

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-57157; File No. SR-BSE-2006-16)

January 15, 2008

Self-Regulatory Organizations; Boston Stock Exchange, Inc.; Notice of Filing of Amendment No. 3 to the Proposed Rule Change and Order Granting Accelerated Approval of Proposed Rule Change, As Modified by Amendments No. 1 and 3 Thereto, to Adopt a Universal Price Improvement Period for Public Customer Orders

I. Introduction

On December 11, 2006, the Boston Stock Exchange, Inc. (“BSE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposal to amend the rules of the Boston Options Exchange (“BOX”) to adopt a Universal Price Improvement Period (“UPIP”), an auction that offers the opportunity for price improvement for eligible Public Customer orders. On February 1, 2007, BSE filed Amendment No. 1 to the proposed rule change. The proposed rule change, as amended, was published for comment in the Federal Register on February 9, 2007.³ The Commission received three comment letters regarding the proposal.⁴ BSE filed Amendment No. 2 to the proposed rule change and a response to the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 55230 (February 2, 2007), 72 FR 6302 (“Notice”).

⁴ See letter from Michael T. Bickford, Senior Vice President, American Stock Exchange LLC (“Amex”), to Nancy M. Morris, Secretary, Commission, dated March 2, 2007 (“Amex Letter”); letter from Michael J. Simon, Secretary, International Securities Exchange, LLC (“ISE”), to Nancy M. Morris, Secretary, Commission, dated March 5, 2007 (“ISE Letter”); and letter from Matthew B. Hinerfeld, Managing Director and Deputy General Counsel, Citadel Investment Group, L.L.C. (“Citadel”), to Nancy Morris, Secretary, Commission, dated March 6, 2007 (“Citadel Letter”).

comment letters on November 19, 2007.⁵ On December 13, 2007, BSE withdrew Amendment No. 2 and filed Amendment No. 3 to the proposed rule change. The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons and is simultaneously approving the proposed rule change, as modified by Amendments No. 1 and 3, on an accelerated basis.

II. Description of the Proposal

A. UIIP Eligibility

BOX will automatically initiate a UIIP auction for Public Customer orders⁶ (“Eligible Orders”) provided certain conditions have been satisfied.⁷ For example, the Eligible Order must be a Limit, Market, or BOX-Top Order that is marketable against the National Best Bid or Offer (“NBBO”).⁸ Further, a Price Improvement Period (“PIP”) auction or UIIP auction in the same series cannot already be underway and, if the NBBO is locked or crossed, the BOX Best Bid or Offer (“BBO”) on the same side of the market as the Eligible Order must not equal the NBBO.

⁵ See letter to Nancy M. Morris, Secretary, Commission, from John Katovich, Chief Legal Officer, BSE, dated November 19, 2007 (“BSE Letter”).

⁶ “Public Customer” means a person that is not a broker or dealer in securities. See Section 1(a)(50), Chapter I of the BOX Rules.

⁷ See proposed Section 29(e), Chapter V of the BOX Rules.

⁸ An Eligible Order also must be for a series of options that is open for trading and cannot indicate a minimum quantity condition or be an Inbound Inter-Market Linkage P/A order. See proposed Section 29(e)(v), Chapter V of the BOX Rules. In Amendment No. 3, the Exchange clarified that a “Fill and Kill” order is not included in the definition of an Eligible Order. See proposed Section 29(e)(vi), Chapter V of the BOX Rules.

B. The UPIP Auction

The UPIP will be three seconds or less, as determined by BOX on a class-by-class basis.⁹ BOX will inform Options Participants as to the duration of the UPIP auctions by publishing a Regulatory Circular. Upon initiation of a UPIP auction, the Box Trading Host will transmit a broadcast message (“Broadcast Message”) to Options Participants informing them of the auction’s initiation, the relevant details of the UPIP Order¹⁰ (i.e., the UPIP Order’s series, size, and side of the market), the end time of the auction, and the applicable Start Price.¹¹ The Start Price will be one improvement increment (e.g., a penny) better than the NBBO if the BBO is equal to the NBBO. If the BBO does not equal the NBBO, the Start Price will be the NBBO. The same conditions apply with respect to the Start Price whether or not the NBBO is locked or crossed.

UIPIP Orders can be modified and cancelled at any time prior to the conclusion of the UPIP auction. The cancellation of a UPIP Order will result in the subsequent cancellation of

⁹ The Exchange clarified in Amendment No. 3 that the UPIP auction shall be permitted on a class-by-class basis. See proposed Section 29(f), Chapter V of the BOX Rules. Amendment No. 3 also amends proposed Section 29(g), Chapter V of the BOX Rules to provide that if a UPIP Order was previously processed as a Directed Order accompanied by a Guaranteed Directed Order (“GDO”) pursuant to Chapter VI, Section 5(c)(iii)(2) of BOX Rules, the duration of the UPIP will not be less than the time the GDO is required to be withheld from trading with the Directed Order as provided in Chapter VI, Section 5(c)(iii)(2)(b)(4) of the BOX Rules. See proposed Section 29(g), Chapter V of the BOX Rules.

¹⁰ Upon commencement of the UPIP auction the “Eligible Order” is referred to as the “UIPIP Order.”

