



BOSTON
STOCK EXCHANGE

November 19, 2007

Ms. Nancy Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: SR-BSE-2006-16

Dear Ms. Morris:

The Boston Stock Exchange (“BSE” or the “Exchange”) respectfully submits this response to comment letters received by the U.S. Securities and Exchange Commission (“SEC” or “Commission”) regarding the BSE proposal to amend the rules of the Boston Options Exchange (“BOX”) to adopt a Universal Price Improvement Period (“UPIP”) to offer the opportunity for price improvement for eligible Public Customer¹ orders (“UPIP Proposal”).² Under the UPIP Proposal, BOX Options Participants would be able to access a universal price improvement mechanism that enables Public Customer Orders submitted to the BOX Trading Host to be eligible for potential price improvement in the UPIP auction, subject to certain eligibility requirements.

In response to the original rule filing, the Commission received three comment letters.³ The commenters expressed concerns regarding: (1) the UPIP discouraging aggressive quoting; (2) an Options Participant’s ability to cancel such UPIP Order if the market is unfavorable and the ability to cancel Improvement Orders as inconsistent with the Firm Quote Rule; (3) the National Best Bid and Offer (“NBBO”) parameters for UPIP Orders; (4) the duration of the UPIP; (5) the interaction between the PIP and UPIP; (6)

¹ Capitalized terms not otherwise defined herein shall have the meanings prescribed under the UPIP rule proposal or as otherwise defined under the BOX Rules.

² See Securities Exchange Act Release No. 55230 (February 2, 2007), 72 FR 6309 (February 9, 2007) (SR-BSE-2006-16).

³ See Letter from Mr. Michael T. Bickford, Sr. Vice President, American Stock Exchange, to Ms. Nancy Morris, Secretary, Securities and Exchange Commission, dated March 2, 2007 (“Amex Letter”); Letter from Mr. Michael J. Simon, Secretary, International Stock Exchange, to Ms. Nancy Morris, Secretary, U.S. Securities and Exchange Commission, dated March 5, 2007 (“ISE Letter”); Letter from Mr. Matthew B. Hinerfeld, Managing Director and Deputy General Counsel, Citadel Investment Group, LLC, to Ms. Nancy Morris, Secretary, Securities and Exchange Commission, dated March 6, 2007 (“Citadel Letter”).

the determination of quotes originating from an Automated Quotation System (“AQS”); and (7) that there should be no other penny pricing initiative during the Penny Pilot. The BSE disagrees with the core concerns expressed by the commenters opposing the proposal for the reasons outlined below.

I. UPIP DISCOURAGES QUOTING

Commenters expressed concerns that the UPIP would encourage Market Makers to post wide and shallow quotes thereby discouraging Market Makers from quoting aggressively until the UPIP auction begins.⁴ One commenter also stated that transparency will suffer because market participants will hide their trading interest until a UPIP begins.⁵ The commenters further believe that those Options Participants that do compete aggressively in the market will not be rewarded.⁶ The same criticisms were leveled against BOX’s original Price Improvement Period (“PIP”) proposal. BOX believes that the commenters’ concerns are unfounded since improvement auctions, as evidenced by the success of the PIP, generally do not discourage aggressive quoting. In fact, such improvement auctions have quite the contrary effect. After over three years of trading, including the PIP process, BOX matches or establishes the NBBO approximately 90-95% of the time. As a result, BOX generally matches the performance of the two largest options exchanges in this measure and is performing better overall than the other three exchanges.⁷

BOX Market Makers have several meaningful incentives to consistently quote at or establish the NBBO. The BOX market model, as opposed to the other existing exchanges, has: (1) an open and competing Market Maker structure with no specialist/DPM and no regulatory limits to the number of Market Makers appointed on a given class; (2) low costs to enter the market; (3) low transaction costs; (4) price and time priority on the BOX Book; and (5) anonymous trading on the BOX Book. This model encourages more Market Makers to be Options Participants on BOX, thereby increasing the competition among Market Makers for executions. Each of the aforementioned factors individually, and especially with their combined effect, give BOX Market Makers the incentive to quote aggressively in order to be executed. Further, BOX Market Makers are rewarded with priority on executions.

