BOX℠
OPTIONS EXCHANGE

December 9, 2011

Via E-mail and FedEx

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Re: SR-BX-2011-046 ("August 1 Fee Filing" or "PIP Fee Proposal")

Dear Ms. Murphy:

The Boston Options Exchange Group, LLC ("BOX") was the inventor of price improvement auctions in the options markets with the innovative Price Improvement Period ("PIP"). Since its inception in 2004, the PIP has saved public customers more than $367 million over the prevailing NBBO. BOX has, over the last few years, adopted an "inverted maker/taker" pricing model whereby the "makers of liquidity" (generally speaking, market professionals such as market makers) pay an inducement fee to liquidity takers (most often, but not uniquely, public customers). This inducement fee, which results in no revenues to BOX itself, was, until the PIP Fee Proposal currently under review, as follows:

- On the BOX central limit order book (that is, transactions not executed through the PIP)
  - For options classes included in the Penny Pilot Program: 15 cents[1];
  - For all other options classes, 55 cents[2]; and
- For all PIP trades, 30 cents (where the initiating party of the PIP was considered to be the maker and the public customer is the taker).

The August 1 Fee Filing under review applies a 75 cent taker/maker fee to all PIP transactions in options series trading in nickel increments (i.e., all non-penny pilot series, and penny pilot series with premiums of $3 or above, hereafter referred to as "nickel series"). As such, it applies to approximately 20% of overall BOX PIP volume. BOX

[1] Effective September 1, 2011, the 15 cent fee was increased to 22 cents. See Securities Exchange Act Release No. 65293 (September 8, 2011) (SR-BX-2011-063).

[2] Effective September 1, 2011, the 55 cent fee was increased to 65 cents. See Securities Exchange Act Release No. 65293 (September 8, 2011) (SR-BX-2011-063).

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believes that this change is in all respects consistent with the Exchange Act. Below, BOX provides both qualitative and quantitative arguments to support its assertions.[3]

BOX August 1 Fee Filing does not discriminate against any market participants.
Because both the make fee and take credit apply to all BOX Participants and account types (e.g. customer, market maker, professional*), there is no discrimination*. Every BOX Participant has exactly the same opportunity to initiate a PIP auction on exactly the same terms. On the contrary, the discrimination takes place on other options exchanges that apply various taxes and fees to facilitate payment for order flow schemes which are inherently discriminatory and opaque.[4]

BOX August 1 Fee Filing was adopted to combat the conflict of interest that broker-dealers face when choosing between receiving payment for order flow and seeking price improvement for their customers.
By allowing broker-dealers acting as agent for customer orders to receive payment for directing their order flow to the BOX PIP, BOX intends to ensure *that more customer orders receive opportunity for price improvement.*[5] Currently BOX, despite its small overall market share, provides the largest proportion of the price improvement received by individual investors in the entire U.S. options markets. As the comments of TD Ameritrade (which largely handles orders from individual investors) make clear, the BOX PIP auction structure provides individual investors with the greatest price improvement benefit of any options market.

75 cent fee on nickel series is competitive with comparable payment for order flow rates for similar activities.
While no hard data are publicly available, BOX believes its inducement fee for nickel series is competitive and comparable to payments in effect to attract order flow on the

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[3] Today we are submitting, under separate cover, data requested by the Staff of the SEC Division of Trading and Markets, concerning a variety of statistics, in different order types and sizes, for the months of June and July 2011, immediately before the implementation of the PIP Fee Proposal, and August, September and October 2011. This data provides the substantiation for all of the assertions in this letter about the effect of the PIP Fee Proposal.

[4] Some critics argue that the PIP Fee Proposal is impermissible because it discriminates between the initiators of a PIP auction and other participants in the PIP auction. This argument is without merit. If that argument were valid, any order inducement fee would be discriminatory, because the recipient of the fee always receives a benefit when compared to other market participants. Yet, every options exchange (through the exchange or through its specialists) pays inducement fees, and the Commission has not disapproved fees at any of those exchanges. This argument provides absolutely no basis for distinguishing between the BOX PIP fee and any of these other inducement fees, including the fees in effect at BOX prior to the PIP Fee Proposal.

