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Via Electronic Mail
and Hand Delivery

Nancy Morris, Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Proposed Rule Change by the Boston Stock Exchange, Inc. Relating to the Directed Order Process on the Boston Options Exchange, File No. SR-BSE-2005-52

Dear Ms. Morris:

The Interactive Brokers Group, on behalf of its affiliates Timber Hill LLC and Interactive Brokers LLC, respectfully submits these comments on the proposal of the Boston Stock Exchange ("BSE") to amend its Directed Order rules to clarify that the identity of the firm submitting a Directed Order to a market maker for price improvement will be disclosed to the market maker.

The BSE proposal presents a straightforward legal and policy issue: whether a market maker, in deciding whether voluntarily to execute an order at a price ***better*** than that market maker's legally enforceable Firm Quote, can consider the source of the incoming order in deciding whether to price improve it (*e.g.*, declining to price improve arbitrage orders sent from competing market makers while agreeing to price improve small customer orders sent from firms with whom the market maker has a business relationship). As we show below, the BSE proposal to allow market makers to know which order flow provider is directing a price improvement order to them is fully consistent with the Commission's Firm Quote Rule and with longstanding market practice, will reduce abusive behavior between market makers, and will foster greater price improvement of public customer orders on BOX.

Background

Most orders on BOX are executed on the BOX order book at the best bid or offer currently being displayed by the dozens of competing market makers on BOX. Similar to an ECN, the BOX order book is fully electronic and anonymous and any marketable order sent to the book will trade at the BOX market makers' collective best Firm Quote.

As an adjunct to the anonymous limit order book, BOX developed a Directed Order process, the purpose of which was to allow BOX order flow providers (or "OFPs") to send customer price improvement orders to specified market makers (and thus to allow market makers to compete for order flow through price improvement provided to brokerage customers rather than payment for order flow to brokerage firms). When a BOX market maker receives a Directed Order, the market maker must either: a) price improve the order by at least one penny (at which time a 3-second "PIP" auction is begun for further price improvement); or b) decline to price improve the order (at which time the order is released to the BOX book and guaranteed to execute at the BOX Firm Quote if BOX is at the National Best Bid or Offer – "NBBO").

Because of a series of procedural protections built into the BOX Directed Order system at the Commission's behest, even if a market maker declines to price improve a Directed Order that has been sent to the market maker, that order will receive firm quote treatment and either will be filled at the market maker's Firm Quote (if NBBO) or linked away to another exchange (if not NBBO). Thus, no order is ever prejudiced by a market maker's decision not to price improve the order.

Under the current BOX technology platform and rules, a market maker must indicate whether it is willing to accept Directed Orders or not. If a market maker opens its gateway to Directed Orders, any BOX order flow provider can send Directed Orders through the gateway. Moreover, such orders can be customer orders, orders from broker-dealers, or even orders from competing market makers.

While no Directed Order is ever prejudiced by a market maker's decision not to price improve it, a market maker incurs a significant burden when it receives a Directed Order. While the market maker holds a Directed Order, the market maker is fully subject to best execution and limit order handling obligations – even though the market maker has no control over whom it receives these orders from. If the market maker determines not to price improve the Directed Order and the Directed Order is released to trade on the BOX book, the market maker must yield priority and all other market makers can trade with the order at NBBO ahead of the original market maker. Moreover, if no other market makers decide to trade with the Directed Order during the three second period after it is released to the book, the original market maker, if it was posting NBBO when the Directed Order was received, must guarantee the Directed Order a fill at the original NBBO, even if the market has moved and that favorable NBBO price otherwise would no longer be available. Forcing the market maker to guarantee its Firm Quote for three seconds for a Directed Order that it declines to price improve, while at the same time forcing the market maker to yield for three seconds to other market makers who want to trade at that price, provides an incentive for the receiving market maker to price improve the Directed Order and yet at the same time protects the Directed Order if the market maker declines to price improve it.