Along with the PIP, the BSE instituted a number of BOX rules intended to encourage Market Maker quoting. One such rule involved the Market Maker Prime (“MMP”) designation.⁸ The MMP designation was developed in order to motivate

⁴ See Citadel Letter at 1; ISE Letter at 2.

⁵ See Citadel Letter at 4.

⁶ See Citadel Letter at 1; ISE Letter at 2.

⁷ See Advertisement of International Securities Exchange (“ISE”) entitled “Best Markets 90% of the Time,” which was available at http://www.iseoptions.com/campaign/pdf/ad_11.pdf.

⁸ See BOX Rules, Chapter V, Section 19.

Market Makers to be first to establish a quote on BOX equal to the NBBO (or to establish a new NBBO). The mechanism incentivizes Market Makers by guaranteeing 20% of the trade allocation resulting from a PIP execution provided the MMP had a pre-posted quotation at the NBBO and matched the execution price at the end of the PIP. In a competitive market such as BOX, this is a strong incentive. Likewise, with the UPIP Proposal the BSE has proposed an additional BOX rule, NBBO Prime (described below), which encourages Market Makers to aggressively quote and, in addition, other market participants to aggressively post limit orders on the BOX Book in order to be first to match or establish the NBBO, and to also compete aggressively in improvement auctions. The BSE believes that these incentives lead to aggressive display of quotes and orders on the BOX Book, which enhances rather than diminishes the transparency of the BOX market.

The UPIP Proposal allows certain Improvement Orders to be designated as NBBO Prime ("NBBO Prime Order"). The NBBO Prime designation is only applicable to a UPIP auction, not the PIP, -- and generally confers time priority to a particular Improvement Order over other Improvement Orders and Unrelated Orders with the same price upon satisfaction of certain conditions. In a UPIP auction, all Improvement Orders are eligible for the NBBO Prime designation. In order to receive the benefits of the NBBO Prime designation, the same beneficial account² -- such as a customer account -- for whom the Options Participant is acting as principal or agent (whether Market Maker, Order Flow Provider ("OFP"), or Customer) and is seeking the NBBO Prime designation must itself have quotes or orders on the BOX Book that are on the opposite side of the UPIP Order ("NBBO Prime Participant Quote").¹⁰ The NBBO Prime Participant Quote must be equal to the NBBO and must have been on the BOX Book prior to receipt of the UPIP Eligible Order by the Trading Host. In addition, NBBO Prime Orders shall only have enhanced time priority for the quantity that does not exceed the size of its NBBO Prime Participant Quote - any residual quantity will be handled in accordance with the normal time priority rules. As between NBBO Prime Orders, the priority shall be governed by the relevant Trading Host order receipt time stamp of each NBBO Prime Participant Quote. Like the MMP designation, the BSE believes NBBO Prime provides a unique incentive structure to the BOX market.

II. ABILITY TO CANCEL: ORDERS/QUOTES ON THE BOOK, THE UPIP ORDER, AND IMPROVEMENT ORDERS

² For purposes of the proposed rule, a "beneficial account" means the underlying type of account (e.g., customer, broker-dealer, market maker, etc.) on whose behalf the Options Participant is trading.

¹⁰ One commenter doubts the technological feasibility of NBBO Prime because firms would have to specify the number of their order on the BOX Book that was first in time priority at the top of the BOX Book. See Citadel Letter at 4, n. 12. However, the OFP does not need to know the priority of the order. The Trading Host will determine those aspects as part of the NBBO Prime functionality. The firm simply needs to supply the unique order identifier to BOX for the appropriate order on the BOX Book. This is the same as it does today for an instruction to cancel or modify any order on the BOX. No OFP is certified to trade on BOX if it can not perform this basic task.

