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August 13, 2010

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

Re: File Nos. SR-BX-2010-49 and File No. S7-09-10

Dear Ms. Murphy:

The International Securities Exchange, LLC ("ISE") appreciates the opportunity to comment on the above-referenced rule filing of the Boston Options Exchange ("BOX") regarding anticompetitive and discriminatory fees BOX charges with respect to its Price Improvement Period ("PIP"). Because we also have concerns with other exchanges' rules that have similar anticompetitive effects, we submit this comment letter in response to the Commission's request for comment on various options fee-related issues.[1]

Overall, we believe that an increasing number of existing and proposed fees from various options exchanges inappropriately impede competition for order flow by "stacking the deck" in favor of firms that seek to trade against – or "internalize" – their retail customer order flow. These rules include: BOX's current proposal; the manner in which the Chicago Board Options Exchange ("CBOE") imposes payment for order flow ("PFOF") fees; and the NASDAQ OMX PHLX's ("Phlx") floor fees. As discussed below, the Commission has rejected discriminatory fees of greater than $.02 that encourage internalization. The BOX, CBOE and Phlx fees clearly violate that standard. We urge you to suspend the effectiveness of the BOX rule filing[2] and to expand your current rulemaking proceedings regarding options fees to address the CBOE and Phlx fees.

I. BOX's Proposed Fee Change Discourages Competition for Order Flow

PIP is a vehicle for a broker-dealer to internalize its small order flow by agreeing to improve the price of a customer order by at least one cent above BOX's current bid or offer, provided that the execution at least equals the national best bid or offer ("NBBO"). The PIP initiator must expose the order and, in theory, can lose some or all of the order to other exchange members that respond to the PIP broadcast. However, BOX's new fees help ensure that its members will be able to use the PIP to internalize small orders at the NBBO, with no real opportunity for customers to receive price improvement.

[1] Release No. 61902, April 14, 2010 (75 F.R. 20738, April 20, 2010) (the "Fee Release"). This submission is in addition to our original comment letter on the Fee Release, Letter from Michael J. Simon, Secretary, ISE, to Elizabeth Murphy, Secretary, Commission, dated June 21, 2010.
[2] *See* newly-revised section 19(b)(3)(A) of the Securities Exchange Act of 1934, as amended ("Exchange Act").

Specifically, BOX's new PIP fees make it economically prohibitive for any member to compete for the small customer orders in the PIP. As of July 19th BOX's PIP fees are as follows (all fees per contract)[3]:

- Public customers: free when taking liquidity; \$.25 when providing liquidity as a PIP initiator; \$.15 when providing liquidity/responding to a PIP;

- Broker-dealers initiating PIPs: a tiered fee of between \$.10 and \$.25;

- Broker-dealers and market makers providing liquidity/responding to a PIP: \$.25;

- In all cases there is an **additional** fee/credit of \$.25, with a credit for removing liquidity and a fee for providing liquidity.

In the aggregate, these fees create significant disincentives for anyone to respond to a PIP broadcast. The PIP initiator pays between \$.10 and \$.25 as the base fee.[4] To the extent the initiator trades against the order, the liquidity fee/credit washes out since the initiating firm pays and receives the fee/credit. Thus, the \$.10 - \$.25 fee is the entire cost of the transaction. In contrast, all persons responding to a PIP pay \$.50 a contract to the extent they trade against the order: both public customers and broker-dealers pay the \$.25 base fee plus the \$.25 "provide liquidity" fee. This makes it \$.25 – \$.40 more expensive for the PIP responder to trade compared to the PIP initiator, significantly dissuading anyone from responding to the PIP and greatly enhancing the ability of the PIP initiator to internalize the order.

BOX is actively marketing these new fees as a way to avoid the break-up of PIP orders and to internalize order flow. Indeed, at least one order router has switched its routing of these small orders from the CBOE to the BOX due to this fee change. While trades are rarely broken-up on the CBOE (for reasons discussed below), there now was even less of a chance of break-up on BOX. Many firms do not even consider sending this order flow to the ISE as these types of orders are routinely broken up.

BOX's fee differential creates an economic barrier to order interaction and promotes internalization or trading against captive retail order flow. The BOX filing fails to explain how these fees are in compliance with the requirements of the Securities Exchange Act of 1934 ("Exchange Act") as being reasonable and non-discriminatory.[5] In this regard, the Commission has clearly established the precedent that only a de minimis fee differential is permitted when dealing with captive order flow. Specifically, the Commission has abrogated a \$.05 fee differential in an analogous situation regarding directed orders, when the Phlx adopted a fee where firms to whom orders are

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[3] We have difficulty following the specific fee changes in the rule proposal itself. Accordingly, we base our comments on Informational Circular IC-2010-04, dated July 16, 2010, which BOX issued contemporaneously with the filing, and which explains the application of the new fees.
[4] BOX's sliding fee scale applies in PIP only to orders initiating a PIP, that is, seeking to internalize the order. It does not apply when responding to PIP and providing price improvement. We view this as another discriminatory application of fees intended to dissuade participation in PIP auctions.
[5] Exchange Act Sections 6(b)(4) and (5).

directed had a \$.05 advantage compared to other firms trading against that order. [6] Thereafter, the Commission let stand a similar \$.02 fee differential.[7] This has been the accepted norm for such fees, at least until this filing. BOX has adopted an inequitable and discriminatory fee structure contrary to the requirements of the Exchange Act.