¹¹ The Start Price is defined as the minimum/maximum (buy/sell) price at which an Improvement Order must be submitted. See proposed Section 29(h), Chapter V of the BOX Rules.

all related Improvement Orders and the UPIP auction.¹² Certain modifications of a UPIP Order will not result in the termination of the UPIP auction.¹³

The UPIP Order will be “stopped” against any quote(s) or order(s) on the BOX Book that is marketable against the UPIP Order at the time the UPIP Order is received by the Trading Host (“Initial BOX Book Quote”) up to the aggregate size of the Initial Box Book Quote (“Initial Aggregate Quote Size”).¹⁴

A modification or cancellation of the Initial BOX Book Quote during the UPIP auction that would decrease the Initial Aggregate Quote Size below the size of the UPIP Order, at the commencement of the UPIP auction, will cause the UPIP auction to immediately terminate. Such modification or cancellation will only be processed after the UPIP Order has been executed. An Options Participant who is part of the Initial Box Book Quote, and whose cancellation or modification of its order or quote causes the UPIP auction to terminate, will have its order or quote placed at the end of the quote and order queue at the applicable price level on the BOX Book. Any modification or cancellation of the Initial BOX Book Quote that does not cause the Initial Aggregate Quote Size to decrease below the size of the UPIP Order,

¹² In Amendment No. 3, the Exchange clarified that the cancellation of a UPIP Order will result in the cancellation of the related Improvement Orders and the UPIP auction itself.

¹³ Such modifications are: the reduction of a UPIP Order quantity; the recharacterization of the UPIP Order type from a Limit Order to a BOX Top or Market Order; and an improvement of the UPIP Order’s original limit price. Any other modification will result in the termination of the UPIP auction. See proposed Section 29(n), Chapter V of the BOX Rules.

¹⁴ The Initial BOX Book Quote is defined as the quote(s) and/or order(s) on the BOX Book at the best price, on the opposite side, and in the same series as the Eligible Order at the time the Trading Host receives it. The Initial Aggregate Quote Size is defined as the aggregate size of the Initial BOX Book Quote. See proposed Section 29(o), Chapter V of the BOX Rules.

however, will be processed immediately by the Trading Host without penalty and the UPIP auction will continue.¹⁵

C. Improvement Orders

Any Options Participant may submit an Improvement Order in response to a Broadcast Message for an impending UPIP auction.¹⁶ Improvement Orders will be visible to all Options Participants, can be submitted in increments of one cent, and must equal or improve the Start Price. Improvement Orders may be cancelled or modified by the Options Participant prior to the conclusion of the UPIP auction. An increase in the quantity of the Improvement Order or modification of the Improvement Order's limit price will result in the creation of a new Improvement Order reflecting the revised terms and the cancellation of the original Improvement Order. At the conclusion of a UPIP auction, the unexecuted portion of an Improvement Order will be cancelled by the Trading Host.¹⁷

1. Proprietary Improvement Orders

An Options Participant who submits an Eligible Order to BOX, which order starts a UPIP, and subsequently submits a Proprietary Improvement Order will be last in time priority at all price levels in the relevant UPIP auction. However, if the Proprietary Improvement Order is generated by an automated quotation system that operates independently from the existence or non-existence of the pending Eligible Order prior to its submission to BOX, the Options

¹⁵ Any orders or quotes on the opposite side of the UPIP Order that are received by the BOX Book after the UPIP auction has commenced (i.e., orders that are not otherwise part of the Initial BOX Book Quote) may be cancelled or modified without causing the UPIP auction to terminate. See proposed Section 29(o), Chapter V of the BOX Rules.

¹⁶ Improvement Orders are those orders submitted to a UPIP auction in response to a Broadcast Message by Options Participants that are on the opposite side of the market as the UPIP Order. See proposed Section 29(j), Chapter V of the BOX Rules.

¹⁷ See Amendment No. 3.

Participant's Proprietary Improvement Order will be treated like an ordinary Improvement Order and qualify for execution at each price level without prejudice.¹⁸

UPIP will default any Proprietary Improvement Order to the end of the priority queue in the UPIP.¹⁹ If an Options Participant desires to have its status in the queue changed and be exempted from the rule, then the Options Participant would need to affirmatively identify its orders from an automated quotation system as the Exchange deems necessary.²⁰

2. Executing Participant Improvement Orders

An Executing Participant is a Market Maker that systemically indicates its willingness to accept and receive Directed Orders.²¹ An Executing Participant that receives a Directed Order that is released to the BOX Book will be last in priority at all price levels for any Improvement Order or quote submitted to a subsequent UPIP auction related to that Directed Order.²² Time priority will prevail between a Proprietary Improvement Order and an Improvement Order submitted by an Executing Participant.²³

In Amendment No. 3, BSE addressed the instance in which a Directed Order with an attached GDO has been entered into the UPIP auction and the UPIP auction is prematurely terminated because of a modification to or cancellation of an order or quote that is a component of the Initial BOX Book Quote or the receipt of a same side, executable order. When a UPIP auction is prematurely terminated in such circumstances, subsequent to the execution of the UPIP Order pursuant to Chapter V, Section 29(p) of the BOX Rules, the GDO will be

¹⁸ See proposed Section 29(k), Chapter V of the BOX Rules.

¹⁹ See BSE Letter, supra note 5, at 7.

²⁰ Id.

²¹ See Section 5(c)(i), Chapter VI of the BOX Rules.

²² See proposed Section 29(l), Chapter V of the BOX Rules.