A commenter expressed concern regarding certain perceived customer protection issues that might be implicated by a Options Participant's inability to cancel or otherwise modify an order or quote on the BOX Book that has been stopped against a UPIP Order during an auction.¹¹ The commenter contended that an Options Participant could use the UPIP to lock in prices for three seconds and then subsequently cancel the order if the market moves against them.¹² We note that by freezing certain quotes/orders on the BOX Book displayed as the BOX quote, like the Guaranteed Directed Order ("GDO") in the Directed Order process, BOX is complying with the Firm Quote Rule.¹³ BSE will consider the UPIP Order guaranteed an execution at the stopped Firm Quote price and size (*i.e.*, Initial Aggregate Quote Size and Initial BOX Book Quote), unless an improved price is available. The BSE does not believe that any quotes or orders on the BOX Book that are held firm are disadvantaged. Rather, they will be treated as the order type intends - executable at the limit price when matched with a contra-side order and cancellable only when there is no pending execution. It is a common practice that broker-dealer and Public Customer orders are not guaranteed an immediate cancellation upon request and may be subject to prior execution.¹⁴

Further, by allowing a UPIP Order to be cancelled, BOX provides the eligible Public Customer Orders with greater flexibility. BSE believes this is necessary because, unlike the PIP, the UPIP is not guaranteed price improvement. Without the ability to cancel a UPIP Order, an OFP would have tremendous difficulty attempting to manage an order that has not been executed and where no trade confirmation has been issued.

Another commenter maintains that the ability to cancel Improvement Orders during a UPIP auction is inconsistent with the Firm Quote Rule.¹⁵ In essence, the commenter argues that an Options Participant would have a free look at the order during the auction and if the market moved against the Options Participant, the Options

¹¹ See ISE Letter at 1-2.

¹² *Id.* at 2.

¹³ We also note that the CBOE's SAL process, which was recently approved by the Commission and is similar to the UPIP proposal, has a Firm Quote provision in which the CBOE quote is frozen for the duration of the auction. See Securities Exchange Act Release No. 54229 (July 27, 2006), 71 FR 44058 (August 3, 2006) (SR-CBOE-2005-90).

¹⁴ In conjunction with the Philadelphia Stock Exchange's adoption of a new Order Routing System, the Commission stated in their approval order that "... when a receiving member organization receives a cancel to a previously received order, the receiving member organization would need to respond to that cancel with an acknowledgement of the cancel or with a message that it is too late to cancel and an execution report or some combination thereof." Securities Exchange Act Release No. 51853 (June 15, 2005), 70 FR 36222, 36222 (June 22, 2005) (SR-PHLX-2005-41). Further, Chairman Levitt stated in a speech given at an Investors Town Meeting that: "[It is a misconception] that an order is canceled when you hit the "cancel" button. The fact is, it's canceled only when the market receives the cancellation. And that may be too late if your order was already executed. Even if you get an electronic confirmation, that may only mean your request to cancel was received - not that your order was actually canceled." Speech by SEC Chairman Arthur Levitt: "Common Sense Investing in the 21st Century Marketplace," Investors Town Meeting, Albuquerque, NM (November 20, 1999).

¹⁵ See AMEX Letter at 3.

Participant could withdraw its Improvement Order.¹⁶ The Firm Quote Rule, however, deals only with displayed prices. Since Improvement Orders are not displayed orders, as in the PIP, we believe that the ability to cancel an Improvement Order prior to the termination of the UPIP auction does not violate the Firm Quote Rule. We believe the Commission's analysis of this display issue for the PIP also holds true for the UPIP auction. In its approval order relating to the PIP, the Commission stated that it "believes that, for purposes of Quote Rule analysis, because the PIP is only three seconds in length, it is analogous to the open outcry auctions currently conducted on the floor-based exchanges, where auction prices are not widely disseminated and are available only for the order that initiated the auction and other orders in the crowd at that particular time."¹⁷ We also note that because UPIP is not an internalization mechanism, the dangers of quote manipulation are not present.

