other options exchanges, the primary method for Market Makers to update their quotes on BOX is to post and update quotes

on multiple series of options at the same time through the use of “bulk quotes”.<sup>4</sup> Generally, these quotes are based on the Market Maker’s proprietary pricing models that rely on various factors, including the price of the underlying security and that security's market volatility. As these variables change, a Market-Maker's pricing model and automated quote system will continuously enter bulk quote updates for most or all series in the class.

In most instances a Market Maker sends a message to BOX to update or refresh its quote on at least one series in its assigned class after each execution by the Market Maker in that options series or any movement in the underlying security’s price. Several executions in the class without any message or quote update from the Market Maker would indicate some type of technical breakdown in either the Market Maker’s communication link with BOX or the Market Maker’s automated trading and quotation system. If a Market Maker’s communication link with BOX is lost or delayed and the Market Maker cannot effectively update its quotes after an execution or when the underlying security’s price moves, then the Market Maker’s stale quotes are vulnerable to being hit and automatically executed across all the series in the assigned class nearly simultaneously. Similarly, if the Market Maker’s pricing model and automated quote update system malfunctions, the Market Maker’s bulk quote update could inadvertently automatically execute across all the series in the assigned class.

These nearly simultaneous multiple executions can create huge unintended principal positions for the Market Maker and expose the Market Maker to unnecessary market risk. Firm risk management procedures dictate that Market Makers must take into account the possibility of such errors and the corresponding risk to the Market Maker and the firm. As a result, the BSE

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<sup>4</sup> A “bulk quote” message is a single message from a Market Maker that simultaneously updates all of the Market Maker’s quotes in multiple series in a class at the same time.

believes that Market Makers widen their quotes, quote less aggressively and limit their quote size in order to avoid such unintended executions and the attendant risks and costs, all to the detriment of customers and other market participants. The proposed rule addresses these concerns.

### **Standard Market Maker Protection**

The Standard Market Maker Protection feature on BOX would protect all Market Makers from excessive multiple and unintended automatic executions due to the following:

- Communication problems preventing the Market Maker from making intended quote updates.
- Technical or systemic errors causing Market Maker quote update errors.
- Bulk quotes unintentionally “sweeping the book” or being “swept”.

The Standard Market Maker Protection Mechanism would begin with a "trade counter" for each class where the Market Maker has a market making appointment. This trade counter would be incremented by one every time the Market Maker executes a trade of at least 10 contracts on any series of the assigned class. The trade counter would reset every time the Market Maker sends a quote update or refresh message to BOX on any one of the series within the class. The Boston Options Exchange Regulation LLC (“BOXR”) Board would define a threshold number for the trade counter to reach (currently determined to be five)<sup>5</sup> to trigger the implementation of the Standard Market Maker Protection Mechanism. This would limit the number of consecutive executions a given Market Maker could have automatically executed on an assigned class without BOX receiving any message from the Market Maker.

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<sup>5</sup> In no case will the threshold be less than five.

Once the trade counter has reached the defined threshold number of five, the Trading Host would automatically cancel all quotes posted by that Market Maker on that class by generating a bulk cancel message. The bulk cancel message would have the same time priority as any other quote update or order message the Trading Host receives, so that any orders or quotes that matched with the Market Maker's quote and were received by the Trading Host prior to the receipt of the cancel message would be automatically executed pursuant to the BOX rules. Orders or quotes received by the Trading Host after receipt of the cancel message would not be executed against the Market Maker.

As soon as the Standard Market Maker Protection Mechanism is triggered, the Market Maker would receive a message to confirm the cancellation of the Market Maker's quotes on the given class. The Market Maker could respond with a quote update or refresh, or no reply, which BOX would assume means a communication or system problem with the Market Maker. At any time the Market Maker may update or refresh any of its quotes for any of the options series in the given class and reset the trade counter to zero.

#### **Advanced Market Maker Protection**

The Advanced Market Maker Protection Mechanism would provide Market Makers with an additional feature that may be enabled/disabled on demand by the Market Makers using a special message sent to the Trading Host. The Market Maker would enable the mechanism by sending BOX an Advanced Market Maker Protection enabling message. When enabled, the Advanced Market Maker Protection feature would cause BOX to automatically reject any bulk quote message sent by the Market Maker on a specific appointed class as soon as one of the following events occurs:

- The Market Maker's Standard Market Maker Protection Mechanism is triggered for the

given class.