²³ See Amendment No. 3 and proposed Sections 29(o)(i) and 29(s)(ii) of the Box Rules.

permitted to immediately execute directly against the remaining size of the UPIP Order.²⁴ This means that a GDO will be permitted to execute against the remaining size of the UPIP Order prior to three seconds having elapsed, but only if there is no other interest on BOX at the same (or better) price as the GDO.²⁵ It will be considered conduct inconsistent with just and equitable principles of trade for an Executing Participant to directly or indirectly enter, modify or cancel quotes or orders on BOX for the purpose of disrupting, prematurely terminating or manipulating any Improvement Auction, including a UPIP auction.²⁶

3. Customer Price Improvement Orders (“CPOs”)

Similar to the CPO in the PIP, OFPs may provide Public Customers with access to the UPIP auction through a CPO, provided certain conditions have been met. The CPO must indicate the price at which the order will be placed in the BOX Book (“BOX Book Reference Price”) as well as the price at which the Public Customer would like to participate in any UPIP that may occur while the order is on the BOX Book (“CPO Auction Reference Price”).²⁷ Further, the terms of the CPO shall include the size of the order. In order for the CPO to be eligible for participation in a UPIP auction, the BOX Book Reference Price must equal the

²⁴ See proposed Section 5(c)(iii)(2)(b)(4), Chapter VI of the BOX Rules and Amendment No. 3.

²⁵ See telephone conference among William Easley, Vice Chairman, BOX; Lisa Fall, General Counsel, BOX; Wayne Pestone, Bingham McCutchen LLP; and Heather Seidel, Assistant Director, Division of Trading and Markets (“Division”), Commission, on January 11, 2008.

²⁶ See proposed Section 5(c)(iii)(2)(b)(4), Chapter VI of the BOX Rules and Amendment No. 3.

²⁷ The BOX Book reference price must be stated in standard five-cent or ten-cent increments, and the CPO Auction Reference Price must be stated in one cent increments. See proposed Section 29(m)(i), Chapter V of the BOX Rules.

BBO at the commencement of a UPIP auction.²⁸ The CPO may also benefit from enhanced time priority pursuant to NBBO Prime.

4. NBBO Prime

An Improvement Order or multiple Improvement Orders may be designated as NBBO Prime (“NBBO Prime Order”) in a particular UPIP auction. The NBBO Prime designation is only applicable for 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.²⁹ Any Improvement Order may be eligible for the NBBO Prime designation in a UPIP auction.

In order to be designated as NBBO Prime, the same beneficial account³⁰ for whom the Options Participant is submitting the NBBO Prime Order must have quotes or orders on the BOX Book that are on the opposite side of the UPIP Order (“NBBO Prime Participant Quote”). The NBBO Prime Participant Quote must be equal to the NBBO and must have been on the BOX Book prior to the time the Eligible Order was presented to the Trading Host. An NBBO Prime Order will only have enhanced time priority for size of its NBBO Prime Participant Quote. Any residual quantity of the NBBO Prime Order will be handled in accordance with the normal time priority rules. Priority among NBBO Prime Orders at the same price will be based on the relevant Trading Host order receipt time stamp of each NBBO Prime Participant Quote.

²⁸ A CPO must be in the same series and on opposite side of the UPIP Order. See proposed Section 29(m)(iii), (iv), Chapter V of the BOX Rules.

²⁹ See proposed Section 30, Chapter V of the BOX Rules.

³⁰ For purposes of NBBO Prime, a “beneficial account” means the underlying type of account (e.g., customer, broker-dealer, market maker, etc.) on whose behalf the Participant is trading. See Notice, supra note 3, at note 14.

NBBO Prime Orders retain their priority even if the NBBO Prime Participant's Quote is subsequently modified or cancelled during the relevant UPIP auction.

An Options Participant seeking priority through the NBBO Prime designation must indicate to the Trading Host the order number of the NBBO Prime Participant Quote when the Options Participant submits the Improvement Order for the same beneficial account. In addition, the Options Participant may indicate whether the NBBO Prime Participant Quote size should be decremented to reflect any execution of the NBBO Prime Order. In the absence of such an indication, the Trading Host will not decrement the NBBO Prime Participant Quote. Market Makers will not be required to identify their relevant order number but will need to indicate to the Trading Host that their applicable NBBO Prime Participation Quote size should be decremented; otherwise their NBBO Prime Participation Quote size will remain unchanged on the BOX Book.³¹

D. Execution in the UPIP

At the conclusion of the UPIP auction, including in the event of a premature termination, the UPIP Order will be matched against the best prevailing orders (including Improvement Orders, CPOs, and Unrelated Orders) and quotes (including the Initial Box Book Quote) submitted during the UPIP auction that are equal to or better than the Start Price, in accordance with the price/time algorithm in Section 16(a) of Chapter V, with the following exceptions to time priority: (1) as provided in proposed paragraphs (k), (l), and (o) of Section 29, Chapter V, regarding Proprietary Improvement Orders and Improvement Orders submitted by Executing Participants;³² and (2) as provided in proposed paragraphs (b) to (d) of Section

³¹ See proposed Section 29(j)(iv), Chapter V of the BOX Rules.

³² See supra notes 18 through 23 and accompanying text.

30, Chapter V, regarding NBBO Prime Orders.³³ Further, in no circumstances will an order for a non-market maker broker-dealer account of an Options Participant be executed ahead of a Public Customer order(s) or a non-BOX Options Participant broker-dealer order(s) at the same price within the UPIP auction. This means that no order for the account of a non-market maker Options Participant will be executed ahead of the order(s) of any Public Customers or non-members of BOX.³⁴

At the conclusion of the UPIP auction, the UPIP Order will be filtered to prevent a trade-through of the NBBO at the conclusion of the auction and will not execute against orders or quotes at prices inferior to the NBBO except in the following circumstances: (1) in accordance with Chapter XII, Section 3(e) of BOX Rules;³⁵ or (2) the away options exchange posting the NBBO is conducting a trading rotation in that options class.³⁶ If the UPIP Order cannot be executed on BOX at or better than the NBBO, it will be routed to another market center(s) posting the NBBO.

