INTERACTIVE BROKERS GROUP

ONE PICKWICK PLAZA
GREENWICH, CT 06830
(203) 618-5800

David M. Battan
Vice President

March 27, 2006

Via Electronic Mail
and Hand Delivery

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

Re: Amendment 4 to 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 Amendment 4 to the proposal of the Boston Stock Exchange ("BSE") to amend its rules with respect to orders being sent to market makers for voluntary price improvement consideration ("Directed Orders"). Under the amended proposal, BOX market makers would be allowed to designate in advance those Order Flow Providers ("OFPs") from whom they will accept such price improvement orders, but the identity of the OFP sending any particular Directed Order will be anonymous to the receiving market maker (and thus market makers will have to evaluate all Directed Orders that they receive on an equal and non-discriminatory basis).

The amended BSE proposal represents a simple and common sense compromise to the dispute that has arisen among BOX members as to whether the origin of a Directed Order sent to a market maker for price improvement consideration should remain anonymous. Under the new proposal the principle of anonymity of orders in an electronic environment will be preserved, yet market makers will not be required to represent or handle price improvement orders from unwanted sources.

Of course, as has always been the case on BOX irrespective of this rule proposal, the BOX system will continue strictly to enforce the Firm Quote rule, and all BOX market makers will have to trade at the price and size of their Firm Quotes immediately with anyone and everyone who sends an order to the BOX book.

To put it simply, under the proposed rule as amended, price improvement will remain voluntary and Firm Quote compliance will remain mandatory. This is precisely what the Exchange Act requires, and the Commission should approve the proposed rule as amended.

Background

Over 80 percent of BOX trading volume is 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. This 80 percent of volume that arises from ordinary BOX order book trades does not involve Directed Orders or price improvement auctions.

As an adjunct to the anonymous limit order book, BOX developed a Directed Order process in order to allow BOX Order Flow Providers 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").

Directed Orders account for a relatively minor portion of the total volume executed on BOX. In the most recent full month for which data is available, less than 13 percent of the contracts executed on BOX resulted from the Directed Order process.

Under the current BOX technology platform and rules, market makers are not required to accept Directed Orders, and indeed only three or four of the twenty-plus BOX market makers even accept such orders. However, once 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.

A BOX 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 currently 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.

These customer protections built into the BOX Directed Order rules have 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.

The original BOX rule proposal (now superseded by the current amended proposal) would have addressed this situation by clarifying that the identity of the firm sending a Directed Order is disclosed to the receiving market maker. This would have enabled market makers to decline to price improve unwanted Directed Orders from professional sources or from hostile competitors. But the original proposal would have been at odds with the general policy preference that orders on electronic markets should be anonymous.

The amended rule proposal preserves the principle of anonymity of orders in an electronic environment but at the same time allows market makers to control who can send them limit orders seeking price improvement. Once the market maker has designated the OFPs from which it will accept price improvement orders, the market maker will not know which OFP is sending an order and will have to evaluate all such orders neutrally. Yet the market maker will be able to protect itself in advance from the burdens of having to handle price improvement orders from competitors.

Analysis

The BOX proposal to allow market makers to designate the firms that may send them limit orders seeking price improvement is consistent with the Firm Quote rule and with the fundamental principles that: a) price improvement is by definition a voluntary execution at a price better than the required Firm Quote price; and b) no broker dealer is required to represent or handle limit orders from unwanted sources.

1. The Firm Quote Rule Allows Price Improvement to Be Offered on a Differential Basis to Certain Order Flow Providers and/or Customers

The Firm Quote Rule requires market makers to execute trades at their publicly displayed price and up to the full amount of their displayed size 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 price.

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 price and at his posted size*** on an equal and non-discriminatory basis.

A. Commenters Opposing the Rule Intentionally Blur the Distinction under the Exchange Act between Firm Quote Obligations and Price Improvement.

As noted above, protections built into the BOX rules assure that any BOX member can always execute against a market maker's Firm Quote (assuming that the market maker is at NBBO and at the top of the BOX book). Thus even if a market maker declines to accept from particular BOX members limit orders *seeking price improvement*, that market maker still must trade on its posted Firm Quotes with <u>all</u> BOX members.

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 sleight of hand.