II. The Commission Should Address Existing Exchange Fees That Similarly Impede Competition

BOX is not alone in imposing significant financial barriers dissuading members from providing liquidity to, or improving the prices of, orders that other members seek to internalize. Due to the difficulty in parsing exchange fee schedules, and the sometimes unanticipated ways that fees can impact behavior, many of these fees have been in existence for quite some time. Nevertheless, we believe that in considering the comments on the Fee Release, the Commission should take whatever regulatory action is necessary to bring such fees into compliance with Exchange Act requirements.

B. CBOE PFOF Fees

Exchanges can structure PFOF fees to be a disincentive for market makers to break up members' attempts to internalize order flow. The selective application of PFOF can result in inappropriate discrimination among members, as well as unfair competition. Such is the case with the CBOE's imposition of PFOF fees in its PIP-equivalent, its Automated Improvement Mechanism or "AIM."[8] CBOE charges market makers a \$.25 per contract PFOF fee in the most active options (which are included in the penny pilot) and \$.65 per contract in other options classes.[9] While the CBOE exempts certain types of transactions from the PFOF fees, such fees do apply to a market maker's transactions in AIM. ISE specifically does not impose PFOF charges for market makers responding to our similar Price Improvement Mechanism ("PIM") orders.

Based on our experience with PIM, market makers are the most likely members to respond to AIM broadcasts. It thus costs market makers \$.25 more (\$.65 more in non-penny names) than the initiating/internalizing firm to trade against AIM orders. The PFOF fees the market makers pay are accumulated into the pool of the market maker to whom the order was preferenced, which most likely is an affiliate of the order entry firm. The preferenced market maker then can pay the PFOF fee it received for the order back to its affiliate. The level of the fee differential, plus the subtle pass-through of the PFOF fees results in price discrimination and has an anticompetitive effect similar to the BOX's "provide liquidity" fees. Such discrimination is well above the \$.02 differential the Commission has sanctioned, and we believe that this is violative of the Exchange Act.

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[6] File No. SR-Phlx-2010-14; Securities Exchange Act Release No. 61547 (February 19, 2010), 75 F.R. 8762 (February 25, 2010).

[7] Phlx rebates \$.25 to directed participants for adding liquidity, while rebating only \$.23 to other members. *See* http://www.nasdaqomxtrader.com/content/marketregulation/membership/phlx/feesched.pdf ("Phlx Fee Schedule"), at Section I, Rebates for and Fees for Adding and Removing Liquidity in Select Symbols.

[8] CBOE Rule 6.74A.

[9] At the most basic level, the PFOF is imposed on all orders resulting from transactions with customer orders received from firms that accept payment.

B. Phlx Floor Brokerage Fees

An even more egregious example of inequitable and discriminatory fees involves the Phlx's Facilitation Order fees. Under Phlx Rule 1064, a Phlx floor broker can bring a customer order to the floor and cross that order with a contra-side order that it holds, subject to the various requirements of the rule. One such requirement is that the broker announce the order to the crowd and include any responses to the announcement in the execution, pursuant to the terms of the rule. However, Phlx has structured its fees to punish any floor participation in the trade.

Specifically, Phlx has waived fees "for members executing facilitation orders pursuant to Exchange Rule 1604 when such members are trading for their own proprietary accounts," specifically when they seek to internalize the order flow.[10] In contrast, anyone else seeking to trade against the order is subject to a $.25 per contract "non-electronic" broker-dealer fee. Thus, a member can internalize for free, but any other member must pay $.25 a contract to participate in the order, including when such member seeks to provide price improvement. This $.25 differential is well above the $.02 differential the Commission has sanctioned, and clearly violates the Exchange Act's fee provisions.

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The Commission has sanctioned the use of crossing or internalization vehicles in the options market for two reasons, to encourage exchange members either: (i) to add liquidity to help execute large, institutional orders; or (ii) to provide price improvement for small customer orders. The practices of BOX, CBOE and Phlx that we describe above serve neither of these purposes. The Commission can begin to address these issues by suspending the effectiveness of the BOX filing. The Commission can address the larger issues in rule making in response to comments received on the Fee Release.

We appreciate the opportunity to comment on these important market structure issues. If you have any questions on our comments, please do not hesitate to contact us.

Sincerely,

Michael J. Simon
Secretary

cc: Robert Cook, Director, Division of Trading and Markets
James Brigagliano, Deputy Director, Division of Trading and Markets
Heather Seidel, Acting Associate Director, Division of Trading and Markets

[10] Phlx Fee Schedule at Section II, Equity Options Fees, third note.