III. NBBO PROTECTION

Commenters also inquired as to the NBBO parameters of UPIP Orders. In particular, a commenter requested clarification as to what would transpire in a UPIP auction if the Best Bid and Offer ("BBO") does not equal the NBBO and there are no Improvement Orders entered on the Trading Host.¹⁸ Two commenters further inquired as to whether the UPIP Order would be routed through Options Intermarket Linkage for execution against the NBBO in the aforementioned situation.¹⁹ Certain commenters also requested clarification on what would happen if the NBBO moved against the UPIP Order.²⁰

BOX does not guarantee an execution of a UPIP Order at the NBBO, rather, BOX guarantees that the Start Price of the UPIP auction will be the NBBO, if BOX is not quoting the NBBO. Also, the proposal was amended so that at the conclusion of the UPIP the entire UPIP Order will be filtered to prevent BOX from executing any portion of the UPIP Order at a price inferior to the NBBO (*i.e.*, will not trade through the NBBO).²¹ When necessary the UPIP Order will be routed through Intermarket Linkage to another market displaying the NBBO. For example, if a UPIP auction Start Price is at the NBBO, no Improvement Orders have been submitted, and the BOX BBO is still not equal to the NBBO at the end of the UPIP, then the UPIP Order will be routed through Intermarket Linkage to another market displaying the NBBO.

¹⁶ *See Id.*

¹⁷ *See Securities Exchange Act Release No. 49068 (January 13, 2004), 69 FR 2775, 2791 (January 20, 2004) (SR-BSE-2002-15).*

¹⁸ *See Amex Letter at 2.*

¹⁹ *See Citadel Letter at 6. See also Amex Letter at 2.*

²⁰ *See Id.*

²¹ Except in the following limited circumstances: (1) in accordance with Chapter XII, Section 3(e) of BOX Rules; or (2) the away options exchange posting the NBBO is conducting a trading rotation in that options class.

The UPIP Order will be due the firm Initial Aggregate Quote Size and Initial BOX Book Quote, unless an improved price is available. BOX will check the NBBO at the conclusion of the UPIP auction. BOX will execute the UPIP Order against Improvement Orders as long as they are at or better than the current NBBO and only against the Initial BOX Book Quote when it equals the current NBBO. Any portion of the UPIP Order that would trade through the NBBO will be routed through Intermarket Linkage to another market displaying the NBBO.

For example, if BOX is not initially quoting for the full size of the UPIP Order (*i.e.*, the UPIP Order is for 50 contracts, BOX is at the BBO for 20 contracts), then the UPIP Order will only be due the firm Initial Aggregate Quote Size of 20 contracts and Initial BOX Book Quote price. If there are no Improvement Orders, then at the conclusion of the UPIP auction BOX will check the current NBBO. If BOX is equal to the current NBBO, then BOX will execute the UPIP Order against the Initial Aggregate Quote Size for 20 contracts. The remaining unexecuted 30 contracts of the UPIP Order will be routed through Intermarket Linkage to another exchange displaying the NBBO.

IV. DURATION OF UPIP

Commenters also inquired about the duration of the UPIP and how Options Participants would be informed about the exposure time of UPIP auctions if they are reduced.²² BOX will inform Options Participants regarding the duration of UPIP auctions by publishing a Regulatory Circular.

V. INTERACTION BETWEEN PIP AND UPIP

Certain commenters requested additional information regarding the possible interaction between the UPIP and the PIP.²³ As stated in the UPIP Proposal, a PIP or a UPIP will not run simultaneously with another PIP or UPIP in the same series, nor will PIPs or UPIPs interact, queue or overlap in any manner.²⁴ Any order, which is received while a UPIP is underway for the same series, that would otherwise meet the price conditions to initiate a UPIP auction will cause the UPIP to immediately terminate pursuant to proposed Section 29(s). Any order, which is received while a PIP auction is underway, that would otherwise meet the price conditions to initiate a UPIP will interact with the PIP as an Unrelated Order under the PIP Rule.²⁵ Any request to initiate a PIP (*i.e.*, submission of a Primary Improvement Order and a PIP Order) while a PIP or UPIP is already in progress in the same series will be rejected. The same commenter also questions whether the proposed Automated Auction Order (“AAO”) would interact with a UPIP auction, and if so, it incorporated by reference its comment letter regarding the

²² See Amex Letter at 4.