Attempting to change the focus from the actual requirements of the Exchange Act and the Firm Quote Rule, one BOX market maker that opposes the current rule proposal argues that BOX market makers should not have the right to refuse Directed Orders from specific BOX participants because: "Directed Orders are a ***core exchange trading function*** … that are ***central to the BOX*** and ***constitute its greatest attraction for market share***."[1] This commenter goes on to say: "It is disingenuous for the BOX to characterize directed orders and the PIP as a ***marginal discretionary*** service offered by members.*"*

---

[1] See March 17, 2006 Letter of Citadel Investment Group ("Citadel Letter") at 3.

The first problem with this argument is that none of these vague and fanciful standards for governing market maker behavior with respect to an exchange function (*"central"* versus *"marginal" or "great attraction for market share"* versus "*not great attraction for market share*" or "*core*" versus "*not core*") ever appear in the Exchange Act or its rules. Rather, the Act and the rules quite clearly and simply require strict equality with respect to a market maker's obligation to trade at its published Firm Quote price and size.

Beyond that, even if these made-up standards *were* the applicable standards under the Exchange Act, the amended rule proposal would have to be approved. Directed Orders clearly *are* both a ***marginal*** and ***discretionary*** portion of the executions on BOX. They are ***marginal*** because less than 13 percent of the executions on BOX arise from Directed Orders (more than 87 percent do not) and only three or four of the twenty-plus market makers on BOX even accept Directed Orders.

Likewise, acceptance and execution of Directed Orders pretty clearly is ***discretionary*** under any reasonable, non-Alice-in-Wonderland interpretation of that term, because under the BOX rules as originally approved by the Commission two years ago and unchanged since, no BOX market maker is ever required to accept any Directed Orders at all. And further, even if a Directed Order is accepted, there is no requirement to price improve it. This seems awfully "***discretionary***".

Perhaps still greater proof of the fact that Directed Orders are ***discretionary*** is that the very commenter that calls Directed Orders "a core function" and "central to BOX" and the "greatest attraction for market share" ***<u>does not accept Directed Orders!</u>*** This market maker instead has chosen to compete for orders by making the highest payments for order flow in the options industry.

This is a perfectly lawful and legitimate business decision and is well within this market maker's rights, but it also illustrates the fundamental principle that this market maker labors so hard to obscure – that ***price improvement is voluntary and discretionary under the Exchange Act and under BOX rules.*** And if price improvement is voluntary and discretionary under the Exchange Act and BOX rules, and if there is no requirement to price improve any order, then there is no basis for the argument that somehow a market maker can be forced to accept and handle arbitrage limit orders from competing market makers and evaluate them for possible price improvement on exactly the same terms as it might price improve orders from its own public customers.

We hope that the Commission will recognize the hypocrisy and inherent contradiction in the opposition to the proposed rule: Because BOX market makers are not required to accept any Directed Orders, what the opponents of the rule are arguing for is the right to raise their drawbridge, sit behind their castle walls and continue not to accept any Directed Orders, while at the same time forcing their competitors to accept the arbitrage orders that they fire out from behind their ramparts.

If this vision of the BOX market structure prevails, and 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.

Indeed, the end of price improvement on BOX seems to be the result that is desired by the commenters that oppose the current BOX rule amendment. As noted, Citadel Investment Group does not even accept Directed Orders for price improvement, instead competing for order flow through an aggressive payment-for-order-flow plan. Likewise, it seems safe to assume that Amex and ISE, who both filed comment letters opposing the prior amendment of the rule proposal, do not wish to see price improvement for public customers flourish on BOX.

The diminution or cessation of price improvement on BOX 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.

Commissioners and Commission staff on several occasions have lauded the price improvement opportunities for public customers on BOX and the salutary effects that BOX has had on the national options market. Likewise, Commission staff has rightly begun to view price improvement on BOX (or another exchange offering similar functionality) as an important consideration in determining whether a broker is providing best execution for its customers' option orders. It would be unfortunate if the Commission were to be persuaded to hamper the price improvement mechanism on BOX by requiring market makers to accept arbitrage orders from their competitors, while at the same time allowing more and more complex payment for order flow schemes to dominate the industry.

B. None of the Commenters Opposing the BOX Rule Are Arguing that Payment for Order Flow Must Be Paid Equally to All Incoming Orders. Yet if the Commission Agrees with the Logic of Citadel and Amex and ISE, Then It Should Require Market Makers and Specialists on All Option Exchanges to Make Order Flow Payments on Fully Equal Terms to Anyone Sending an Order.

The Commission knows that "price improvement" is merely payment for order flow in which the payment goes directly to the customer rather than to the customer's broker. 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 of course 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 conflated 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.