The customer protections built into the BOX Directed Order rules have nonetheless created an opportunity for some BOX market makers to engage in abusive practices that were not intended and that jeopardize the ability of all market makers to price improve customer orders. Some BOX market makers have declined to accept any Directed Orders themselves, and yet at the same time have adopted the tactic of sending large numbers of unwanted Directed Orders to other, competing market makers using various arbitrage strategies. For example, a market maker may buy an option for $5.00 on another exchange and then immediately send a Directed sell Order to a market maker on BOX against BOX's $5.00 bid, attempting to pick up a risk-free dollar or two per contract. Or if the BOX best bid is $5.00 for 20 contracts, a marker maker may send a sell order to the BOX book for 20 and at the same time send a Directed Order for 20 contracts to a competing market maker. Again, because of the customer protections built into the BOX rules, the BOX market maker receiving these Directed arbitrage Orders either will end up price-improving a competing market maker's order, or declining to price improve it and thus having to yield priority at the NBBO.[1]

The current BOX rule proposal would address this situation by clarifying that the identity of the firm sending a Directed Order is disclosed to the receiving market maker. This will enable market makers to decline to price improve unwanted Directed Orders from professional sources or from hostile competitors. As explained above, these orders declined for price improvement still will be executed at the market maker's Firm Quotes, but the receiving market maker will be able to limit price improvement to the customers

[1] A market maker (MM1) may also send a Directed sell Order in a volatile stock. If the receiving market maker (MM2) declines to price improve the order, the order will go to the BOX book. If the market moves down during the subsequent three seconds, MM1 will get a favorable high fill on its sell order from MM2 at the NBBO as it existed prior to the market moving down. If the market does not move down, or moves up, MM1 can put in a buy order itself or through an affiliate during the three seconds (because MM2 has to wait until three seconds have elapsed before it can trade against MM1's now-unfavorable sell order). Through this activity the original market maker sending the Directed Order creates a free option for itself to trade or not to trade against MM2 depending on the movement of the market during the three seconds in which MM2's quote essentially is frozen.

and firms to whom the market maker actually wishes to confer this voluntary benefit. Without this protection, market makers subject to large numbers of Directed Orders sent for arbitrage purposes or by hostile competitors simply will have to tighten their risk parameters and give less price improvement to everyone – or stop giving price improvement at all.

This would be a poor result for public option customers. Since the inception of the BOX market and its price improvement auction, option spreads have narrowed, trading volumes and liquidity are expanding, competing exchanges have been forced to adopt electronic trading and to begin to develop price improvement mechanisms, and tens of millions of dollars that otherwise would have been paid to broker-dealers as payment for order flow has been paid instead directly to option customers:

- Total savings to option investors in 2005 through BOX price improvement auctions was over $32.5 MM.
- 53% of marketable public customer orders sent to BOX received price improvement-- an average of 2,970 public customer orders each day.
- Average price improvement per contract on BOX was $2.55.
- Price improvement on BOX particularly benefited small customer orders, as 87% of all price improvement was for orders of 20 contracts or fewer.

Based on the developments of the past six months it has become crystal clear that each of the other exchanges except BOX are competing with each other almost solely based on how much payment for order flow they give to brokers and how clever their payment for order flow schemes are. BOX, and the BOX market makers who attempt to use the Directed Order process to provide price improvement, instead are attempting to compete based on benefit to the customer. If the Directed Order process is allowed to be subverted such that market makers are forced unwittingly to price improve orders of competing market makers and firms, then true public customer price improvement will whither or end altogether and competition among exchanges and market makers will return to being exclusively based on payment for order flow. On the other hand, if approved the current BOX rule proposal will maintain the price improvement incentive by allowing market makers to provide this voluntary benefit on a targeted basis that enhances their businesses.

Analysis

In addition to being sound as a policy matter, the BOX proposal to allow market makers to know who is sending them Directed Orders and thereby to limit price improvement to specific order flow providers is consistent with the Firm Quote rule and with the Commission's frequent statements on price improvement and limit order handling.