- The Panic Quote function is triggered by the Market Maker for the given class.<sup>6</sup>

Quoting for the Market Maker on an options class would be disabled once the Advanced Market Maker Protection Mechanism is triggered for such class.<sup>7</sup> Any subsequent bulk quote update message would be rejected. Quoting for the Market Maker would only be reactivated by the Market Maker sending to BOX a new Advanced Market Maker Protection enabling message.

### **Standard and Advanced Market Maker Protection**

These mechanisms would protect both Market Maker quotes currently posted and in the BOX book and those incoming bulk quotes that a Market Maker may erroneously generate as part of an automatic update. For example, this would mean that a new bulk quote message from a Market Maker that is immediately executable across multiple series would not generate a number of executions greater than the defined threshold number (i.e. would not allow the Market Maker to unintentionally sweep the book).

Without these protection mechanisms multiple unintentional trades could automatically occur. These executions would not properly reflect the true nature of the market and would subject Market Makers to unreasonable market risk and multiple execution and clearing fees, with no real economic justification behind the trades.<sup>8</sup> The Exchange believes the proposed rule change would reduce these inefficiencies and risks by preventing a BOX Market Maker from

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<sup>6</sup> See discussion of Panic Quote below.

<sup>7</sup> No other options classes would be affected.

<sup>8</sup> In many instances such trades qualify under the BOX obvious error rule and are busted. However, not all trades created by these circumstances technically qualify. The Market Maker Protection Mechanism would also spare BOXR from expending considerable resources to address obvious errors that arise in this manner.

erroneously trading automatically multiple times. Under normal circumstances, BOX Market Maker quotes do match and are automatically executed; however, these are usually only on a few series in a class and involve immediate quote updates after an execution. The trade counter would not reach the threshold level under most circumstances.

The Exchange believes these protection mechanisms would eliminate trades that are involuntary, the result of technological error or inaccuracy, and that impede certain liquidity providers' ability to competitively quote. Also, the Exchange believes the protection mechanisms would increase the liquidity available in the BOX market and would enhance competition because Market-Makers would be better able to quote larger size aggressively with fewer concerns over technological breakdowns.

### **Panic Quote**

A Market Maker may simultaneously cancel all its quotes in an assigned class by triggering the Panic Quote function. The Panic Quote function would be triggered by the Market Maker sending a Panic Quote message to the BOX Trading Host through the Panic Quote channel, or otherwise requesting BOX operations staff to manually generate the Panic Quote message to the Trading Host in order to cancel all of the Market Maker's quotes in that class.

Triggering the Panic Quote function would also trigger the Advanced Market Maker Protection Mechanism, and all subsequent bulk quote messages would be rejected by the BOX Trading Host until the Market Maker sends a new Advanced Market Maker Protection enabling message.

These market maker protections do not relieve a Market Maker's obligations pursuant to Chapter VI, Sections 5 and 6 of the BOX Rules; in particular, Chapter VI, Section 6(d) of the BOX Rules which addresses a Market Maker's obligation to enter continuous quotations for the options

classes to which it is appointed. After a market maker protection has been utilized, Market Makers are expected to resume entering continuous quotations for the options classes to which they are appointed as soon as practicable.

2. Statutory Basis

The Exchange believes that the proposal is consistent with the requirements of Section 6(b) of the Act,<sup>9</sup> in general, and Section 6(b)(5) of the Act,<sup>10</sup> in particular, in that it is designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and protect investors and the public interest.

B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The Exchange has neither solicited nor received comments on the proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding, or (ii) as to which the Exchange consents, the Commission will:

- (A) by order approve such proposed rule change; or

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<sup>9</sup> 15 U.S.C. 78f(b).

<sup>10</sup> 15 U.S.C. 78f(b)(5).

- (B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-BSE-2004-52 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-BSE-2004-52. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth

Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the BSE. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available. All submissions should refer to File Number SR-BSE-2004-52 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>11</sup>

Jill M. Peterson  
Assistant Secretary

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<sup>11</sup> 17 CFR 200.30-3(a)(12).