Any unexecuted portion of the UPIP Order not executed in the UPIP auction will be released to the Box Book and handled as provided in Section 16, Chapter V of the BOX Rules, except that a quote or order on the BOX Book that is for the same beneficial account as an

³³ See proposed Section 29(p), Chapter V of the BOX Rules. See also Amendment No. 3, which clarifies these exceptions in proposed Section 29(p), Chapter V, the substance of which were discussed in the Notice, supra note 3.

³⁴ See proposed Section 29(p), Chapter V of the BOX Rules and Amendment No. 3.

³⁵ Chapter XII, Section 3(e) of the BOX Rules states that “[u]nder circumstances where the Options Official determines that quotes from one or more particular away markets in one or more classes of options are not reliable, the Options Official may direct the Market Operations Center (‘MOC’) to exclude the unreliable quotes from the determination of the NBBO in the particular class(es).”

³⁶ The original filing provided that only the quantity of the UPIP Order that exceeded the Initial Aggregate Quote Size was filtered at the conclusion of the UPIP auction. The Exchange modified the rule text in Amendment No. 3 to apply the NBBO trade-through filter to the entire size of the UPIP Order.

Improvement Order that executed against the UPIP Order in the UPIP auction and that was on the BOX Book before the UPIP Order was received by BOX will have time priority over other quotes and orders on the BOX Book (except customer orders).³⁷

E. Treatment of Unrelated Orders in the UPIP

Unrelated Orders that are submitted to the Trading Host during a UPIP auction that are on the opposite side of the market from a UPIP Order and are executable against the NBBO will be executed immediately against the UPIP Order at the mid-point of the (i) NBBO and (ii) the best of the UPIP Improvement Order, the UPIP Start Price or the NBBO.³⁸ If the Unrelated Order on the opposite side of the market as the UPIP Order has a quantity equal to or greater than the UPIP Order, the UPIP auction will terminate. Otherwise, the immediate execution of the Unrelated Order against the UPIP Order will not cause the termination of the UPIP auction and the auction will continue. Conversely, an Unrelated Order that is on the same side of the market as the UPIP Order that is executable against the NBBO will cause the UPIP to immediately terminate and the UPIP Order will be executed pursuant to proposed Section 29(p) of Chapter V of the BOX Rules.³⁹

In Amendment No. 3, BSE amended paragraph (s) of Section 29, Chapter V of the BOX Rules to emphasize that it will be considered conduct inconsistent with just and equitable principles of trade for any Options Participant to enter Unrelated Orders into BOX for the

³⁷ See proposed Section 16(a)(iv), Chapter V of the BOX Rules. In Amendment No. 3, BSE clarified that such order on the BOX Book will receive only time priority. See Amendment No. 3.

³⁸ See proposed Section 29(s)(i), Chapter V of the BOX Rules. Any rounding required will be to the benefit of the Unrelated Order. Id.

³⁹ If the Unrelated Order is still UPIP eligible, a new UPIP will commence. If the Unrelated Order is no longer UPIP eligible, the order will go on the BOX Book. See telephone conference among William Easley, Vice Chairman, BOX; Lisa Fall, General Counsel, BOX; and Heather Seidel, Division, Commission, on December 21, 2007.

purpose of disrupting or manipulating any UPIP auction, including purposely causing premature termination.⁴⁰

III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-BSE-2006-16 on the subject line.

Paper comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number BSE-2006-16. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549,

⁴⁰ See Amendment No. 3.

on official business days between the hours of 10:00 am and 3:00 pm. Copies of such filing also will be available for inspection and copying at the principal office of BSE. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-BSE-2006-16 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

IV. Discussion

After careful consideration of the amended proposal and the comment letters, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange⁴¹ and, in particular, the requirements of Section 6 of the Act.⁴² Specifically, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,⁴³ which requires, among other things, that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. Significant aspects of the proposal are discussed below.

The Commission notes that the UPIP is similar to BOX's existing price improvement auction, the PIP, and other price improvement mechanisms, such as the Price Improvement Mechanism ("PIM") of the ISE, that initiate auctions in penny increments through which

⁴¹ In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

⁴² 15 U.S.C. 78f.

⁴³ 15 U.S.C. 78f(b)(5).

exchange participants compete to potentially price improve a customer order. However, unlike the PIP, in the UPIP customer orders do not depend on the ability of at least one party to guarantee price improvement for the full size of the Customer Order.⁴⁴

A. Price Competition

One commenter believes that the UPIP auction would encourage Market Makers to post wide and shallow quotes and discourage Market Makers from quoting aggressively until the UPIP auction begins because: (1) the most desirable orders will bypass the centralized auction; (2) after a UPIP auction is completed, the centralized auction will be exposed to UPIP “rejects;” and (3) the UPIP Order can be cancelled or modified but orders on the top of the BOX Book when the auction starts cannot.⁴⁵ This commenter also believes that transparency will suffer because market participants will hide their true trading interest until a UPIP auction begins.⁴⁶

Another commenter believes that the ability of a Participant to modify or cancel a UPIP Order, while the quotes and orders on the top of the BOX Book will essentially be frozen, will provide a three-second option or “second-look” opportunity for the Participant that submitted the UPIP Order to the detriment of the quotes and orders at the top of the book.⁴⁷ The commenter believes that this could severely limit the amount of liquidity Market Makers would be willing to

⁴⁴ The Commission notes that the Simple Auction Liaison System of the Chicago Board Options Exchange, Incorporated (“CBOE”), which provides for the automatic initiation of an auction process in certain circumstances for any order that is eligible for automatic execution by the Hybrid System, also does not depend on a contra-side order. See Securities Exchange Act Release No. 54229 (July 27, 2006), 71 FR 44058 (August 3, 2006) (SR-CBOE-2005-90).