1. <u>The Firm Quote Rule Allows Price Improvement To Be Offered On a Differential Basis to Certain Order Flow Providers And/Or Customers</u>

The Firm Quote Rule requires market makers to execute trades at their best posted prices on a fair and equal basis to anyone who presents them with a marketable order. But there is no requirement under the Exchange Act or any Commission precedent that a market maker price improve an order or even consider an order for price improvement, which by definition is a *voluntary execution by the market maker at* ***better*** *than its Firm Quote.*

Because price improvement – by definition – means voluntarily rebating some of the bid-ask spread back to the customer and giving the customer a better fill than required, market makers and specialists have always had discretion as to which customers and order flow firms they will consider for price improvement. A market maker can improve orders from some firms and not others; as long as the market maker always trades on his ***posted quote*** on an equal and non-discriminatory basis.

A. Box Rules Guarantee Firm Quote Treatment

As noted above, protections built into the BOX rules assure that even if a market maker declines to price improve a Directed Order sent to it, the order still will be executed at that market maker's Firm Quote, or if another BOX market maker is posting a better price, then at the BOX Best Bid or Offer. Thus even if a market maker systematically declines to price improve every order sent to it by a competing firm, every such order nonetheless will be executed promptly and automatically at the BOX Firm Quote (or linked away if BOX is not at the NBBO). There is thus no danger that disclosing the identity of the firm sending a Directed Order will return the options markets back to the bad old days where "firm quotes" were only really firm to some customers some of the time.

The opponents of the proposed rule intentionally overlook this point and purposefully blur the distinction between: a) a market maker's ***mandatory obligation*** to execute any order, from anyone at the Firm Quote; with b) a market maker's ***voluntary discretion*** to go beyond the Firm Quote and provide price improvement. The Commission should ignore this attempted sleight of hand. The BOX rules and the BOX system always guarantee Firm Quote compliance.

B. The Commission Has Recognized that Market Makers May Provide Price Improvement Solely to Their Own Customers Or To Customers of Affiliated Firms

It has long been established that price improvement need not be offered equally to all customers or firms. Instead, the Commission repeatedly has recognized that market makers (especially in the equities markets) historically have used voluntary price improvement to attract certain types of orders or customers. See *e.g.*, *SEC Report to the Congress: The Impact of Recent Technological Advances on the Securities Markets* (Nov. 1997)("market makers * * * accept orders of up to a few thousand shares in the most active listed stocks from retail firms or discount brokers. * * * market maker systems include price improvement algorithms that execute customer orders at prices better than the prevailing market quotes under certain market conditions.").

Firms providing voluntary price improvement on an exclusive basis to their customers or to customers of their affiliates use it as a marketing advantage to gain customers and market share. *See, e.g.,* Website of Bernard L. Madoff Investment Securities LLC ("Madoff")("The hallmarks of our system are price improvement, speed, and enhanced liquidity delivered with a level of client service that sets us apart from our competitors. Madoff utilizes a market based, algorithmic approach to defining price improvement and enhanced liquidity."). There has never been any suggestion that such market makers must accept price improvement orders or provide voluntary price improvement to competitors or to customers of competitors. To require that market makers price improve orders from competitors' customers on an equal basis with orders from their own customers would eliminate the very purpose of these price improvement programs.

Indeed in this respect price improvement is similar to payment for order flow. Both payment for order flow and price improvement come from the same source of funds – namely, "extra" profit that a specialist or market maker realizes in a securities transaction by virtue of the bid-ask spread. A market maker may voluntarily rebate some of this "extra" profit back to the customer by giving a fill at a price better than the Firm Quote – in which case it is called price improvement. Or a market maker may voluntarily rebate some of this extra profit back to the broker that sent the order – in which case it is called payment for order flow.