[5] One critic argued that BOX does not sufficiently contribute to options market quality because (according to the unverified statistics they proffer), BOX quotes at the NBBO 18% of the time. This is patently untrue. For the two months preceding the implementation of the PIP Fee Proposal, BOX's NBBO matching rate averaged 31%, and during the first six weeks that the PIP Fee Proposal was in effect the rate was 32%. In any event, the implementation of the PIP Fee Proposal had no impact on BOX's NBBO matching rate, and thus, this argument is irrelevant to the issue of whether the Commission should approve that proposal.

same series at exchanges that operate payment for order flow schemes. *Only the Commission has access to data to prove or disprove this assertion.*[6] We do know that the posted and Commission-filed 'Payment for Order Flow Fees' at PHLX are as high as 70 cents per contract and at AMEX are as high as 65 cents per contract, and there is no basis for the Commission to disapprove the BOX PIP Fee Proposal when it did not disapprove those other fees.[7]

There is no evidence that the Options Participant receiving taker credits passes these monies on to the initiator of the PIP, whether an associated firm or not.
While the BOX monthly billing does indeed provide each Options Participant, using the same Participant ID number, with a net payment amount due or to be received from BOX for the month, critics have conveniently ignored that BOX provides full detail of the debits and credits associated with each transaction on BOX on a daily basis so that the credits and debits can be correctly applied to the Participant's own billing to his customers, both internal and external. BOX taker/maker credits and debits are no more likely to be moved amongst market participants than are payment for order flow fees at other exchanges. *Only the Commission can determine the monetary flow occurring within options market participants.*

The BOX PIP Fee Proposal was not designed to facilitate, nor has it resulted in, excessive levels of internalization.
There are several ways to assess the level of competition in PIP including:

- The average rate of retention by the PIP initiator of PIP orders at the end of a PIP;
- The average number of competing orders received during a PIP;
- Actual price improvement:
    - average number of PIP orders receiving any improvement;
    - average price improvement received by PIP orders that receive any improvement; and
    - average overall price improvement.

Because the PIP Fee Proposal was in effect for two distinct periods; the first during August to early September, and the second during late September and October 2011, for a total of ten weeks or 50 trading days, it is possible to provide data on each of the above criteria for the period before and during the effective period of the PIP Fee Proposal to

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[6] BOX agrees with the commenters who wrote that the Commission should institute uniform market quality reporting statistics for the options markets similar to the current Regulation NMS Rule 605 in the listed equities markets. Today the options markets are opaque and neither investors nor even broker-dealers have a reliable means of evaluating the best market in which to execute their options orders.

[7] One critic argues that only some orders are charged the marketing fees or payment for order flow fees at the other options exchanges and thus, those fees should be discounted. By utilizing the critic's own logic BOX's proposed $0.75 inducement fee also should be discounted because this inducement fee only applies to a subset of orders. In August, BOX's blended average inducement rate was approximately $0.30. In any event, as to the orders for which those fees are charged, there is no meaningful distinction between the "discrimination" in favor of the initiator of those orders on those exchanges, and the PIP initiators at BOX.

assess the impact the change may have had on competition in the PIP involving the options series affected by the filing (that is, “nickel series”).

Average rate of retention by the PIP initiator in nickel series
The average rate of retention of a PIP order by the PIP initiator in June and July of 2011 (the two months prior to the PIP Fee Proposal) was 39% and 38% respectively. For the ten weeks that the PIP Fee Proposal was in effect, it was 37%. *Thus, on this measure there was no statistically significant change in the level of competition of PIPs in the options series concerned by the August 1 Fee Filing.* This is true regardless of whether BOX was at NBBO or not at the start of the PIPs in these series. In other words, contrary to the arguments of the critics, the BOX PIP Fee Proposal did not enable PIP initiators to retain a greater percentage of their orders; they retained orders at the same rates after the BOX PIP Fee Proposal as they had beforehand.

BOX also examined the rate of retention for those PIPs either initiated by the Participant acting as agent for the PIP order *or* via a directed order sent to an “affiliated” BOX Market Maker. In the nickel series concerned by the August 1 Fee Filing, the retention rate in June and July 2011 averaged 38.5%; for the period when the PIP Fee Proposal was in effect, it averaged 37%. Whether looking at PIP orders as a whole, or PIP orders directed to an affiliate, there is nothing whatsoever in the data to support the assertion that the PIP initiator in nickel series on BOX has a competitive advantage which would result in higher rates of interaction with their PIP order.

Average number of competing orders in a PIP
The average number of competing orders received on the nickel series in June and July 2011 was 2.3 and 1.7, respectively. For the period when the PIP Fee Proposal was in effect, it was 2.4. On this measure, *competition actually increased during the period the new fee was in effect*. In other words, contrary to the arguments of the critics, the BOX PIP Fee Proposal did not make it more difficult for other market participants to compete in PIP auctions; in fact competition increased.

Average number of PIP orders being improved
In June and July 2011, 57% and 56%, respectively, of all PIP orders on nickel series received at least some price improvement. During the period the August 1 Fee Filing was in effect, 56% of all PIP orders on nickel series were improved. Virtually identical data was observed when only PIPs initiated by an “affiliated” party are considered. *The August 1 Fee Filing had no effect whatsoever on the percentage of orders being improved.* In other words, contrary to the arguments of the critics, the BOX PIP inducement fee did not make it impossible for other market participants to offer price improvement in PIP auctions – they did so at exactly the same rates after the PIP Fee Proposal as they had before it.