⁴⁵ See Citadel Letter, supra note 4, at 1 to 2 and 4.

⁴⁶ Id. at 4.

⁴⁷ See ISE Letter, supra note 4, at 1 to 2. See also Citadel Letter, supra note 4, at 4 (stating that the ability of the UPIP Order to cancel will give investors a free option to cancel their orders based on intervening market movements, while orders at the top of the book are frozen).

provide on BOX. This commenter further believes that the dissemination of Improvement Orders during the UPIP auction, which allows the Participant that entered the UPIP Order to monitor the amount of price improvement being offered (if any), compounds the “second look” problem.⁴⁸ This commenter also believes that this inability to cancel or modify an order at the top of the BOX Book raises customer protection issues, and that customers and their brokers should be made aware that cancelling or modifying their orders on the BOX Book may actually cause them to be executed at an undesirable price.⁴⁹

In response, BSE notes that in general BOX Market Makers have several meaningful incentives to consistently quote at or establish the NBBO, including: (1) an open and competing market maker structure with no specialist/designated primary market maker and no regulatory limits to the number of market makers appointed in 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.⁵⁰ Further, BSE notes that the UPIP rules allow certain Improvement Order to be designated as NBBO Prime Orders. An NBBO Prime designation confers time priority in a UPIP auction to a particular Improvement Order over other Improvement Orders and Unrelated Orders with the same price upon satisfaction of certain conditions. To be eligible to be designated NBBO Prime, the same beneficial account for whom the Options Participant is acting and that is seeking the NBBO Prime designation must have had a quote or order on the BOX Book on the opposite side of the UPIP Order equal to the NBBO

⁴⁸ See ISE Letter, supra note 4, at 2-3.

⁴⁹ Id. at 1 to 2.

⁵⁰ See BSE Letter, supra note 5, at 2.

prior to receipt of the UPIP Order by the Trading Host. BSE believes that this requirement will encourage all Options Participants to compete aggressively to match or establish a new NBBO.⁵¹

The Commission does not believe that, given the overall structure of BOX and the NBBO Prime functionality, the UPIP auction will discourage aggressive quoting on BOX. The availability of the NBBO Prime functionality is designed to encourage market makers and other market participants to aggressively post quotes or limit orders on the BOX Book, to be the first to match the NBBO, or to establish a new NBBO, because those participants will have time priority in the UPIP auction. Further, because NBBO Prime Orders only receive enhanced time priority for the quantity that does not exceed the size of the related order that was on the BOX Book, market participants may be incented to post greater size in order to receive priority on a larger allocation. Finally, with regard to BSE's proposal to allow Public Customers to cancel UPIP Orders, BSE states that, because the UPIP does not guarantee price improvement, the ability to cancel a UPIP Order is necessary to allow an OFP to manage an order that has not been executed and for which no trade confirmation has been issued.⁵² The Commission believes that the ability for UPIP Orders to be cancelled is consistent with the Act.

B. NBBO Prime Requirements

One commenter doubts the technological feasibility of the NBBO Prime functionality because firms seeking NBBO Prime status will be required to specify the number of their order on the BOX Book that was first in time priority at the top of the BOX Book.⁵³ BSE represents that the requirement to provide the unique order identifier to BOX for the appropriate order on

⁵¹ Id. NBBO Prime is similar to the "Market Maker Prime" ("MMP") designation in a PIP auction that is awarded to a Market Maker that is first to establish a quote on BOX equal to the NBBO or establish a new NBBO.

⁵² See BSE Letter, supra note 5, at 4.

⁵³ See Citadel Letter, supra note 4, at note 12.

the BOX Book utilizes the same technology that firms currently use to cancel or modify orders on BOX and that an OFP cannot be certified to trade on BOX unless it can perform this task.⁵⁴ The Commission therefore does not believe this requirement should place an unreasonable burden on Options Participants to be able to avail themselves of the NBBO Prime functionality.

C. “Freezing” Top of the Book Quotes and Orders

As noted above, two commenters expressed concerns about BSE’s proposal to prohibit orders and quotes at the top of the BOX Book at the commencement of a UPIP auction to be cancelled.⁵⁵ In response, BSE stated that “freezing” certain quotes and orders on the BOX Book at the start of a UPIP auction is necessary to comply with the Quote Rule,⁵⁶ and disagrees that quotes or orders on the BOX Book held firm in this manner will be disadvantaged. BSE believes such orders and quotes will be treated as the entering participant intends – i.e., executable at the limit price when matched with a contra-side order and cancellable only when there is no pending execution.

Rule 602 under the Act requires a responsible broker or dealer to execute orders to buy or sell a security presented to it by another broker or dealer, or any other person belonging to a category of persons with whom such responsible broker or dealer customarily deals, at a price at least as favorable to such buyer or seller as the responsible broker’s or dealer’s published bid or published offer in any amount up to its published quotation size.⁵⁷ Therefore, the Commission agrees that the “stop” feature is necessary to ensure market participants’ compliance with Rule 602 under the Act and believes that it is consistent with the Act. The Commission notes,

⁵⁴ See BSE Letter, supra note 5, at note 10.

⁵⁵ See supra note 47 and accompanying text.

⁵⁶ 17 CFR 242.602.