Payment for order flow for options is not required to be paid on an equal basis to all types of orders or order flow providers, and is not in fact paid on an equal basis to all types of orders or order flow providers. Market makers pay for certain types or sizes of orders and not others and pay for orders from certain firms and not others. Again, this underscores that price improvement, like payment for order flow, is a benefit that is conferred on a voluntary basis by a market maker. The Commission has never confused this voluntary ability to provide price improvement (or payment for order flow) with the mandatory obligation to execute at the market maker's Firm Quote. It should not do so now.

2. <u>**BOX Market Makers Incur A Significant Burden In Handling Directed Orders And Should Be Able to Discourage Transmission of Orders from Unwanted Sources by Declining to Provide Price Improvement**</u>

A market maker incurs a significant burden when it receives a Directed Order. While the market maker holds a Directed Order, the market maker is subject to best execution and limit order handling obligations. If the market maker declines to price improve the Directed Order and the Directed Order is released to trade on the BOX book, the market maker must yield priority and all other market makers can trade with the order at NBBO ahead of the original market maker. Moreover, if no other market makers trade with the Directed Order during the three second period after it is released to the book, the original market maker must guarantee the Directed Order a fill at the market maker's Firm Quote, even if the market has moved and that favorable price is no longer available. Receiving a Directed Order in a certain option therefore essentially freezes the market maker's quote for three seconds, exposing him to potential loss in the event that the market in the underlying stock moves.

BOX market makers that wish to provide price improvement to their own customers or to customers of firms with whom they have a business relationship are willing to accept these burdens inherent in the Directed Order process in exchange for the opportunity to grow their business and market share. The circumstance becomes much different, however, where competing market makers, ***who themselves refuse to accept any Directed Orders***, send large numbers of Directed arbitrage and market maker Orders through the system to other market makers. In this case the receiving market makers lose all of the benefit of participating in the Directed Order program. If a market maker price improves a particular order – this merely benefits the market maker's competitor. If the market maker declines to price improve, the market maker is stuck and cannot update its price for three seconds and must guarantee its competitor a fill at its Firm Quote. Allowing a market maker systematically to decline to price improve hostile Directed Orders is currently the only practical means of discouraging such orders from being sent.

3. <u>**BOX Order Flow Providers (Rather Than Market Makers) Who Provide Price Improvement on BOX Are Aware of the Identity of the Sender and Are Not Required to Price Improve Their Competitors' Orders**</u>

Opponents of the current BOX proposal claim that it is inherently unfair for a BOX market maker to know the identity of the firm that sent the Directed Order to the market maker and to be able to differentiate among order sources in deciding whether to provide price improvement. But this overlooks the fact that BOX Order Flow Providers themselves also can provide price improvement (just like marker makers) by acting as a counterparty to a customer order in a BOX PIP auction. PIP auctions started by BOX OFPs are no different than PIP auctions started by BOX market makers, and yet BOX OFPs certainly know the source of the incoming price improvement order (indeed they know the identity of the underlying customer) and they certainly are under no obligation to price improve their competitors' orders on an equal basis. It would put BOX OFPs at a tremendous competitive advantage to be able to differentiate among order sources in deciding whether to provide price improvement and yet to deny this right to BOX market makers. Again, such a policy decision merely would discourage firms from acting as BOX market makers or from providing *any* price improvement at all through the Directed Order process.

Conclusion

The BOX Directed Order process was designed to allow market makers to compete to provide price improvement to public customer orders instead of having to make payments for order flow to those customers' brokers. The Directed Order process has been subverted by certain market makers who themselves refuse to accept Directed Orders and yet send large numbers of unwanted orders through the Directed Order gateway. This imposes serious burdens on the receiving firms, and unless they are given some method to defend themselves from this hostile Directed Order flow, price improvement for customers will slow or stop on BOX.

Please contact either of undersigned if you require any additional information or would like to discuss these matters further.

s/ Thomas Peterffy

Thomas Peterffy
Chairman

David M. Battan
Vice President

cc: Chairman Christopher Cox
Commissioner Cynthia A. Glassman
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Annette L. Nazareth
Robert L.D. Colby
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