Average price improvement
In June and July 2011, the average price improvement on the nickel series was slightly more than $0.020 (and $0.036 for only those orders receiving improvement). The comparable data for the period when the August 1 Fee Filing was in effect were $0.024 (and $0.043). The average rate of improvement for PIP transactions initiated by "affiliated" firms is virtually identical to that above. *Thus, the average price improvement actually increased in the nickel series while the PIP Fee Proposal was in effect.*[8]

Because a considerable portion of the period when the August 1 Fee Filing was in effect was during a period of significant market volatility in which there were increased opportunities for price improvement (wider spreads), BOX also looked at the trend in price improvement for PIPs in the series not affected by the Filing (e.g. penny series). Average price improvement for the penny options series increased by 23% during the effective period of the PIP Fee Proposal, closely in line with the 21% increase in price improvement in the nickel series noted above. In other words, the PIP inducement fee did not make it more difficult for market participants to offer price improvement in the nickel series; there was no meaningful difference between the levels of price improvement in the series subject to the PIP Fee Proposal and price improvement in other series.

The BOX PIP Fee Proposal Satisfies the Legal Standard of Review for SRO Rule Proposals.

Pursuant to Section 19(b)(2)(C) of the Exchange Act, the Commission "shall approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of [the Exchange Act] and the rules and regulations . . . that are applicable to such organization." Among the substantive standards for self-regulatory organizations under Section 6(b) of the Exchange Act is that their rules must "provide for the equitable allocation of reasonable dues, fees and other charges among its members and issuers and other persons using its facilities." Under Section 6(b), SRO rule proposals also must "protect investors and the public interest" and must not be "designed to permit unfair discrimination between customers, issuers, brokers, or dealers." Under Section 3(f) of the Exchange Act, the Commission is required to consider whether a self-regulatory organization rule proposal "will promote efficiency, competition and capital formation." Finally, under the Administrative Procedure Act, the Commission's decision to approve or disapprove a self-regulatory organization rule must not be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."

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[8] One of the critics makes an elaborate argument (although unsupported by any underlying data) that price improvement declined at BOX in the first half of 2011. But this argument is logically unrelated to the only issue that is actually before the Commission: whether to disapprove the August 1 PIP Fee Proposal. As to that issue, the data is unequivocal: after the fee went into effect, competition increased, price improvement increased and the rate of internalization did not increase.

Thus, the issue before the Commission is a narrow one: whether to approve an increase, from 30 cents to 75 cents, of the order inducement fee for a subset of orders (for options series trading in nickel increments) in BOX's PIP auction process. BOX has submitted a substantial amount of data concerning the operation of its market both before the August 1 Fee Filing went into effect, and while that fee was in effect. That data is unequivocal: the amount of price improvement increased, the amount of competition increased, and there was no meaningful change in internalization while the fee was in effect. This evidence demonstrates that the PIP fee (all of which is paid to investors, not kept as revenue for BOX) is both equitable and reasonable, and promotes efficiency and competition. As discussed above, the PIP fee does not unfairly discriminate: it is fully transparent and applies consistently to all market participants. The argument that the PIP fee discriminates in favor of the initiator of a PIP auction overreaches: there is no basis for distinguishing this fee from the dozens of other order initiation fees previously approved by the Commission and in effect at all of the options exchanges, all of which also provide a benefit to the order initiator. And we believe it would be arbitrary and capricious for the Commission to find that a 75 cent fee is impermissible when it has previously approved 70 cent and 65 cent fees, for similar classes of orders, at other, larger options exchanges. Finally and most importantly, the millions of dollars in price improvement provided to individual investors while the PIP fee was in effect demonstrate that the proposal protects investors and is in the public interest. For all of these reasons, the Commission should approve the August 1, 2011 PIP Fee Proposal.

Conclusion

For all of the reasons cited above, BOX believes there is no basis to disapprove the August 1 Fee Filing. The Commission staff, in its order to review, raised a number of issues not specifically related to the filing itself. BOX would welcome an overall review of options industry practices regarding enticements and inducements to attract public customer order flow, especially the effect of payment for order flow schemes that are in effect at most of its competitors, as well as a comparison of the rates of price improvement achieved by each of the exchanges. BOX does not believe, however, for the reasons outlined above, that the August 1 Fee Filing should be the basis or trigger for such a review, nor should BOX be prevented from competing effectively for options orders while that review occurs.

Accordingly, BOX requests that the Commission immediately reinstate the August 1 Fee Filing while it undertakes any larger review regarding internalization and/or payment for order flow across all the options exchanges as it sees fit. BOX is willing to operate the PIP Fee Proposal as a pilot program while the Commission undertakes such a review. Please contact me at (312) 444-6328 if you have any questions regarding this matter.

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Respectfully submitted,

Anthony D. McCormick
Chief Executive Officer

cc: Heather Seidel, Associate Director, Division of Trading and Markets