⁵⁷ Id.

however, that BOX Participants should, as with any order type or exchange functionality, take steps necessary to ensure their customers understand the operation of the UPIP auction with respect to incoming orders and orders resting on the BOX Book.

D. Private Auctions

One commenter argues that, because the broadcast message commencing a UPIP auction and the responding Improvement Orders will only be accessible to BOX participants and will not be publicly disseminated, only BOX Participants will know the “true” BOX market.⁵⁸

Under the Commission’s Quote Rule, an exchange is required to collect, process, and make available to quotation vendors the best bid, the best offer, and aggregate quotation sizes for each subject security listed or admitted to unlisted trading privileges which is communicated on any national securities exchange by any responsible broker or dealer.⁵⁹ The Commission believes that because the UPIP auction is at most only 3 seconds in length, it is analogous to the open outcry auctions conducted on 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.⁶⁰ Accordingly, the Commission finds the UPIP auction to be consistent with the Quote Rule.

One commenter notes that that unlike the PIP, the proposed UPIP auction does not require at least three market makers to quote in an options series before a UPIP may be

⁵⁸ See Citadel Letter, supra note 4, at 4.

⁵⁹ 17 CFR 242.602(a)(i).

⁶⁰ See Securities Exchange Act Release Nos. 49068 (January 14, 2003), 68 FR 3062 (January 22, 2003) (Commission approval establishing trading rules for BOX, including rules for the PIP); 49323 (February 26, 2004), 69 FR 10087 (March 3, 2004) (Commission approval establishing rules for PIM); and 53222 (February 3, 2006), 71 FR 7089 (February 10, 2006) (Commission approval establishing rules for CBOE’s Automated Improvement Mechanism (“AIM”)).

initiated.⁶¹ The Commission does not believe that the Act requires an exchange to have market makers in an auction. Although Market Makers could be an important source of liquidity in the UPIP auction, they likely will not be the only source. Any Options Participant can submit an Improvement Order in a UPIP Auction, on its own behalf or on behalf of a customer. Further, the Auto Auction Order (“AAO”)⁶² and CPO are specifically designed to allow customers to more easily participate in an Improvement Auction, including the UPIP. The Commission therefore believes that the proposal not to require minimum market maker participation in the UPIP is consistent with the Act.

Another commenter notes that the proposal provides that the duration of the UPIP will be 3 seconds or less as determined by the Board on a case-by-case basis and questions whether a UPIP duration of less than 3 seconds would result in a meaningful auction.⁶³ This commenter also inquires how Options Participants will be informed about the exposure time of UPIP auctions if they are reduced. The Commission believes that BSE’s response that BOX will inform Options Participants regarding the duration of the UPIP auctions by publishing a Regulatory Circular is consistent with the Act.⁶⁴ The Commission also notes that the UPIP auction is designed to provide an opportunity for price improvement for certain orders, without a guarantee to a facilitating firm. Thus, the Commission does not believe that the UPIP auction raises the same potential conflict concerns as an auction where there is a guarantee from a facilitating firm. The Commission therefore believes that the duration of the UPIP auction, as proposed, is consistent with the Act.

⁶¹ See ISE Letter, supra note 4, at 3.

⁶² See Securities Exchange Act Release No. 56186 (August 2, 2007), 72 FR 44593 (August 8, 2007) (approving the AAO functionality on BOX).

⁶³ See Amex Letter, supra note 4, at 4.

⁶⁴ See BSE Letter, supra note 5, at 6.

E. NBBO Protection

A commenter requested clarification as to what would occur in a UPIP auction if the BBO does not equal the NBBO and there are no Improvement Orders entered during the UPIP auction. Specifically, this commenter asked if the UPIP Order would be executed at the NBBO, or if the UPIP Order would be routed through the Options Intermarket Linkage to a better away market.⁶⁵ This commenter further asked at what price the UPIP Order is executed if the NBBO changes during the UPIP auction.⁶⁶ Similarly, another commenter noted that the UPIP Order would not execute against a better price if the NBBO changes during the UPIP Auction.⁶⁷

BSE responded that the UPIP Order is not guaranteed an execution at the NBBO.⁶⁸ At the conclusion of the UPIP auction, the UPIP Order will be matched against the best prevailing orders or quotes, whether Improvement Orders, Unrelated Orders, or the Initial BOX Book Quote, that are equal to or better than the Start Price, which is at least as good a price as the NBBO at the commencement of the auction.⁶⁹ In addition, at the conclusion of the UPIP auction 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 at the end of the UPIP auction. If the UPIP Order cannot be executed on BOX at or better than the NBBO, then the UPIP Order will be routed through Intermarket Linkage to another market displaying the NBBO at the conclusion of the UPIP

⁶⁵ See Amex Letter, supra note 4, at 2.

⁶⁶ Id.

⁶⁷ See Citadel Letter, supra note 4, at 6.

⁶⁸ See BSE Letter, supra note 5, at 5.

⁶⁹ Such matching shall occur in compliance with the priority provisions of proposed Chapter V, Section 29(p) of the BOX Rules.

auction.⁷⁰ The Commission believes that BSE adequately clarified this aspect of the proposal, as amended, and that it is consistent with the Act.

F. Compliance with the Act

1. Quote Rule

One commenter believes that the ability to cancel Improvement Orders during a UPIP auction is inconsistent with the purpose and intent of BOX's firm quote rule. This commenter argues that an Options Participant would have a free look at the UPIP Order during the auction and could withdraw its Improvement Order if the market moved unfavorably.⁷¹

The Commission's Quote Rule requires a responsible broker or dealer to execute any order presented to it at its published price and up to the full amount of its published size.⁷² Because no order would be presented to execute against an Improvement Order until the end of the UPIP auction, the Commission believes that the ability to cancel an Improvement Order prior to the termination of the UPIP auction does not violate the Quote Rule.