²³ See ISE Letter at 3.

²⁴ See Proposed Chapter V, Section 18, Supplement .02 and Proposed Chapter V, Section 29, Supplement .01 of the BOX Rules.

²⁵ See Proposed Chapter V, Section 18(i) of the BOX Rules.

AAO. The recently approved AAO would interact in a UPIP and therefore we incorporate by reference our comment response letter for the AAO proposal.²⁶

VI. AUTOMATED QUOTATION SYSTEMS

A question has also arisen regarding the ability of BOX to identify quotes as originating from an AQS and the relevant standard for making such a determination.²⁷ UPIP will default any Proprietary Improvement Order to the end of the priority queue in the UPIP. If an Options Participant desires to have its status in the queue changed and be exempted from the rule, then the Options Participant will have to affirmatively identify its AQS orders as the Exchange deems necessary.

BSE would surveil for compliance with this rule through its current examination program. We note that the ISE uses a similar AQS mechanism for its directed order process.²⁸

VII. PENNY PILOT

Commenters also suggest that the Commission's initiative with regard to the options exchanges Penny Pilot program should prohibit the approval of UPIP.²⁹ One commenter even states that the UPIP will "distort" Penny Pilot data because of the "seismic shift in market structure" it would create.³⁰ The BSE sees no reason not to implement another "penny pricing" initiative such as the UPIP during the Penny Pilot. The UPIP and the Penny Pilot can run simultaneously, thereby providing Public Customers greater access to penny pricing with minimal impact to the results of the Penny Pilot. BOX was the first options exchange to introduce penny pricing with the PIP and is continuing its path of innovation with the UPIP.

Though the UPIP would be primarily utilized for those classes that are limited to trading in standard increments greater than one cent (non-penny classes), some of the UPIP classes may be included in the current Penny Pilot. However, we believe this will have minimal impact on the results of the Penny Pilot. While flattered by the notion that the UPIP will be so successful as to cause a "seismic shift" in the whole options market, distorting the statistical results of the Penny Pilot, we doubt that this would result from

²⁶ See Securities Exchange Act Release No. 55233 (February 2, 2007), 72 FR 6626 (February 12, 2007) (SR-BSE-2006-56); Letter from William Meehan, General Counsel, Boston Stock Exchange to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, re: File No. SR-BSE-2006-56 (June 8, 2007). The ISE Letter also questioned whether an incoming AAO could itself initiate a UPIP. The Limit Order which is associated with the AAO that is priced at the standard minimum trading increment of five or ten cents can start a UPIP if at its rounded price it would be executable at NBBO, however at that instant the order is not considered an AAO and is handled as any other UPIP Order.

²⁷ See Amex Letter at 3-4.

²⁸ See Rule 811 of the ISE Rules.

²⁹ See Citadel Letter at 7; ISE Letter at 3-4; Securities Exchange Act Release No. 55155 (January 23, 2007), 72 FR 4741 (February 1, 2007) (SR-BSE-2006-49).

³⁰ See Citadel Letter at 7.

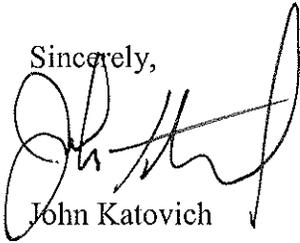
the introduction of the UPIP or impact the Staff's decisions regarding the Penny Pilot. Nonetheless, we will volunteer to provide the Staff with UPIP statistics for those classes included in the Penny Pilot as we have for the PIP.

CONCLUSION

The BSE is confident that the explanations provided herein will sufficiently address the various concerns and questions expressed in the comment letters submitted regarding the UPIP Proposal. We look forward to working with the Commission to gain timely and final approval for this BOX proposal.

If there are any questions regarding this letter, please do not hesitate to contact me.

Sincerely,

A handwritten signature in black ink, appearing to read 'John Katovich', written over the word 'Sincerely,'.

John Katovich

Chief Legal Officer

cc: Elizabeth King
Heather Seidel