If Citadel is correct that "disastrous consequences" will befall the nation's options markets unless BOX market makers who accept Directed Orders for price improvement are forced to accept them on a strictly equal basis from competing professionals and market makers, then the Commission in order to avoid this parade of horribles must likewise order any market maker that makes payments for order flow on any option exchange to make such payments on a strictly equal basis to all competing firms and market makers.

Simply stated: It would be a strange and counterintuitive result to reject the current BOX rule proposal and thereby restrict *price improvement* such that it essentially *must* be paid to a market maker's professional competitors, while at the same time allowing *payment for order flow to continue unrestricted and unfettered* by any such "equality" principle. Such a ruling would lead directly to less price improvement and more payment for order flow. This is what the opponents of the BOX proposal desire and demand.

2. **<u>BOX Market Makers Incur A Significant Burden in Handling Directed Orders and Should Not Be Forced to Handle These Limit Orders from Unwanted Sources against Their Will</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 market makers *who themselves refuse to accept any Directed Orders*, send large numbers of Directed arbitrage and market maker Orders through the system to their competitors. 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. Allowing a market maker to decline to accept Directed Orders from hostile competitors will preserve market makers' ability and incentive to provide price improvement.

Citadel argues that BOX market makers should be forced against their will to handle limit orders from their competitors seeking price improvement because BOX market makers perform the same role as specialists on traditional exchanges. *See* Citadel letter at 3 ("specialists often have limited order handling obligations with respect to orders sent to their bin or post"). This is quite a misleading argument. On exchanges where specialists have been required to represent limit orders on an agency basis it is because those specialists have sole responsibility to manage the limit order book, and the only way for a trader to place a limit order on the book is through the specialist. The very market structure of these exchanges dictates that the specialist be forced to handle limit orders because the specialist is the sole gateway for such orders to get to the book and be displayed.

BOX is entirely the opposite. All BOX members (both OFPs and market makers) have direct access to the BOX limit order book and can place any limit order on the book instantaneously and without going through any intermediary. The Directed Order process, which is at issue here, is solely a mechanism for price improvement and is not a mechanism for transmission of limit orders to the BOX book. Since there is no need to send a Directed Order to a market marker in order to place a limit order on the BOX book, the analogy to the traditional specialist's order handling obligations is inapposite and there is no rationale for forcing market makers to have to handle Directed Orders from their competitors.

3. BOX Order Flow Providers Are Not Required to Price Improve Their Competitors' Orders

BOX OFPs have the right to seek to trade against their customers' orders by initiating a PIP auction, just as BOX market makers do. PIP auctions started by BOX OFPs are no different than PIP auctions started by BOX market makers, and yet BOX OFPs certainly are under no obligation to price improve their competitors' orders on an equal basis. Again this illustrates the inherently voluntary and discretionary nature of price improvement.

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.

3. The Nasdaq and PHLX Precedents Cited in Citadel's Comment Letter Do Not Address the Issues Presented by the Current BOX Proposal

The Citadel Letter cites two recent rule proposals considered by the Commission (the Nasdaq exchange application and a PHLX rule proposal regarding Firm Quote execution size) that Citadel claims are applicable here. But again, both of these proposals addressed issues relating to executions at the Firm Quote price and size and had nothing whatsoever to do with price improvement.

With respect to the Nasdaq exchange application, the Commission was concerned that the Nasdaq market system lacked price or time priority in terms of access to market makers' collective Firm Quotes—thus raising questions as to whether the Nasdaq Market System lacked traditional elements of exchange trading. It is hard to see how this has any relevance to the BOX market. BOX's electronic order book is the mechanism for accessing BOX market makers' collective Firm Quotes and is the mechanism by which 80% of BOX volume is executed, and the BOX order book ***does operate by strict price time priority***.

With respect to the PHLX proposal, as far as we understand it the Commission did not wish to allow that Exchange to establish differential Firm Quote size guarantees for different order flow providers. The PHLX proposal thus had to with equal treatment with respect to the Firm Quote displayed size. It had nothing to do with price improvement or whether price improvement must be provided to market maker arbitrage orders on the same terms as public customer orders.

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 the current rule proposal addresses this by allowing market makers to designate from whom they will accept Directed Orders, while at the same time providing that all Directed Orders are anonymous. This is a fair and reasonable resolution of this issue which is consistent with the Commission's precedents on these issues.

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

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
Elizabeth King
Deborah Flynn
Brian Cartwright
Chester S. Spatt