2. Section 11(a) of the Act

Section 11(a) of the Act prohibits a member of a national securities exchange from effecting transactions on that exchange for its own account, the account of an associated person, or an account over which it or its associated person exercises discretion, unless an exception applies.⁷³ Section 11(a)(1)(G) and Rule 11a1-1(T) under the Act provide an exception to the general prohibition in Section 11(a) on an exchange member effecting transactions for its own account. Specifically, a member that "is primarily engaged in the

⁷⁰ See BSE Letter, supra note 5, at 5 and Chapter V, Section 29(q) of the BOX Rules.

⁷¹ See Amex Letter, supra note 4, at 3.

⁷² 17 CFR 242.602(b)(2).

⁷³ 15 U.S.C. 78k(a).

business of underwriting and distributing securities by other persons, selling securities to customer, and acting as broker, or any one or more of such activities, and whose gross income normally is derived principally from such business and related activities”⁷⁴ and effects a transaction in compliance with the requirements in Rule 11a1-1(T)(a)⁷⁵ may effect a transaction for its own account. Among other things, Rule 11a1-1(T)(a)(3) requires that an exchange member presenting a bid or offer for its own account or the account of another member shall grant priority to any bid or offer at the same price for the account of a non-member of the exchange.⁷⁶

BSE’s proposal provides that “no order for a non-market maker broker-dealer account of an Options Participant will be executed before Public Customer order(s) and non-BOX Options Participant broker-dealer order(s) at the same price.”⁷⁷ Because BSE’s proposed rules will require Options Participants that are not Market Makers to yield priority in the UPIP auction to all non-member orders,⁷⁸ the Commission believes that the proposal is consistent with the yielding requirements in Section 11(a)(1)(G) and Rule 11a1-1(T) under the Act. However, the Commission notes that, in addition to yielding priority to non-member orders at the same price, members also must meet the other requirements under Section 11(a)(1)(G) and

⁷⁴ 15 U.S.C. 78k(a)(1)(G)(i). Paragraph (b) of Rule 11a1-1(T) under the Act provides that the requirements of Section 11(a)(1)(G)(i) of the Act are met if during its preceding fiscal year more than 50% of the member’s gross revenues was derived from one or more of the sources specified in that section. In addition to any revenue which independently meets the requirements of Section 11(a)(1)(G)(i), revenue derived from any transaction specified in paragraph (A), (B), or (D) of Section 11(a)(1) of the Act or specified in Rule 11a1-4(T) shall be deemed to be revenue derived from one or more of the sources specified in Section 11(a)(1)(G)(i).

⁷⁵ 15 U.S.C. 78k(a)(1)(G)(ii).

⁷⁶ 17 CFR 240.11a1-1(T)(a)(3).

⁷⁷ See proposed Section 29(p), Chapter V of the BOX Rules.

⁷⁸ See Amendment No. 3.

Rule 11a1-1(T) to effect transactions for their own accounts in reliance on this exception (or satisfy the requirements of another exception).

G. Surveillance

The proposal provides that the UPIP will default any Proprietary Improvement Order to the end of the priority queue in the UPIP unless the Options Participant affirmatively identifies that its order was generated by an automated quotation system that operates independently from the existence or non-existence of a pending UPIP Order. A commenter questioned how the BOX system will differentiate between proprietary orders that have or have not been generated by automated quotation systems, and what standard (if any) will be used for making a determination that a particular system is an automated quotation system.⁷⁹ BSE has represented that it will surveil for compliance with this rule through its current examination program.⁸⁰ BSE also notes that ISE uses a similar mechanism for its Directed Order process.⁸¹

H. Interaction Among UPIP and PIP

One commenter asks for more clarity on the interaction of the PIP, UPIP, and directed order functionalities.⁸² In response, BSE noted that a PIP or a UPIP auction will not run simultaneously with another PIP or UPIP auction in the same series, nor will PIP or UPIP auctions interact, queue, or overlap in any manner.⁸³ BSE states that any order that is received

⁷⁹ See Amex Letter, supra note 4, at 3 to 4.

⁸⁰ See BSE Letter, supra note 5, at 7.

⁸¹ Id.

⁸² See ISE Letter, supra note 4, at 3. For example, this commenter noted that when a market maker receives a directed order on BOX, it must either initiate a PIP or release the order to the market within three seconds. Therefore, if there is a UPIP in progress at the time the directed order is received, the market maker cannot initiate a PIP. Id. at note 3.

⁸³ See proposed Section 18, Chapter V, Supplementary Material .02 and proposed Section 29, Chapter V, Supplementary Material .01 of the BOX Rules.

while a UPIP is underway for the same series, which would otherwise meet the price conditions to initiate a UPIP auction, will cause the UPIP auction to immediately terminate.⁸⁴ Further, any order that 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 rules.⁸⁵ Any request to initiate a PIP (including from a market maker that has received a directed order) while a PIP or UPIP is already in progress in the same series will be rejected.⁸⁶ The Commission believes that BSE has adequately clarified the interaction among the UPIP, PIP, and directed orders.⁸⁷

One commenter questioned whether the AAO would interact in a UPIP Auction.⁸⁸ In response, BSE clarifies that the recently approved AAO will be able to interact in a UPIP.⁸⁹ BSE also notes that the Limit Order that is associated with the AAO that is priced at the

⁸⁴ See proposed Section 29(s), Chapter V of the BOX Rules.

