



INTERNATIONAL SECURITIES EXCHANGE

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March 5, 2007

Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-0609

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

Dear Ms. Norris:

The International Securities Exchange, LLC ("ISE") appreciates the opportunity to comment on the above referenced proposal ("Proposal") of the Boston Stock Exchange, Inc. ("BSE"), on behalf of its Boston Options Exchange ("BOX") facility.¹

Under the Proposal, the BSE proposes to adopt an Automatic Auction Order ("AAO"), which are orders entered in penny increments in options classes that are not quoted in penny increments. These orders are displayed on BOX at the nearest standard trading increment, but contain a better hidden penny price that is available to participate in the BOX's Price Improvement Process. The AAO has attributes that are similar to an existing BOX order type, the Customer PIP Order ("CPO"), but there are several aspects of the AAO that raise significant regulatory and market structure issues. Accordingly, we urge the Commission to institute proceedings to disapprove the Proposal.

Internalization in Pennies Without Market Exposure

The Proposal provides that the hidden penny price of an AAO resting on the BOX book is not only available to participate in a PIP auction, but also to be executed against the hidden penny price of another AAO. Other orders in the BOX marketplace, such as market orders and limit orders that are marketable against the displayed price of an AAO, would not receive the benefit of the hidden penny price.

This lack of AAO transparency and interaction raises significant regulatory concerns. Specifically, it provides a mechanism by which firms can receive and

¹ Exchange Act Release No. 55253, (February 2, 2007), 72 F.R. 6626 (February 12, 2007).

them on the BOX with no exposure to the marketplace. In all other circumstances the Commission has required at least a three second exposure period – to the entire market – before members may internalize customer orders or execute them against solicited interest. Not only would this aspect of the AAO allow firms to cross orders with no exposure to the BOX market place and no opportunity for price improvement, but it would do so in penny increments in options classes not quoted in pennies.

The Commission required BOX to include in its PIP and directed orders programs very specific priority, order handling and exposure provisions as a condition to allowing orders to be executed in penny increments in options classes that are not permitted to be quoted in penny increments. In particular, the PIP auction provides BOX participants an opportunity to match or improve the price of an order in penny increments before it is internalized by the entering firm. Through use of the AAO, a BOX participant will be able to execute crosses with no exposure to any BOX participants.

Priority Participation in PIP

There are several aspects regarding how the proposed AAO will interact in the PIP that are not consistent with the Commission's approval of the PIP. While the filing states that "AAO allows for increased competition in the Improvement Auction and offers greater opportunity for price improvement to occur by providing for additional Improvement Orders capable of improving prices," this statement is not true because:

- AAO Improvement Orders are generated at the conclusion of the three second exposure period at a price that matches the best Improvement Order received during the three second exposure period up to the original penny price of the order. This means that the AAO penny interest is not broadcast to BOX participants during the three seconds like other Improvement Orders and does not provide any additional price improvement opportunity because they only match the best price provided by other BOX participants. This is particularly troublesome because the AAO could actually contain a price that would provide additional price improvement to the PIP order.
- AAO Improvement Orders get the time priority based upon the entry time of the AAO. That is, the first AAO always will have time priority in a PIP because by definition it was entered before the PIP was initiated. Therefore, not only does this proposed new order type fail to add to price competition in the PIP since such orders only match the best price achieved through a PIP auction, they are given time priority over the best price established by other participants. This will serve to discourage all other BOX participants from competing aggressively for PIP orders.

- An AAO does not lose its initial time priority if there are changes to the initial penny order price, so long as the change does not affect the displayed limit order price. Because all other Improvement Orders are broadcast to market participants as they are entered into the PIP auction, 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. While these other participants in the PIP auction can monitor and adjust their Improvement Orders, only through use of an AAO can a participant adjust the price at which they are willing to participate in a PIP auction without other participants knowing about its interest and to maintain its time priority for the adjusted price.

The combination of the above three features of the AAO so advantage this order type that we believe it will all but eliminate price competition in the PIP auctions.²

Conclusion

The Proposal is contrary to established Commission policy related to internalization, and also conflicts with the protections currently built into the PIP to encourage price competition. In particular, the Proposal would remove transparency related to the execution of AAO orders in penny increments, both in allowing AAOs to execute against each other and in the way in which AAOs are integrated into the PIP auction only after the exposure period has ended.

Furthermore, the options markets have instituted a pilot program to study the effects of quoting and trading options in pennies. We believe that such pilot is the appropriate method to approach penny pricing in the options markets since it does so in a transparent and fair environment. We urge the Commission not to permit BOX to employ a mechanism under the guise of "penny price improvement" that bypasses auction market principles.

Sincerely,



Michael J. Simon
Secretary

² BOX will automatically generate an Improvement Order for a PIP on behalf of an AAO if its limit price is at the BOX BBO at the time a PIP is initiated. This is different than a BOX CPO, which requires the member to separately enter an Improvement Order into a PIP. This is an important distinction when considered in combination with the advantageous priority and execution aspects of this proposed order type.