⁸⁵ See proposed Chapter V, Section 18(i) of the BOX Rules.

⁸⁶ Id. and BSE Letter, supra note 5, at 6.

⁸⁷ Another commenter believes that the Commission should not approve the proposed rule change until it has addressed the issue of whether market makers will be able to unfairly discriminate against certain customers when the UPIP or PIP auctions are used in conjunction with a Directed Order process without anonymity. See Amex Letter, supra note 4, at 2-3. The Commission believes that the issue of anonymity in the Directed Order process is more appropriately addressed in the context of the BSE proposed rule change on that issue. See Securities Exchange Act Release Nos. 56014 (July 5, 2007), 72 FR 38104 (July 12, 2007) (SR-BSE-2007-31) (extending to January 31, 2008 the effective date of Section 5(c)(i), Chapter 6 of the BOX Rules, which allows the BOX Trading Host to identify to an Executing Participant the identity of the firm entering a Directed Order); and 53357 (February 23, 2006), 71 FR 10730 (March 2, 2006) (SR-BSE-2005-52) (notice of proposed rule change to permit Executing Participants to choose the firms from which they will accept Directed Orders while providing complete anonymity for Directed Orders that are passed on to the Executing Participant for possible representation in a PIP auction).

⁸⁸ See ISE Letter, supra note 4, at 3.

⁸⁹ See BSE Letter, supra note 5, at note 26.

standard minimum trading increment of five or ten cents can start a UPIP if, at its rounded price, it would be executable at the NBBO.⁹⁰

I. Penny Pilot

One commenter argues that the Penny Pilot Program⁹¹ initiative should prohibit the approval of the UPIP. This commenter believes that the UPIP will distort Penny Pilot data.⁹² Another commenter believes that the Penny Pilot is the appropriate method to approach penny pricing in the options market because it is a fair and transparent environment.⁹³

As discussed above, with respect to the commenters' substantive arguments, the Commission believes the proposed rule change is consistent with the Act. The Commission has previously approved exchange proposals to trade in penny increments, including BSE's PIP.⁹⁴ The Commission believes it is consistent with the Act to approve the BSE's initiative designed to allow trading in penny increments.⁹⁵

J. Acceleration of Proposed Rule Change As Amended

The Commission finds good cause to approve the proposal prior to the thirtieth day after the proposal was published for comment in the Federal Register. The proposed rule change, as

⁹⁰ Id.

⁹¹ The Penny Pilot was approved by the Commission to allow BOX to quote certain options series in pennies on a pilot basis. See e.g., Securities Exchange Act Release No. 55155 (January 23, 2007), 72 FR 4741 (February 1, 2007) (SR-BSE-2006-49).

⁹² See Citadel Letter, supra note 4, at 7.

⁹³ See ISE Letter, supra note 4, at 3 to 4.

⁹⁴ See Securities Exchange Act Release Nos. 49068 (PIP); 49323 (PIM); and 53222 (AIM), supra note 60.

⁹⁵ The Exchange has represented that it will provide the Commission with statistics regarding the UPIP for those classes included in the Penny Pilot. See BSE Letter, supra note 5, at 8.

modified by Amendment No. 1, was published for full notice and comment.⁹⁶ The Commission believes that the changes made in Amendment No. 3 generally strengthen the proposal. In Amendment No. 3, BSE made several changes to clarify its rules,⁹⁷ respond to commenters,⁹⁸ and comply with the requirements of the Act.⁹⁹ The Commission believes that it has received and fully considered substantial, meaningful comments with respect to the BSE's proposal, as amended, and that Amendment No. 3 does not raise issues that warrant further delay. For these reasons, the Commission finds good cause, consistent with Section 19(b)(2) of the Act,¹⁰⁰ to grant accelerated approval of the proposed rule change, as amended.

⁹⁶ See Notice, *supra* note 3.

⁹⁷ See, e.g., BSE clarifies that: the definition of an Eligible Order does not include “fill or kill” orders; the UPIP auction will only be available for certain classes of options as determined from time-to-time by BOX; the cancellation of the UPIP Order will result in the cancellation of the related Improvement Orders and the UPIP auction itself; any unexecuted portion of an Improvement Order will be cancelled; time priority will prevail between a Proprietary Improvement Order and an Improvement Order submitted by an Executing Participant; and in the instance when a UPIP is concluded, only time priority will be granted to an order on the BOX Book that executes against the remaining portion of a UPIP Order if that order has been placed for the same beneficial account as an Improvement Order in the UPIP auction.

⁹⁸ See, e.g., BSE revises the proposal to apply its NBBO trade-through filter at the conclusion of the UPIP auction.

⁹⁹ See, e.g., BSE revises the proposal to provide that: in no circumstances will the orders for a non-market maker broker-dealer account of an Options Participant be executed before a Public Customer or non-BOX Options Participant at the same price in the UPIP; and it will be conduct inconsistent with just and equitable principles of trade for (1) any Options Participant to enter Unrelated Orders into BOX for the purpose of disrupting or manipulating any UPIP auction, including purposely causing premature termination or (2) for an Executing Participant to directly or indirectly enter, modify, or cancel quotes or orders on BOX for the purpose of disrupting, prematurely terminating or manipulating any Improvement Auction.

¹⁰⁰ 15 U.S.C. 78s(b)(2).

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁰¹ that the proposed rule change (SR-BSE-2006-16), as amended, be, and it hereby is, approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁰²

Florence E. Harmon
Deputy Secretary

¹⁰¹ 15 U.S.C. 78s(b)(2).

¹⁰² 17 CFR 200.30-3(a)(12).